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Congress of the United States

U.S. House of Representatives

Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

To: Members, Subcommittee on Investigations, Oversight and Regulations
From: Committee Staff
Re: Hearing: JOBS Act Implementation Update
Date: April 8, 2013

On Thursday, April 11, 2013 at 10:00 am in Room 2360 of the Rayburn House Office Building, the Subcommittee on Investigations, Oversight and Regulations will meet for the purpose of investigating the Securities and Exchange Commission's (SEC) efforts to implement the Jumpstart Our Business Startups Act of 2012 (JOBS Act).[1] The JOBS Act is a bipartisan effort to reduce regulatory burdens associated with small businesses obtaining equity investment from the public. The failure to implement the JOBS Act with all due celerity prevents small businesses from obtaining needed capital that can be used for expansion and job creation. Witnesses from the SEC will explain the status of JOBS Act implementation and private sector witnesses will expatiate on the benefits of the JOBS Act to the economy.

I. Introduction – Financing a Small Business

As a hypothetical, assume that two congressional staffers leave to start a cupcake shop.[2] The former staffers determine that the cupcake shop will require $300,000 to start the business.[3] Furthermore, for purposes of this memorandum, it is assumed that the staffers organize the cupcake business as a corporation in which each owner receives shares in the cupcake business.[4] There are three options by which the potential cupcake magnates can acquire the $300,000.

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[1] Pub. L. No. 112-106, 126 Stat. 306 (2012), codified at scattered sections of Chapters 2A and 2B of Title 15, United States Code. To be sure, the title of the Act is pleonastic but the goal of a cute acronym apparently trumps good English usage. For a discussion of pleonasms in writing, see any edition of H.W. Fowler's classic, MODERN ENGLISH USAGE.

[2] To be sure, the cupcake shop may be somewhat passé. On the other hand, it is certainly more concrete (and that hopefully does not describe the texture of the cupcakes being sold) than the hypothetical widget manufacturer beloved by introductory economics professors (and if anyone can define a widget, please alert Committee staff).

[3] Whether the necessary funds are an accurate depiction of the financing to start this business is beyond the scope of this memorandum.

[4] There are numerous ways to organize a business and each has its benefits and costs (both from a liability standpoint and a tax standpoint). *See* C. BAGLEY & C. DAUCHY, THE ENTREPRENEUR'S GUIDE TO BUSINESS

The staffers could obtain a loan (called debt financing) in which they are required to make periodic payments to repay the loan. The primary drawback of debt financing is that it reduces cash flow to the business during the start-up when revenue will be limited as the business tries to build customers. On the other hand, once the loan is repaid, the two staffers control the business and will receive all of the increased value of the business should they sell it.[5]

As an alternative, the ex-staffers could contribute the $300,000 from their own savings to start the business. They would then have $300,000 in what is called "equity" in the business.[6] Typically, the owners would allocate shares in the cupcake corporation according to their equity contribution.[7] Assuming that each contributed $150,000, the two staffers would own an equal number of shares of the cupcake corporation.[8]

If the two staffers are typical (and received typical Congressional salaries), it is unlikely that they would have saved $300,000. The ex-staffers might request that relatives who live in the same state (federal securities laws only apply to interstate sales[9]) provide them the $300,000 for an equity stake in the company. Under that arrangement, the ex-staffers would not own the entire company so they would not obtain the full sale price of the company if it is sold. On the other hand, the equity stake of the relatives would not require periodic payments to repay a loan and thus the primary benefit of equity financing to a startup is that is conserves cashflow while building the business.

Now assume that the ex-staffers do not have any relatives that can provide them with an equity stake in the business and they try to raise equity funds from strangers. At this point, the efforts by the ex-staffers will be complicated by federal securities laws.

II. Federal Securities Laws and Small Business Financing

Every sale of a security[10] in interstate commerce is controlled by the strictures of the Securities Act of 1933 (colloquially referred to as the "33 Act"). While a full explication

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LAW 51-71 (3d ed. 2008) [hereinafter Business Law]. For purposes of this memorandum, the hypothetical business will be organized as a corporation in which shares are issued to the owners. *Id.* at 74-87.

[5] A good analogy to debt financing is the mortgage used to purchase a home. If the homeowner sells the home before the mortgage is repaid, the homeowner does not receive the full purchase price of the home but only the difference between the sale price and what is remaining on the mortgage that must be paid off with the proceeds of the sale.

[6] Again using the homeownership analogy, someone purchases a home for $300,000 and uses cash, the homeowner has an equity stake in the home of $300,000.

[7] *Id.* at 84-86.

[8] The textual analogy is an oversimplification. For example, one staffer might have $300,000 while the other has the secret cupcake recipe. In that case, each still might own 50 percent of the company even though their dollar contributions are quite different.

