The Journal of Business, Entrepreneurship & the Law

Volume 7 | Issue 2 Article 4

5-15-2014

# The JOBS Act: Encouraging Capital Formation But Not IPOs

Jesse Scott

# THE JOBS ACT: ENCOURAGING CAPITAL FORMATION BUT NOT IPOS

JESSE SCOTT*



## I. INTRODUCTION

The United States initial public offering (IPO) market was in dire need of resuscitation when Congress passed the Jumpstart Our Business Startups (JOBS) Act in the spring of 2012. In 2008 there were only forty-five IPOs, down roughly 95% from the one-year high of 791 in 1996.[1] Not only were IPOs down, but also the average age of companies conducting an IPO was up from approximately five and a half years in the late 1990s to nine years in the late 2000s.[2] The decline has even led some to question the United States' primacy in the global IPO market.[3]

*Juris Doctorate Candidate, 2014, Pepperdine University School of Law. MBA, 2011, Oregon State University.

[1] IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 6 (2011).

[2] *Id.* at 1.

[3] *Id.* at 7 ("The United States raised just 15 percent of global IPO proceeds in 2010, down from

IPOs play an important role in the life cycle of growing businesses. Entrepreneurs need finance to grow their operations or pursue innovative new products.[4] In doing so, they rely on funding from angel investors, venture capitalists, and private equity firms.[5] These three groups of investors require high rates of return for the high risk of the investment.[6] Thus, a major part of the business planning process is determining an exit. As such, the primary exit vehicles include an IPO, merger, or acquisition.[7] The IPO has traditionally been the golden standard of the three because of the numerous benefits, which include: 1) access to capital to fund organic growth, repay debt, or fund an acquisition; 2) increased liquidity providing a possible exit for existing owners and public markets to trade on; 3) branding through media and research analyst coverage; 4) public currency to finance growth acquisitions; and 5) benefits for current employees in the form of extended employment and the availability of stock options.[8]

While the merger and acquisition (M&A) market has accounted for some of the lost IPOs,[9] M&As do not provide all the benefits that accompany companies that go public. Of great concern to Congress and the health of the United States' economy, M&As do not create numerous meaningful jobs, which generally occurs after a company has an IPO.[10] Thus, the JOBS Act is intended to bring about a revival in the U.S. IPO market in order to create jobs and spur economic growth.

---

its average of 28 percent over the preceding 10 years.").

[4] *Id.*

[5] Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 ENTREPRENEURIAL BUS. L.J. 369, 369 (2007).

[6] *Id.*

[7] JOSH LERNER ET AL., VENTURE CAPITAL, PRIVATE EQUITY, AND THE FINANCING OF ENTREPRENEURSHIP 198 (Jenifer Manias et al. eds., 2012).

[8] *IPO Advantages*, NYSE EURONEXT (last visited Jan 31, 2013) http://usequities.nyx.com/listings/ipo-advantages. While an IPO may be the gold standard, the decision between an IPO and an acquisition should be evaluated by the executives and board of the company.

[9] IPO TASK FORCE, *supra* note 1, at 6 (stating, "Acquisitions by a shrinking number of larger companies [due to the lack of IPOs] have become the primary liquidity vehicle for venture capital-backed companies as compared to IPOs").

[10] *Id.* M&As actually reduce the number of jobs in the short term as the acquiring company eliminates redundant positions. *Id.* The importance of the IPO market to job growth cannot be understated.

> From 1980 to 2005, firms less than five years old accounted for all net job growth in the U.S. In fact, 92 percent of job growth occurs after a company's initial public offering . . . . Furthermore, in a survey of emerging growth companies that have entered the public markets since 2006, respondents reported an average of 86 percent job growth since their IPOs.

*Id.* at 5. One report even claims that 22 million jobs may have been lost in the decline of the IPO market. *Id.* at 7.

The IPO Task Force[11] concluded that it was not any single regulatory change that caused the IPO market's decline, but rather the cumulative effect of a series of regulatory changes.[12] Specifically, the Task Force found that the changes have:

> 1. driven up costs for emerging growth companies looking to go public, thus reducing the supply of such companies,
>
> 2. constrained the amount of information available to investors about such companies, thus making emerging growth company stocks more difficult to understand and invest in, and
>
> 3. shifted the economics of investment banking away from long-term investing in such companies and toward high-frequency trading of large-cap stocks, thus making the IPO process less attractive to, and more difficult for, emerging growth companies.[13]

To the first point, the securities regulations were targeted at large public companies, which were at the heart of the major corporate scandals that prompted the reforms.[14] However, the regulations had disproportionally adverse consequences on emerging companies considering an IPO.[15] The average cost for initial regulatory compliance for an IPO is $2.5 million.[16] On top of that, yearly compliance costs average $1.5 million following the IPO.[17]

Furthermore, the fees associated with going public are a major concern for growth companies. First, the company will pay 3% or more of the size of the offering to lawyers, accountants, and advisers.[18] Next the company will typically pay 7% to the underwriter.[19] Finally, the stock will be underpriced at about 7%, costing the pre-IPO shareholders.[20] Thus, the cost associated with an

---

[11] The IPO Task Force consists of members from across the emerging growth company ecosystem, including venture capitalists, entrepreneurs, securities attorneys, academics, accountants, public investors, and investment bankers. *Id.* at 33–34. Furthermore, the IPO Task Force "aims to illuminate the root causes of the U.S. IPO crisis and provide recommendations to policymakers for restoring access to the public markets for emerging, high-growth companies." *Id.* at 33.

[12] *Id.* at 8.

[13] *Id.*

[14] *Id.* at 9.

[15] *Id.*

[16] *Id.* CEOs are clearly worried about compliance costs, as exemplified in the IPO Task Force survey in which CEOs of emerging companies continually cited administrative and compliance concerns for the skepticism of going public. *Id.*

[17] *Id.*

[18] Oesterle, *supra* note 5, at 372.

[19] *Id.*

[20] *Id.*

IPO can total around 17% of the total offering.[21]

There have also been numerous key changes in the United States' capital markets that have had an adverse effect on the IPO market. The changes started in the 1990s when the economic incentives of investment firms shifted.[22] First, electronic trading led to "lower commissions and reduced the role of traditional brokers," who exposed investors to small and medium cap securities.[23] "This started to bring down the cost of transactions by making trading more efficient."[24] Further, decimalization of securities "reduced the economic opportunity per trade for investment banks."[25] Stocks were no longer traded in fractions of dollars, but instead, in pennies.[26] As a result, "investment banks now generate revenue primarily by executing a high volume of low-priced trades meant to capitalize on short-term changes in the price of highly liquid, very large-cap stocks."[27] To illustrate the change, high-frequency trades account for nearly seventy-five percent of the current equities trade volume at U.S. exchanges, compared to slightly more than twenty percent in 2004.[28] In this new environment, research analysts have shifted their focus to trading, rather than emerging companies.

This note will analyze several of the key provisions of the JOBS Act and their effect on raising capital for small growth companies. The scope of this note will exclude the Title III crowdfunding provisions, as there is already substantial discussion about the topic in the legal and business communities. Part II discusses the IPO registration process. Part III explores the JOBS Act and its effect on securities regulation. Specifically, this note will cover the Title I IPO on-ramp, the Title II changes to Regulation D, the Title IV changes to Regulation A and 144A, and finally the Title V and VI changes to shareholder limits. Part IV analyzes the impact the JOBS Act will have on raising capital for small growth enterprises. Part V will conclude.

---

[21] *Id.*

[22] IPO TASK FORCE, *supra* note 1, at 13.

[23] *Id.*

[24] Andrea Burzynski, *Did Lower Transaction Costs Kill Small Cap IPOs?*, INSTITUTIONAL INVESTOR, Mar. 2012, at 73.

[25] IPO TASK FORCE, *supra* note 1, at 13. Profit margins fell an approximately 96%, estimates former Nasdaq executive David Weild. Andrea Burzynski, *supra* note 24.

[26] IPO TASK FORCE, *supra* note 1, at 13.

[27] *Id.*

[28] *Id.*

## II. THE IPO PROCESS

The IPO process is a long, complex road which incorporates numerous functional groups, such as accountants, lawyers, and underwriters. This section is primarily concerned with the regulations surrounding the process, rather than the actual steps an issuer should take in completing a public offering.

To start, section 5 of the Securities Act restricts the "release or publication of information during the IPO process."[29] This timeframe is known as the "quiet period."[30] The quiet period can be broken down into three stages: the pre-filing period, the waiting stage, and the post-offering period.[31] While the SEC has never defined when the quiet period begins, a company should assume it begins when they select an underwriter.[32] The quiet period ends twenty-five days after the offering date.[33] During the pre-filing period, the issuer cannot make any offers to sell its securities.[34] This restriction is commonly known as "gun-jumping."[35] The waiting period occurs between the date the Form S-1 is filed and the date the SEC deems it to be effective.[36] During this time the issuer can make oral offers subject to several restrictions and certain types of written offers.[37] Finally, the post-offering period begins on the offering date and ends twenty-five days later, as mentioned above.[38] During this period, oral offers are permissible (but still subject to the same restrictions as during the waiting period), written offers may be made, and sales may be conducted and

---

[29] DAVID A. WESTENBERG, INITIAL PUBLIC OFFERINGS: A PRACTICAL GUIDE TO GOING PUBLIC 11–3 (2d ed. 2012). The purpose of section 5 is to "ensure that written offers and sales of securities are made only pursuant to a prospectus meeting all SEC disclosure requirements." *Id.*

[30] *Id.* at 11–2.

[31] *Id.* at 11–4 to 11–5.

[32] *Id.* at 11–4.

[33] *Id.* at 11–5.

[34] *Id.* at 11–4.

[35] *Id.*

[36] *Id.*

[37] *Id.* Oral offers are subject to three caveats:

> [1] Communications via email, the company's website, or radio or television broadcasts are generally treated as if they were written communications.
>
> [2] Oral statements reduced to writing by someone outside of the company, such as an interview with a journalist, may be considered to be written statements by the company.
>
> [3] Oral statements remain subject to the antifraud rules of the SEC and must not substantively differ from the information contained in the written prospectus.

*Id.* at 11–4. Furthermore, "[w]ritten offers may be made during the waiting period by means of a preliminary prospectus that contains an estimated offering price range, meets all other applicable SEC rules, and is filed as part of the Form S-1 with the SEC." *Id.* at 11–5.

[38] *Id.* at 11–5.

finalized.[39]

The primary form to be filed with the SEC is a Form S-1.[40] This form is central to the IPO process and ensuring effectiveness in the registration statement.[41] There are essentially three main parts of a Form S-1. First, there is the prospectus, which contains comprehensive insight into the issuing company and is provided to investors.[42] Second, there is the outside cover and "Part II" of the Form S-1,[43] which contain information related to the offering, but are not included in the prospectus.[44] And finally, there are numerous required exhibits and schedules to correspond with the information provided in the rest of Form S-1.[45]

The prospectus is generally governed by Regulation S-K and Regulation S-X.[46] The prospectus covers virtually all components of the issuers' business and, by the time it is completed, looks substantially similar to a book.[47] The main sections of the prospectus include: risk factors, use of proceeds[48], financial statements[49], management's discussion and analysis (MD&A),[50] company

---

[39] *Id.*

[40] *Id.* at 13–3.

[41] *Id.* at 13–2.

[42] *Id.* at 13–3.

[43] Part II of Form S-1 requires: expenses incurred during the issuance, indemnification of officers and directors, a listing of recent sales of unregistered securities, and various exhibits and financial schedules. *See* Registration Statement Under the Securities Act of 1933 (Form S-1), *available at* http://www.sec.gov/about/forms/forms-1.pdf.

[44] *Id.*

[45] *Id.*

[46] *Id.* Regulation S-K presents narrative disclosure requirements. *See generally* 17 C.F.R. § 229 (2012). On the other hand, Regulation S-X presents financial disclosure requirements. *See generally* 17 C.F.R. § 210 (2011).

[47] Westenberg, *supra* note 29, at 13–32. The typical length of the prospectus is between 150 and 250 pages. *Id.*

[48] The use of proceeds sections must explain what the company plans to do with the raised capital. *Id.* at 13–8. In many instances, however, the issuer will have no specific plans for the raised capital. *Id.* In these situations, companies will generally state that the "net proceeds will be used for general expansion of business operations, or working capital . . . and do not disclose more specific uses." *Id.*

[49] The financial statements can be found in two parts of the prospectus. *Id.* at 13–10, 13–28. First, they can be found in the selected financial data sections, which incorporate five years of financial data and presents it in a comparative columnar form. *Id.* at 13–10. Second, audited financial statements can be found towards the end of the prospectus. *Id.* at 13–28. The financial statements in this section must include a three-year income statement, statement of cash flows, and changes in shareholder equity. *Id.* at 13–28 to 13–29. The balance sheet, however, may use two years of audited data. *Id.* at 13–28.

[50] The MD&A section provides investors with "information relevant to the assessment of the financial condition, results of operations, liquidity, and capital resources of the company, with particular emphasis on the company's prospects for the future." PRICEWATERHOUSECOOPERS, ROADMAP FOR AN IPO: A GUIDE TO GOING PUBLIC 48 (2010). The objectives of the MD&A, as

business, and executive compensation.[51]

Once the Form S-1 is filed, the SEC reviews the document and provides comments.[52] The rigorous review focuses on the issuer's compliance with the disclosure and accounting requirements.[53] As mentioned above, once the SEC is finished making comments on the Form S-1, they will return the document to the issuer for revisions and amendments.[54] The issuer will keep revising the form until all SEC comments are resolved.[55] Once the Form S-1 is deemed effective, the company and underwriters will price the offering and trading will generally begin the next day.[56]

## III. THE JOBS ACT PROVISIONS

The purpose of the JOBS Act is to ease the regulatory burden placed on emerging businesses that go public and thus spur economic activity and job growth.[57] As such, the bill enacts an array of regulatory easement, stemming from the so-called IPO on-ramp, to remove general solicitation bans and increase investor threshold limits.[58] The key provisions of the JOBS act are discussed in this section.