[9] 15 U.S.C. § 77c(a)(11) (exempting from SEC authority all transactions solely occurring within one state).

[10] The Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb, has a broad definition of the term security, *see* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 231, 247 (5th ed. 2004) [hereinafter Loss]. For purposes of this memorandum, it is sufficient to state that the sale of stock in the cupcake corporation constitutes a security for purposes of the Securities Act of 1933. *Id.* at 266.

of the process for selling securities in compliance with the "33 Act" is beyond the scope of this hearing, it is important to note that compliance for the sale of securities is both complex and costly. The costs stem from the process of registering securities with the SEC.[11] Registration is designed to provide potential investors with sufficient information so that they can assess the value of the potential investment and know that the disclosures are accurate.[12] According to a recent survey of chief financial officers, the costs of issuing stock under the "33 Act" exceed $1 million.[13] For our future cupcake magnates, spending more than $1 million to raise $300,000 makes no economic sense.[14]

Congress recognized that the full costs of registration to sell securities made no sense for the equity needs of small businesses. As a result, Congress exempts certain transactions from the registration requirements.[15] Of those exemptions, the one most relevant to small businesses (and thus our future cupcake magnates) is any transaction by an issuer not involving a public offering (colloquially referred to as a "private placement").[16]

A. Private Placements in General

Private placements are made available to a limited number of investors (denominated as qualified investors) who can understand and bear the risk of the investment.[17] The issuers in this exemption must be able to prove that the offering was made only to a limited number of investors who were qualified to assess the risks and could bear such risks.[18] Applying the logic of this to our cupcake entrepreneurs, if they sold stock to a

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Furthermore, this memorandum will use the terms "stock," "shares," and "securities" interchangeably even though that is technically not correct.

[11] The SEC was created by § 4 of the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78d. Not surprisingly, the Securities and Exchange Act is colloquially referred to as the "34 Act." An easy way to distinguish between the "33 Act" and "34 Act" is that the "33 Act" covers the initial distribution of a security while the "34 Act" covers the regulations that the issuers must follow after initial distribution. *See* Loss, *supra* note 9 at 45. Although the costs of compliance with the post-distribution requirements under the "34 Act" are significant, *see* Business Law, *supra* note 4, at 708-09, they generally do not affect most small businesses (and certainly not the owners of our hypothetical cupcake shop) because they are not publicly held as that term is defined in the "34 Act" (originally 500 persons) and expanded to 2,000 by the JOBS Act. Given this, the memorandum will not address those matters.

[12] Business Law, *supra* note 4, at 157.

[13] PRICEWATERHOUSECOOPERS, CONSIDERING AN IPO? THE COSTS OF GOING PUBLIC MAY SURPRISE YOU 2 (Sept. 2012), *available at* http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf.

[14] Of course, some might argue that opening another cupcake shop in an over-cupcaked world makes no sense, but the economics of that is far less evident than spending $1 million to raise $300,000.

[15] 15 U.S.C. § 77d.

[16] *Id.* at § 77d(2). In the literature, the reference is often directly to § 4(2) of the "33 Act" rather than the United States Code cite.

[17] Of course, one might note that many of the investments that were at the root cause of the 2008 financial crisis were issued as private placements. The obvious query, far beyond the scope of this memorandum, is whether any of the so-called qualified investors actually understood the risk of those investments; of course, it also is quite likely that even the issuers had any idea of the associated risk but again that is a story for another memorandum.

[18] Business Law, *supra* note 4, at 159; *see SEC v. Ralston Purina*, 346 U.S. 119, 125-26 (1953). In *Ralston Purina*, the Court held that any issuance of securities to the public could fall within the confines of

few individuals who could assess their business plan and have sufficient resources that they could lose all of their money and not care, the ex-staffers could raise the $300,000 without registering with the SEC. Of course, the ex-staffers still would have to be able to prove that the sale was limited to qualified investors.

1. Regulation D Private Placements

Recognizing that proving whether an offering met the exemptions in § 4(2) or 4(5) of the "33 Act" could involve significant potential court litigation, the SEC developed a series of safe harbors that, if met, would conclusively demonstrate that the issuance of the stock fell within the aforementioned statutory exemptions and the issuer need not comply with the registration requirements of the "33 Act." Collectively, these safe harbors are referred to as "Regulation D."[19]

The first exemption is under rule 504 that permits the sale of securities to an unlimited number of individuals (without regard to their qualifications as investors) if the sale only raises a maximum of $1 million.[20] Thus, relatives, friends, or others interested in receiving stock for funding our future cupcake shop owners could do without falling afoul of federal securities laws.