---

stated by the SEC, are to:

> [P]rovide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management; enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Westenberg, *supra* note 29, at 13–12. This section provides management's perspective on past financial results. *Id.* at 13–11. The forward-looking information generally includes industry trends and how the company will adapt to the changing environment. *Id.*

[51] *See generally* Westenberg, *supra* note 29, at 13–3 to 13–30 (providing a detailed overview of each section of the prospectus).

[52] Gariel Nahoum, *Small Cap Companies and the Diamond in the Rough Theory: Dispelling the IPO Myth and Following the Regulation A and Reverse Merger Examples*, 35 HOFSTRA L. REV. 1865, 1869–70 (2007).

[53] Westenberg, *supra* note 29, at 17–7. The SEC will not review the "fairness or substantive terms of the offering," instead, the SEC's purpose is to ensure "full disclosure of all information that is material to an investment decision." *Id.*

[54] Nahoum, *supra* note 52, at 1870.

[55] DAVID A. WESTENBERG, *supra* note 29 at 17–15.

[56] *Id.* at 20–3.

[57] 34 SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW REPORT, THE JOBS ACT, PART 4: FURTHER LESSONS FROM THE LEGISLATIVE HISTORY (Harold S. Bloomenthal, 7th ed. 2012).

[58] *See* Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012) [hereinafter JOBS Act].

### *A. Title I – Reopening American Capital Markets to Emerging Growth Businesses*

Title I of the JOBS Act aims to increase the number of smaller growth companies going public. The IPO on-ramp is what Senator Toomey (R-PA) called the "centerpiece" of the JOBS Act.[59] This portion of the law is essentially based off the recommendations offered by the IPO Task Force, which was comprised of "venture capitalists, experienced CEOs, public investors, securities lawyers, academicians, and investment bankers."[60] The Task Force kept with SEC tradition in recommending a framework for scaled regulation.[61]

Before the passage of the JOBS Act, smaller companies seeking to go public had a narrow exception to some of the disclosure requirements under the Securities and Exchange Act.[62] This exemption applies to companies with a market capitalization of under $75 million.[63] While the intentions are good, the $75 million mark fails to address the needs of emerging growth companies (EGCs).[64] For example, many companies considering an IPO are high-growth, venture-backed companies seeking to generally raise between $50 million and $150 million.[65] Companies of this size will typically have a market capitalization of more than $75 million, and thus fall outside the exemptions. Taking this into consideration, the JOBS Act defines an EGC as an issuer with total annual gross revenues of less than one billion dollars during its most recently completed fiscal year.[66] Thus, the new EGC regulations will include

---

[59] WOLFF, *supra* note 57, at 1.

[60] IPO TASK FORCE, *supra* note 1, at 4; *see also id.* at 19-24 (detailing the IPO on-ramp recommendations by the Task Force).

[61] *Id.* at 19. The report references the 2007 SEC rules, which provided "regulatory relief and simplification for Smaller Reporting Companies . . . in the form of scaled disclosure," and the 2010 rule, which "exempt[ed] smaller companies from the provisions of Sarbanes-Oxley Section 404(b)." *Id.*

[62] *See* ALAN S. GUTTERMAN, 25 BUSINESS TRANSACTIONS SOLUTIONS § 104:108 (2013).

[63] *Id.*

[64] An "emerging growth company" is a high growth company with potential to go public. *See* IPO TASK FORCE, *supra* note 1, at 1.

[65] *Id.* at 19.

[66] Jeffrey W. Rubin, *The JOBS Act: An Overview—What Every Business Lawyer Should Know*, BUSINESS LAW TODAY, May 2012, at 1, 1. The one-billion-dollar threshold will be adjusted for inflation every five years. JOBS Act, *supra* note 58, § 101(a). Furthermore, an issuer will continue to be an EGC until the earliest of:

> (A) the last day of the fiscal year of the issuer during which it had total annual gross revenues of $1,000,000,000 . . . or more;
>
> (B) the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant

those companies with a greater potential for a public offering. Moreover, the limitation is not too broad to encompass the larger companies for which many of the securities regulations were created. For example, the $1 billion limit would exclude approximately 85% of the IPOs conducted in the last five years.[67] The legislation provides an "on-ramp" in the form of a five-year limit on the availability of the exemption.[68] Therefore, the IPO on-ramp allows companies to gradually ramp-up reporting compliance operations.

Once a company is deemed to be an EGC, there are several provisions of the Act that will be beneficial to the EGC. One benefit of being an EGC is the reduction in the amount financial statements that must be filed with the registration statement. Prior to the JOBS Act, companies looking to go public had to file three years of audited financial statements.[69] Now, they only have to submit two years of audited financial statements.[70] Furthermore, the company need not provide financial data prior to the earliest audited period in the IPO registration statement.[71] Thus, the five-year disclosure of selected financial data required in the prospectus does not apply to EGCs.[72] However, the JOBS Act failed to reduce the financial statement requirements under the Exchange Act.[73] This eliminates most of the gains from the reduced Securities Act disclosure, because companies still need to collect and present the information.

The IPO on-ramp also affects an EGC's level of compliance with accounting standards. Under the JOBS Act, EGCs may not be required to comply with changes in financial accounting standards until private companies are required to.[74] This is an important feature because the Public Company

---

> to an effective registration statement under this title;
>
> (C) the date on which such issuer has, during the previous 3-year period, issued more than $1,000,000,000 in non-convertible debt; or
>
> (D) the date on which such issuer is deemed to be a 'large accelerated filer', as defined in section 240.12b-2 of title 17, Code of Federal Regulations, or any successor thereto.

*Id.*

[67] IPO TASK FORCE, *supra* note 1, at 20.

[68] *See supra* text accompanying note 2. Section (B) details the five-year limit. *Id.*

[69] John T. Palter, *Benefits and Compliance Concerns Related to the Passage of the JOBS Act*, ASPATORE SPECIAL REPORT, August 2012 at 7. Specifically, the registration statement requires three years of information for the income sand cash flow statement. *Id.*

[70] JOBS Act, *supra* note 58, § 102. Likewise, EGCs are only required to discuss the fiscal periods presented in the financial statements for its MD&A section. David A. Westenberg, *New Capital Formation Legislation Enacted – JOBS Act Has Broad Implications for IPOs*, PRACTICING LAW INSTITUTE (2012) [hereinafter Westenberg, *New Capital Formation*].

[71] JOBS Act, *supra* note 58, § 102.

[72] HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 1:510 (2d ed. 2012).

[73] *Id.*

[74] *Id.*

Accounting Oversight Board has been considering implementing auditor independence and audit firm rotations.[75] Moreover, EGCs are exempt from the Sarbanes-Oxley requirement that an independent registered public accounting firm audit and report on the effectiveness of the company's internal controls.[76]

In addition to reducing financial statement disclosure, the JOBS Act also reduces the amount that needs to be disclosed regarding executive compensation. Specifically, EGCs no longer need to include the Compensation Discussion and Analysis section.[77] Likewise, the company need only disclose the compensation of three executives and are exempt from disclosing the relationship between financial performance and executive compensation.[78] And finally, EGCs are exempt from disclosing the relationship between executive compensation and financial performance and the ratio between CEO compensation and the median employee compensation.[79]

Section 102(a)(1) of the JOBS Act exempts EGCs from shareholder approval requirements of the Exchange Act.[80] The shareholder approval requirements comprise of say-on-pay, say-on-frequency, and say-on-golden parachute provisions.[81] These provisions grant shareholders the right to vote on any changes regarding these matters.[82] This exemption has the potential to incentivize young entrepreneurs who seek to maintain compensation authority to consider an IPO.

Section 105 of the JOBS Act increases communication during the IPO process. First, Section 105(a) permits the publication or distribution by a broker or dealer of research reports concerning the EGC.[83] Remember, the IPO Task Force listed the lack of information surrounding EGCs as a main concern.[84] Without this information, EGC securities are difficult to value, and thus, invest in.[85] Second, Section 105(c) liberalizes the communications an IPO can make with potential investors, so long as those investors are qualified institutional

---

[75] IPO TASK FORCE, *supra* note 1, at 24. Auditor independence relates to removing some of the ancillary business ventures conducted between auditing firms and the companies they audit, such as consulting. *Id.* Audit firm rotation means mandating a limit on the years an auditing firm can continuously audit a single company. *Id.* The IPO Task Force argues that such rules would be highly disruptive and costly to emerging companies. *Id.*

[76] Westenberg, *New Capital Formation*, *supra* note 70.

[77] *Id.*

[78] *Id.*

[79] *Id.*

[80] JOBS Act, *supra* note 58, § 102.

[81] *See* 15 U.S.C. § 78n–1(a)–(b) (2012).

[82] *Id.*

[83] JOBS Act, *supra* note 58 at § 105(a).

[84] *See* IPO TASK FORCE, *supra* note 1.

[85] *Id.*

buyers (QIBs) or institutional accredited investors.[86] This allows EGCs to "assess the market interest in an offering" prior to filing the registration statement.[87] Finally, research analysts will be able to have greater communication with potential investors and the EGC's management;[88] however, it is still unclear how useful the provision will be, considering there are several Financial Industry Regulatory Authority (FIRNA) rules that conflict with the provision.[89]

Finally, an EGC may submit a confidential draft registration statement to the SEC prior to its IPO date.[90] Normally, an S-1 form is publically available via the SEC's EDGAR system,[91] revealing valuable information to competition.[92] Confidentiality will be beneficial if there is an error in the process or if the company withdraws from conducting an IPO.[93] However, the EGC would miss out on valuable publicity, which could attract potential investors.[94]

### *B. Title II – Access to Capital for Job Creators*

Title II of the JOBS Act orders the SEC to revise Rule 506 of the Securities Act.[95] "Rule 506 is a non-exclusive safe harbor under Section 4(a)(2)

---

[86] JOBS Act, *supra* note 58 at § 105(c).

[87] HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *supra* note 72 at § 1:520.

[88] *See* JOBS Act, *supra* note 58 at § 105(b).

[89] HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *supra* note 72 at § 1:517. The FINRA rules in conflict with the 105(b) provision include:

> FINRA Rule 2711(c)(4)—prohibits research analysts from soliciting investment banking business;
>
> FINRA Rule 2711(c)(5)(A)—A research analyst may not participate in a road show;
>
> FINRA Rule 2711(c)(5)(B)—A research analyst may not engage in a communication with a customer in the presence of investment banking personnel or company management about an investment banking services transaction.

*Id.* Guidance from the SEC and FIRNA are expected in the near future. *Id.*

[90] *See* JOBS Act, *supra* note 58, at § 106. "Confidential" in this sense means the nonpublic review by the SEC staff as long as the registration statement is filed no later than twenty-one days before the date on which the issuer conducts a roadshow. *Id.* Furthermore, the information is not subject to the Freedom of Information Act. *Id.*

[91] EDGAR stands for "Electronic Data Gathering, Analysis, and Retrieval system." *Important Information About EDGAR*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/edgar/aboutedgar.htm. It is the database where companies file SEC submissions. *Id.*

[92] Westenberg, *New Capital Formation*, *supra* note 70.

[93] *Id.*

[94] *Id.*

[95] *See* JOBS Act, *supra* note 58, at § 201.

. . . of the Securities Act, which exempts transactions by an issuer 'not involving any public offering' from the registration requirements of Section 5 of the Securities Act."[96] The major benefit of a Rule 506 offering is that there is no cap on the amount of the offering.[97] Furthermore, the offering can be made to an unlimited number of "accredited investors,"[98] but is limited to thirty-five purchasers.[99] Yet, the offering must still comply with Rules 501[100] and 502.[101]

---

[96] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33–9354,104 SEC, Docket 1913 at 5 (Aug. 29, 2012) [hereinafter SEC Release 9354] (citing 15 U.S.C. 77d(a)(2)). *See also* 17 C.F.R. § 230.506(a) (stating, "Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.").

[97] SEC Release 9354, *supra* note 96, at 5. The title of Rule 506 is as follows: "Exemption for limited offers and sales without regard to dollar amount of offering." 17 C.F.R. § 203.506.

[98] Rule 501(a) states, "*Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person[.]" 17 C.F.R. § 230.501(a). Rule 501 then enumerates who and what qualifies as an accredited investor. *See* 17 C.F.R. § 230.501(a). Specifically, Rule 501(a) includes entities such as: banks, investment companies, and insurance companies (501(a)(1)); directors, officers, or general partners of the issuer (501(a)(4)); individuals with a net worth, or spouses with joint net worth, of $1,000,000, not including the primary residence (501(a)(5)); individuals with "income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year" (501(a)(6)); trusts with total assets greater than $5,000,000 (501(a)(7)); and any entity in which all equity owners are accredited investors (501(a)(8)). *See* 17 C.F.R. § 230.501(a).

[99] 17 C.F.R. § 203.506(b)(i); *see also* 17 C.F.R. § 230.506(b)(ii) (defining the nature of a purchaser by stating, "Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description."). Similarly, Rule 501(e) defines the parameters of the purchaser's calculation. *See* 17 C.F.R. § 230.501(e). Rule 501(e)(1) states:

> (1) The following purchasers shall be excluded:
>
> (i) Any relative, spouse or relative of the spouse of a purchaser who has the same primary residence as the purchaser;
>
> (ii) Any trust or estate in which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(iii) of this section collectively have more than 50 percent of the beneficial interest (excluding contingent interests);
>
> (iii) Any corporation or other organization of which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(ii) of this section collectively are beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; and
>
> (iv) Any accredited investor.

17 C.F.R. § 230.501(e)(1)(i–iv).

[100] Rule 501(e) defines who is exempt from Rule 506(b). *See* 17 C.F.R. § 230.501(e)(1).