The second exemption, rule 505, permits the sale of securities to an unlimited number of accredited investors,[21] and up to 35 unaccredited investors for a maximum of $5 million. This exemption might come in useful if the putative cupcake owners (after opening their initial shop) need $2 or $3 million to open a chain of cupcake shops. However, finding investors may be difficult because no advertising or solicitation is permitted under this exemption.[22]

The final exemption, rule 506, authorizes the sale of securities without a cap on the value raised in such sale to an unlimited amount of accredited investors and up to 35 unaccredited investors, as long as those 35 are considered sophisticated (i.e., can evaluate the risks associated with the investment). In such a circumstance, the cupcake owners could sell shares to their friends who may have gone to business school and could evaluate the investment (quite possibly better than the ex-staffers) even though they do not meet the net worth or income standards for an accredited investor. As with the exemption under Rule 505, no general solicitation or advertising is permitted.

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the registration requirement in the "33 Act." However, the Court concluded that any offering is private if the purchasers do not need the protections associated with the registration of a security prior to its sale.

[19] 17 C.F.R. §§ 230.500-.508.

[20] *Id.* at § 230.504; *see* Douglas Lurio, *Regulation D Offerings and Private Placement of Securities*, in PENNSYLVANIA BAR INST., PRIVATE PLACEMENT OF SECURITIES 11-12 (2012). Advertising and solicitation is permitted if the security is sold in a state that requires registration of securities under state securities laws. *Id.* at 12.

[21] Accredited investors are those businesses or individuals who, due to their wealth, are assumed to be sufficiently sophisticated to protect themselves when purchasing unregistered securities and can absorb potential losses. 17 C.F.R. § 230.501. Individuals qualify as accredited if their net worth exceeds $1 million dollars (exclusive of their primary residence) or they have more than $200,000 in annual income. *Id.* at § 230.501 (a)(5)-(6).

[22] Business Law, *supra* note 4, at 162.

B. Regulation A

The one aspect of the exemptions from registration[23] under Regulation D that generally complicates the ability of the ex-staffers to raise money is the inability to advertise their need for the money. Essentially, the cupcake shop owners would have to know[24] people who have the money they need which may or may not be the case. To ease the ability of small businesses to raise capital, the SEC promulgated "Regulation A."[25] The rule creates a limited public offering if the issuer is trying to raise no more than $5 million, permits the issuer to advertise,[26] and does not impose any requirement on the type of investor who may purchase the securities.[27] While the registration requirements associated with Regulation A are significantly less burdensome than those associated with a normal registration under the "33 Act," issuers still must file a registration document with the SEC. Thus, the costs of Regulation A will be substantially more than those associated with Regulation D. Our cupcake shop owners would then have to weigh the costs of the registration under Regulation A against the inability to solicit investors whom they do not know.

III. Crowdfunding

Crowdfunding entails obtaining small amounts of money from large numbers of individuals, generally through various types of Internet portals, such as Kickstarter. This type of crowdfunding has been used by artists, movie producers and the like to raise funds for their projects.[28] For example, the creator of the television series Veronica Mars, Rob Thomas, obtained contributions from more than 69,000 backers (presumably fans)[29] to raise more than $4.6 million in order to put into production a Veronica Mars feature film.[30] Obviously, such crowdfunding would be an excellent way for our ex-staffers to obtain funds for their cupcake business. However, if they sold shares of the company, this would violate the federal securities laws since they would be soliciting purchasers for stock in their putative cupcake emporium to the public and not complying with the registration requirement of the "33 Act."[31] Nevertheless, if there was some

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[23] It is important to remember that under Rule 504 advertising only can happen if the security is registered under state law. While that may be less costly than registration with the SEC, it still could exceed the $300,000 needed to open the cupcake shop.

[24] The SEC has determined that the issuer must have a pre-existing relationship with the potential investors, i.e., cannot simply cold call rich people. *Id.* at 162.

[25] 17 C.F.R. §§ 230.251-.263.

[26] Business Law, *supra* note 4, at 163-64.

[27] *Id.* at 167, Table 7.1.

[28] Thomas Hazen, *Social Networks and the Law: Crowdfunding or Fraudfunding?*, 90 N.C. L. REV. 1735, 1736 (2012).

[29] Depending on the amount pledged, a contributor could receive any number of gifts, including, but not limited to: a DVD of the movie; Kristen Bell (the actress who plays Veronica Mars) to record an outgoing voice mail message on the contributor's phone; or attendance at the Hollywood premier and after party. http://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project

[30] *Id.*

[31] *See* Joan Heminway & Shelden Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 906-907 (2011).

mechanism to accommodate crowdfunding under the securities laws, the ex-staffers might be as successful as Mr. Thomas in raising funds for their venture. Alas, to ensure that crowdfunding does not fall askance of the securities laws Congressional action was required.