[101] *See* 17 C.F.R. § 230.506(b)(1). Rule 502 prescribes the conditions that must be met under

Rule 502(c) includes the prohibition on general solicitation.

The JOBS Act requires the general-solicitation and advertising ban in Rule 502(c) will not apply to offers and sales of securities made under Rule 506, provided all purchasers of the securities are accredited investors.[102] To accomplish this, the SEC proposes to create a new Rule 506(c).[103] Under the new Rule 506(c), an issuer would be allowed to solicit and advertise the offering as long as: 1) "the issuer . . . take[s] reasonable steps to verify that the purchasers of the securities are accredited investors;" 2) "all purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they do, at the time of the sale of the securities;" and 3) "all terms and conditions of Rule 501 and Rules 502(a) and 502(d) must be satisfied."[104]

Similarly, the JOBS Act revises Rule 144A so that:

> [S]ecurities sold under [Rule 144A] may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.[105]

Like Rule 506, Rule 144A is a "safe harbor exemption from the registration requirements of the Securities Act for resales of certain 'restricted securities' to QIBs."[106] Thus, as long as an intermediary complies with

---

Regulation D. One such condition is that unaccredited investors must be furnished the information listed under Rule 502(b)(2). *See* 17 C.F.R. § 230.502(b). Another condition is that the securities cannot be resold without registration or an exemption. *See* 17 C.F.R. § 230.502(d). However, the most notorious is the general solicitation ban under Rule 502(c), which limits the manner in which the offering may take place. *See* 17 C.F.R. § 230.502(c). Section 502(c) states the following:

> (c) [N]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:
>
> (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
>
> (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising . . . .

17 C.F.R. § 230.502(c)(1)–(2).

[102] *See* JOBS Act, *supra* note 58, at § 201.

[103] *See* SEC Release 9354, *supra* note 96, at 11.

[104] *Id.* at 11–12.

[105] JOBS Act, *supra* note 58, at § 201.

[106] SEC Release 9354, *supra* note 96, at 6 (footnote omitted). Section 4(1) of the Securities Act exempts "transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77(d). Under section 2(a)(11), "The term 'underwriter' means any person who has purchased from an

paragraph (d) of Rule 144A, they will be exempt from the Securities Act registration requirements, allowing the intermediary to initially purchase the securities, and then immediately resell them to QIBs.[107] Unlike Rule 506 exemptions, Rule 144A does not have an express provision prohibiting general solicitation and advertising; however, the limitation to QIBs essentially acts as a general solicitation ban.[108] Under the proposed rule, "[the] resales of securities . . . could be conducted using general solicitation, so long as the purchasers are limited" to QIBs or those the seller reasonably believes to be a QIB.[109]

The importance of Regulation D offerings is shown by the fact that they are one of the most—if not the most—often used offering vehicles.[110] Within the Regulation D exemptions, Rule 506 is the most prevalent.[111] Rule 506 offerings raised an estimated $581 billion, $902 billion, and $895 billion in 2009, 2010, and 2011, respectively.[112] This amounts to approximately 99% of the capital reportedly raised under Regulation D during this period.[113] Furthermore, in 2010 and 2011, the "amounts raised in Regulation D offerings exceeded the amounts raised in all other private offerings . . . , public debt and public equity offerings, combined."[114]

The Rule 144A market also plays a key role in capital formation.[115] "In 2011 and 2010, the estimated amount of capital . . . raised in Rule 144A

---

issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking." 15 U.S.C. § 77(b)(a)(11). However, Rule 144A(b) states:

> Any person, other than the issuer or a dealer, who offers or sells securities in compliance with the conditions set forth in paragraph (d) of this section shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter of such securities within the meaning of sections 2(a)(11) and 4(a)(1) of the Act.

17 C.F.R. § 230.144A(b). The paragraph (d) requirements include in part that "[t]he securities are offered or sold only to a qualified institutional buyer or to an offeree or purchaser that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer." 17 C.F.R. § 230.144A(d). Paragraph (a) of Rule 144A defines who qualifies as a "qualified institutional buyer." *See* 17 C.F.R. § 230.144A(a). Furthermore, "restricted securities" are defined in Rule 144(a)(3) and include "[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering . . . [and] [s]ecurities acquired in a transaction or chain of transactions meeting the requirements of § 230.144A." 17 C.F.R. § 230.144(a)(3).

[107] SEC Release 9354, *supra* note 96, at 7.

[108] *Id.*

[109] *Id.* at 37.

[110] *Id.* at 22.

[111] *Id.*

[112] *Id.*

[113] *Id.*

[114] *Id.*

[115] *Id.*

offerings was $168 billion and $233 billion, compared to $984 billion and $1.07 trillion, respectively, raised in registered offerings."[116] Thus, the changes imposed by the legislature and developed by the SEC can have a significant impact on capital raising entrepreneurs and emerging businesses.

### *C. Title IV – Small Company Capital Formation*

"Regulation A" of the Securities Act is another vehicle for securities regulation that is exempt from most reporting requirements.[117] The purpose behind Regulation A is to "provide a simple and relatively inexpensive procedure for small business use in raising limited amounts of needed capital."[118] As such, a Regulation A offering is a less expensive and time-consuming alternative to a public offering; however, as noted above, the offering size is limited.[119] Prior to the JOBS Act, Regulation A offerings were limited to $5 million in a twelve month period.[120] However, Title IV of the JOBS Act increases the cap on Regulation A offerings to $50 million in a twelve month period.[121] This increase in the offering size has the potential to revive the under-used exemption.

The need for reviving Regulation A is shown in the depressing number of Regulation A filings over the years. At its peak in 1997, there were 116 Regulation A filings.[122] This number decreased to nineteen in 2011.[123] Moreover, many filings do not pass SEC review.[124] The peak year for qualified Regulation A offerings was 1998, with fifty-seven offerings.[125] This number has drastically dropped to just one qualified offering in 2011.[126] Thus, Regulation A has essentially become useless.

---

[116] *Id.*

[117] *See* 15 U.S.C. § 77c (2012). The SEC is granted the authority to exempt securities in which the enforcement "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering[.]" *Id.* at § 77c(b)(1).

[118] UNITED STATES GOV'T ACCOUNTABILITY OFFICE, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS 5 (2012) [hereinafter GAO, SECURITIES REGULATION].

[119] 7 HICKS, EXEMPTED TRANS. UNDER THE SEC ACT OF 1933 § 6:1 (2012). The size of the allowed offering has slowly grown over time: $100,000 from 1933–1945, $300,000 from 1945–1970, $500,000 from 1970–1978, $1,500,000 from 1978–1992, and $5,000,000 from 1992–2012. *Id.* at § 6:2.

[120] 15 U.S.C. § 77c (2012).

[121] *See* JOBS Act, *supra* note 58, at § 401.

[122] GAO, SECURITIES REGULATION, *supra* note 118, at 9.

[123] *Id.*

[124] *See generally id.*

[125] *Id.*

[126] *Id.*

Regulation A has become known as the "mini registration," because of its similarities with a registered offering.[127] However, significant differences do exist.[128] First, Regulation A includes an "unworthy offering doctrine" that limits who can offer the securities.[129] Second, the disclosure requirements are less burdensome than compliance with the Section 8 requirements.[130] Furthermore, "[f]inancial statements of issuers not subject to [the] Exchange Act . . . need not be certified . . . ."[131] Finally, Regulation A offerings are not subject to strict liability for certain misstatements in a registration statement under Section 11 of the Securities Act.[132]

In order to offer securities under Regulation A, an issuer must meet several requirements.[133] First, the issuer must be "organized under the laws of the United States or Canada, . . . with its principle place of business in the United States or Canada[.]"[134] Second, the issuer cannot be a reporting company under section 13 or 15(d) of the Exchange Act.[135] Third, the issuer cannot be a "development stage company that . . . has no specific business plan or purpose . . . ."[136] Fourth, the issuer cannot be an investment company.[137] Finally, the issuer is subject to the unworthy offering doctrine, as mentioned above.[138]

---

[127] HICKS, *supra* note 119, at § 6:5.

[128] *Id.*

[129] *Id.*; *see also* 17 C.F.R. § 230.262 (2012) (enumerating ways an issuer may be disqualified from using Regulation A). One such disqualification excludes those who have been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or the making of any false filing with the SEC in the past 5 years. 17 C.F.R. § 230.262(a)(3) (2012).

[130] HICKS, *supra* note 119, at § 6:5.

[131] *Id.*

[132] *Id.* However, the exemption will "not lie where an issuer uses a false or misleading offering circular." *Id.* at § 6:6.

[133] *See* 17 C.F.R. § 230.251(a) (2012).

[134] *Id.* at § 230.251(a)(1).

[135] *Id.* at § 230.251(a)(2). The apparent reason for this is to force larger companies into public offerings with more disclosure requirements. *See* Rutheford B. Campbell, Jr., *Regulation A: Small Businesses' Search For "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 103 (2006).

[136] 17 C.F.R. § 230.251(a)(3) (2012). The exclusion also applies to companies that plan to merge with an unidentified company. *Id.* While at first glance the wording of section 230.251(a)(3) is ambiguous, the SEC has adopted a narrow interpretation of the rule. *See* Rutheford B. Campbell, *supra* note 135, at 103 (stating "that it applies only to offerings by a 'blank check' company, which is defined in the Release as a company 'that has no specific business or plan except to locate and acquire a presently unknown business or opportunity.'").

[137] 17 C.F.R. § 230.251(a)(4) (2012) (stating that the issuer cannot be an investment company under the Investment Company Act of 1940). In addition, the issuer cannot issue "fractional undivided interests in oil or gas rights, . . . or a similar interest in other mineral rights." *Id.* at § 230.251(a)(5).

[138] *Id.* at § 230.251(a)(6) (referencing the unworthy offering doctrine enumerated in section 230.262).

If an issuer is eligible for a Regulation A offering, the issuer must file an offering statement, which includes an offering circular, with the SEC.[139] The offering statement is quite similar to a registration statement and prospectus in a registered offering.[140] For example, the offering statement includes information concerning "a company's business and financial condition, its officers, directors and principal stockholders, risk factors, [and] a description of the use of [the] offerings proceeds . . . ."[141] It is the offering circular that contains the investment information.[142] The financial information required in the offering circular includes "a one year balance sheet and income information for two years."[143] Unlike a registration statement, the financial information need not be audited, but must be prepared according to generally accepted accounting principles.[144] Once the offering statement is cleared by the SEC, the offering circular must be provided to investors.[145]

Title IV of the JOBS Act requires the SEC to create a new class of exempted securities, substantially similar to Regulation A, with a maximum offering size of $50 million.[146] Like Regulation A, the securities are unrestricted, meaning they can be freely traded on secondary markets.[147] Furthermore, the securities can be sold to accredited or unaccredited investors, unlike Regulation D offerings.[148] This provides a greater pool of potential investors. In addition, the new Regulation A offerings are exempt from the general solicitation and advertising bans.[149] Thus, companies may "test the waters" and "publish or deliver a written document to prospective purchasers or make scripted radio or television broadcasts to determine whether there is an interest in their contemplated securities offering before filing an offering

---

[139] Rutheford B. Campbell, *supra* note 136, at 104 (citing 17 C.F.R. § 230.251(d)(i) (2005)). The offering statement has four components: "the notification, the offering circular, the exhibits and a signature page." *Id.*

[140] *Id.*

[141] Vanessa Schoenthaler, *The JOBS Act in a Nutshell—Part IV Regulation A Redux*, 100F STREET (May 9, 2012), http://100fstreet.com/index.php/2012/05/the-jobs-act-in-a-nutshell-part-iv-regulation-a-redux/.

[142] Rutheford B. Campbell, *supra* note 136, at 105. "The narrative disclosures required in the offering circular include information about the issuer's business, properties, pending and threatened litigation, risk factors, officers and directors (including experience and compensation paid to them by the issuer), stock ownership, and use of proceeds." *Id.*

[143] *Id.*

[144] *Id.*

[145] GAO, SECURITIES REGULATION, *supra* note 118, at 6.

[146] 15 U.S.C. § 77c (2012).

[147] GAO, SECURITIES REGULATION, *supra* note 118, at 6.

[148] *Id.*

[149] *Small Business and the SEC*, U.S. SEC. AND EXCH. COMM'N, http://www.sec.gov/info/smallbus/qasbsec.htm#rega (last modified 10/10/2013).

statement with the SEC."[150] This enables companies to gauge the potential of the offering before investing time, money, and other resources.

The new class of securities also has differences from the old Regulation A. For example, the JOBS Act requires issuers of the new class of securities to "file audited financial statements with the [SEC] annually."[151] Furthermore, the JOBS Act grants the SEC authority to require additional information, such as "audited financial statements, a description of the issuer's business operations, its financial condition, its corporate governance principles, its use of investor funds," and other matters deemed necessary.[152] Finally, the unworthy offering doctrine is expanded to include "regulations adopted in accordance with section 926 of the Dodd–Frank Wall Street Reform and Consumer Protection Act."[153]

### *D. Titles V & VI – Registration Thresholds*

Prior to the passage of the JOBS Act, Section 12(g) of the Exchange Act required a company with more than $10 million is assets and more than five hundred shareholders of record to register a security with the SEC.[154] When Section 12(g) was passed, over-the-counter-markets were becoming more popular.[155] Because over-the-counter-markets are nonreporting, they fostered an environment of fraud.[156] Thus, Section 12(g) was created to bring larger companies and their securities under the supervision of the SEC.[157]

There are several nuances to the 12(g) requirements. Of greatest importance, the shareholder requirement refers to shareholders of record, not beneficiary shareholders.[158] Shareholders of record are the names on the corporate books, which own legal title to the security and generally consist of

---

[150] *Id.*

[151] 15 U.S.C. § 77c(b)(2)(F) (2012).

[152] *Id.* at § 77c(b)(2)(G)(i).