IV. The JOBS Act

The complexity of the federal securities laws, especially as they apply to small businesses, such as our cupcake entrepreneurs, in conjunction with a still stagnant economic recovery, led Congress to action in the spring of 2012. The need was bolstered by a growing sense that the costs of federal securities regulations were reducing the number of companies seeking to obtain funds from the public through the conventional registration process set out in the "33 Act."[32] Finally, the potential benefit from the ever-burgeoning crowdfunding marketplace[33] was not lost on a Congress seeking to reduce barriers for small businesses to raise equity financing. In the spring of 2012, Congress passed and the President signed the JOBS Act.

For our ex-staffers seeking $300,000, the Act greatly expands the ability to utilize Rule 506 exemption transactions particularly as it relates to advertising and solicitation. First, they are authorized to contact, in on-line forums, accredited investors (without regard to whether they had any personal contact with them prior to such contact). Second, our ex-staffers can advertise and solicit investors without such activity being deemed a public offering.[34]

Should the cupcake emporium owners wish, they also can utilize crowdfunding as a private placement exemption under § 4(2) of the "33 Act." They can raise up to $1 million (more than enough to open their shop and maybe have enough for a second store should their cupcakes prove irresistible to the public) from a large pool of small investors as long as it done through a third-party portal, such as Kickstarter. To prevent fraud, the JOBS Act requires that issuers provide certain disclosures to investors, the third-party portals that host the requests and the SEC.[35] Obviously, if those disclosures are overly onerous, it undermines the utility of crowdfunding for our cupcake entrepreneurs and other small businesses.

Should our putative cupcake titans wish to use Regulation A, Congress increased the amount of funds that can be raised from $5 million to $50 million (which should be

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[32] *E.g.*, GRANT THORNTON, THE TIPPING POINT: IS STOCK MARKET STRUCTURE CAUSING MORE HARM THAN GOOD? 2 (2011), *available at* http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Capital%20Markets%20Series/The%20tipping%20point/capital%20market%20series%20-%20Nov%202011%20-%20FINAL.pdf ; G. Nahoum, Note, *Small Cap Companies and the Diamond in the Rough Theory*, 35 HOFSTRA L. REV. 1865, 1865 (2007).

[33] Joan Heminway & Shelden Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. at 881 and Table 6.

[34] Mary Mullany & Gerald Guarcini, *JOBS Act Alerts*, in PENNSYLVANIA BAR INST., PRIVATE PLACEMENT OF SECURITIES 179-80 (2012).

[35] *Id.*

enough to start a national chain of cupcake shops).[36] In addition, users of Regulation A are given greater freedom to determine whether sufficient interest exists from investors prior to filing documentation with the SEC.[37]

In addition to these changes that would be of major benefit to our ex-staffers seeking to open their cupcake emporium, the JOBS Act reduced a number of other regulatory burdens for larger small businesses. It reduced public disclosure requirements for issuers known as Emerging Growth Companies (those with less than $1 billion in gross revenue or have been a public company for less than five years whichever comes first).[38] The JOBS Act also increased the threshold of what constitutes a publicly-held company and thus requiring registration under "33 Act" from 500 to 2,000 persons.[39] These modifications are important and may be addressed by witnesses during the hearing; however, these changes are of little utility for the equity needs of the typical small business.[40]

V. Implementation Issues and Potential Harm to Small Businesses

To implement the JOBS Act, the SEC is required to conduct a series of rulemakings under very tight deadlines. For example, § 304(a)(1) of the JOBS Act,[41] requires that the regulations for establishment of crowdfunding portals be completed within 270 days of enactment. According to the statute, those regulations certainly should have been completed no later than January 5, 2013. Yet, the crowdfunding rules have yet to be proposed much less finalized. Similarly, Congress required that the changes to Rule 506 be accomplished by July 4, 2012; despite that imprecation, the SEC issued a **proposed** rule on September 5, 2012, more than a month after the rules were to be finalized.[42]

While the SEC dithers, small businesses flail. Our hypothetical cupcake emporium owners are unable to raise funds (despite the potentially awe-inspiring bakery products that they can produce) to open their store and hire employees. Multiply this situation by hundreds of thousands of small business owners or potential owners and one recognizes that the SEC's lack of celerity has a real impact on the American economy.

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[36] *Id.*
[37] *Id.*
[38] *Id.* at 179.
[39] *Id.* at 180.
[40] For example, if the ex-staffers should succeed and outgrow potential classification as an emerging growth company, it is likely that will celebrate rather than mourn their lost status.
[41] 15 U.S.C. § 78c note.
[42] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Proposed Rule, 77 Fed. Reg. 54,464 (Sept. 5, 2012).