[153] *Id.* at § 77c(b)(2)(G)(ii).

[154] *See* § 78l(g). Once an issuer has registered under the Section 12(g), all the Exchange Act reporting requirements would apply to the company. ZE'-EV EIGER, MORRISON FOERSTER, SEC STAFF GUIDANCE ON JOBS ACT AMENDMENTS TO EXCHANGE ACT REGISTRATION THRESHOLDS 1 (2012). As such:

> [T]he issuer would . . . be required to file annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and proxy statements on Schedule 14A, and certain persons would be required to report transactions on Forms 3, 4, and 5 and Schedules 13D and 13G.

*Id.*

[155] Tyler Adam, *The JOBS Act: Unintended Consequences of the "Facebook Bill,"* 9 HASTINGS BUS. L.J. 99, 107 (2012).

[156] *Id.* at 107–08.

[157] *Id.* at 107.

[158] 15 U.S.C. § 78l(g).

broker-dealers.[159] Beneficiary shareholders, on the other hand, are the individuals who own the rights, in equity, associated with the security.[160] Therefore, shareholders of record reveals a much smaller total than the actual number of shareholders.

The JOBS Act increases the shareholder threshold, discounts employees, and creates a new threshold for banks.[161] First, Section 501 increases the shareholder of record threshold from five hundred persons to two thousand persons or five hundred persons who are not accredited investors.[162] Second, Section 502 states that the shareholders of record number "shall not include securities held by persons who received the securities pursuant to an employee compensation plan."[163] And third, the JOBS Act creates a separate requirement for banks and bank holding companies. These companies must register a class of securities when they have assets over $10 million and two thousand shareholders of record.[164]

## IV. ANALYSIS

### *A. Positive Effects on the IPO Market for EGCs*

The IPO On-Ramp will decrease the age of companies conducting IPOs. Currently, the average age of companies conducting an IPO is nine years.[165] Back in the late 1990s, that figure was five and a half years.[166] The IPO On-Ramp provides the necessary changes in the IPO process to incentivize emerging growth companies to conduct a public offering. For example, reduced financial disclosure provided under IPO On-Ramp would grant companies time to build up their internal reporting infrastructure to support the Exchange Act reporting requirements. Companies that qualify as an EGC may provide less years' worth of financial information, thereby allowing management more time to contemplate the public offering before they are required to make cost reconstructive audits or install the infrastructure for public reporting.[167]

---

[159] Tyler Adam, *supra* note 155, at 108, 110.

[160] *Id.* at 108.

[161] *See* JOBS Act, *supra* note 58, at §§ 501–601.

[162] *Id.* at § 501. The JOBS Act did not change the $10 million total asset requirement. *Id.* To deregister a security, the security must be held of record by less than three hundred persons. *Id.* at § 601.

[163] *Id.* at § 502

[164] *Id.* at § 601. Moreover, banks and bank holding companies may deregister a class of securities when they have less than twelve hundred shareholders of record. *Id.*

[165] IPO TASK FORCE, *supra* note 1, at 1.

[166] *Id.*

[167] PRICEWATERHOUSECOOPERS, *supra* note 50, at 16. One sector that is using the new relaxed

Furthermore, the IPO On-Ramp reduces the risk associated with public reporting. As mentioned before, EGCs need not comply with changes in accounting standards until private companies must also comply.[168] Thus, the risk of increased costs due to changing accounting standards is removed to the extent those changes don't affect other private companies.

Confidential filing also reduces the risk associated with a public offering. Under the former registration rules, all registration statements were made public.[169] As such, competitors were able to see the company's financial statements and strategic plans.[170] Furthermore, bad publicity follows a failed IPO and leaves investors skeptical about the prospects of the company. The confidential filing provision permits EGCs to conceal their cards until twenty-one days after the registration is final, a major incentive for EGCs considering an IPO. [171]

The initial feedback is that companies are taking advantage of the IPO On-Ramp. A report by Ernst & Young revealed that "[n]early three-quarters of the [eighty-seven] U[nited] S[tates] companies that publicly filed their IPO registration between the start of April, 2012, and year-end counted themselves as 'emerging-growth' . . . ."[172] Of such, 59% took advantage of the confidential filing provision.[173] This figure is probably lower than expected in future years, because companies that recently filed an IPO would have been preparing the IPO under the former rules. The study also revealed that all EGCs opted out of the internal control audits.[174] This reduces costs and resources associated with coordinating an outside audit. However, the filers have decided to provide more financial information than required under the IPO On-Ramp.[175] Only 31% of

---

regulations more than others is the biotech industry. Jessice Holzer, *JOBS Act Sputters on IPOs*, WALL ST. J., (Mar. 28, 2013), at C3. This is because biotech companies are generally "unprofitable when they go public." *Id.* For example, Intercept Pharmaceuticals "took advantage of the relaxed standards for financial reporting and executive-pay disclosure." *Id.* According to the company's CEO, Dr. Mark Pruzanski, the relaxed standards "saved the company about $250,000 and two weeks of work." *Id.*

[168] *See supra* Part III.A.

[169] *Id.*

[170] Chris Dieterich, *After JOBS Act, Confidential Filers Rise*, WALL ST. J. (Feb. 18, 2013, 5:55 PM), *available at* http://online.wsj.com/article/SB10001424127887324162304578307052032008888.html.

[171] JOBS Act, *supra* note 58, at § 501. *See also* Jessice Holzer, *supra* note 167 (highlighting the benefits of confidential filing for EGCs like Natural Grocers by Vitamin Cottage, a grocery chain that went public in July 2012).

[172] Chris Dieterich, *supra* note 170.

[173] *Id.*

[174] *Id.*

[175] *Id.*

EGCs provided two years' worth of financial statements.[176] As mentioned earlier, this is probably because many of the companies were preparing the financial statements under the former regulations. Likewise, a failure to release financial statements that you already have may raise a red flag to investors.[177] Investors may start to wonder if the provided financial statements are misleading.

### *B. Negative Effects on the IPO Market for EGCs*

The cumulative effect of the JOBS Act will not substantially alleviate the declining trend of IPOs. While the IPO On-Ramp incentivizes EGCs to conduct a public offering, the other titles of the JOBS Act offer enticing options to finance a private offering. For example, Title II removes the general solicitation ban associated with Rule 506 offerings, thus making these offerings more attractive. Rule 506 offerings are already the most popular offering form,[178] and general solicitation will make them even more popular. Moreover, Title IV increases the dollar limit on Regulation A offerings. While Regulation A is scarcely used, increasing the offering size limit will make it more attractive. And finally, Titles V and VI raise the shareholder threshold under Section 12(g). Thus, companies on the verge of the former five hundred shareholder limit no longer face the possibility of reporting under the Exchange Act.

### *C. Benefits to Private Markets*

While Titles II–VI will not curb the declining IPO trend, they do provide valuable benefits to capital formation. For example, under the proposed Rule 506(c) companies would be able to advertise their offerings through numerous media outlets including television, newspapers, and the Internet.[179] As such, the issuer would be able to reach a larger investor pool, which would result in an increase to their access to capital.[180] Moreover, the changes would result in reduced search costs associated with finding accredited investors, while also increasing efficiency in finding investors.[181] With the ability to reach a greater number of potential investors, there is likely to be competition amongst

---

[176] *Id.*

[177] *Id.*

[178] *See supra* Part III.B.

[179] DAVID J. KAUFMAN ET AL., SEC RULE PROPOSAL WOULD PERMIT PUBLIC OFFERINGS IN "PRIVATE PLACEMENTS" AND FACILITATE CAPITAL FORMATION (Sept. 13, 2012) http://www.duanemorris.com/site/static/SEC_Rule_Proposal_Would_Permit_Public_Offerings_in_Private_Placements_and_Facilitate_Capital_Formation.pdf.

[180] SEC Release 9354, *supra* note 96, at 47.

[181] *Id.*

investors, which would result in a lower cost of capital for issuers.[182]

Without the general solicitation ban, many issuers may be able to conduct their offerings without an intermediary.[183] The result of which would be lower transaction costs and, consequentially, a lower cost of capital for the issuer.[184] From 2009 through 2011, "approximately 11% of all new offerings [under Form D] reported sales commissions of greater than zero because the issuers used intermediaries," with an average commission of 5.7% of the offering.[185] The use of intermediaries has a greater cost to small companies when compared to their larger peers. For example, "issuers reporting annual revenues up to $25 million pay on average a 6.4% commission, while issuers with annual revenues over $100 million pay approximately a 3.3% commission, and hedge funds and other privately offered funds pay approximately a 2.7% commission."[186] Thus, the proposed changes would have a potentially greater impact on emerging companies, in line with the goals of the JOBS Act.

Another key benefit of the proposed Rule 506 is the reduced uncertainty as to whether a Rule 506 offering can be accomplished.[187] Attorneys regularly consult their clients to avoid the media when their company is considering a Rule 506 offering.[188] The uncertainty issues surrounding general solicitations are clearly evident when companies are reluctant to "respond to press inquiries or to correct inaccurate reports."[189] Likewise, the proposed Rule 506 will reduce compliance costs associated with complying with the general solicitation ban.[190]

The new rule would also provide numerous benefit investors. For example, investors would be able to "identify, and potentially invest in, a larger

---

[182] *Id. See also* DAVID J. KAUFMAN , *supra* note 179 (stating, "Increased competition for quality investments could also improve terms for issuers and funds, reducing their cost of capital.").

[183] SEC Release 9354, *supra* note 96, at 48. *See also* DAVID J. KAUFMAN, *supra* note 179 (stating, "[T]he ability to advertise its offer of securities on its own website or a third-party website designed to facilitate these types of offerings could obviate the need to engage an investment banker and may enable issuers to attract investors that they otherwise would be unable to reach.").

[184] SEC Release 9354, *supra* note 96, at 48.

[185] *Id.*

[186] *Id.*

[187] *Id.*

[188] *See* Joe Wallin, *How Startup America Can Make Life Better For Startups: Allow General Solicitation (Installment 2)*, STARTUP L. BLOG (Feb. 9, 2011), http://www.startuplawblog.com/2011/02/09/how-startup-america-can-make-life-better-for-startups-installment-2/ (stating, "[O]ne of the pieces of advice I regularly give my startups in the middle of a financing round is: 'We are going to file the Form D as required; the media is going to call you to ask about your offering–you cannot talk to the media about your securities offering while it is ongoing. So, don't talk to them.'").

[189] SEC Release 9354, *supra* note 96, at 48–49.

[190] *Id.*

and more diverse pool of potential investment opportunities."[191] Furthermore, there would be reduced information asymmetries due to the removal of the general solicitation ban.[192] This could lead to more accurate and reliable pricing of the securities offered.[193]

The purposed Rule 506 will also have an effect on private markets as well as the public market.[194] The cumulative effects mentioned above could potentially create a shift in investments from public equity and debt markets, or other private markets, to the Rule 506 market.[195] Furthermore, this could have a negative impact for the IPO market, as companies choose to stay private longer by taking advantage of Rule 506(c).[196]

As for Rule 144A, permitting general solicitation could "significantly affect private trading systems by permitting information vendors to provide more information about Rule 144A securities."[197] Information about Rule 144A offerings could be made public, as long as sales were limited to QIBs.[198] These improvements supporting greater dissemination of information could lead to increased market efficiency.[199] However, the removal of the general solicitation ban is unlikely to lead to a greater number of potential investors because the QIB field is already limited.[200]

The effect of the Title V and VI changes will be substantial. First, the registration threshold increase will significantly reduce the number of companies that will need to register because of the Section 12(g) triggers. For example, an SEC study found that of the 2,524 companies registered under Section 12(g), only 318 had two thousand or more shareholders of record.[201] While this information does not show how many companies on the precipice of reaching the old five hundred-shareholder limit would be affected, it is indicative that most of the companies registered under the old threshold would

---

[191] *Id.* at 49.

[192] *Id.*

[193] *Id.*

[194] *Id.* at 50.

[195] *Id.*

[196] Brian Hamilton, *The JOBS Act: IPO on-ramp or public company off-ramp?*, FORBES (Mar. 7, 2012, 11:34 AM), http://www.forbes.com/sites/sageworks/2012/05/07/the-jobs-act-ipo-on-ramp-or-public-company-off-ramp/ (stating, "Several aspects of the JOBS Act will help companies that want to stay private do so, even if they previously were on the cusp of being forced to go public.").

[197] SEC Release 9354, *supra* note 96, at 101.

[198] *Id.*

[199] *Id.*

[200] *Id.* at 47.

[201] U.S. SEC. EXCH. COMM'N, REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12G5–1 AND SUBSECTION (B)(3) 26 (2012), *available at* http://www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf.

not meet the new threshold.

Furthermore, Title VI could potentially keep hundreds of small banks private that were on the cusp of the registration threshold, and even lead to many banks deregistering.[202] "Just 16% of the nation's roughly 7,400 banks and thrifts are publicly traded. . . . Many of those are thinly traded, but most are required to file quarterly and annual financial reports with the securities agency."[203] Under the JOBS Act, banks with fewer than 1,200 shareholders of record may deregister and no longer file financial information.[204] As such, many banks are taking advantage of the new deregistration limit. For example, Coastal Banking Company, a bank with $475 million in assets, deregistered in May 2012.[205] It is now saving $150,000 to $200,000 a year.[206] Likewise, Harleysville Saving Financial deregistered in December 2012 and saved six cents per share.[207] Additionally, deregistration opens doors to a number of banks that were in search of additional capital, but were close enough to the threshold that they could not take on any more investors.[208]

The exclusion of securities offered as employee compensation will also decrease the number of companies registering under 12(g). Employee compensation has had an effect on large companies and their decision to conduct IPOs. For example, Microsoft, Google, and Facebook all faced the five-hundred-person threshold from their employee base alone.[209] However, there are many companies that go public without reaching the 12(g) threshold.[210] Furthermore, this provision essentially creates more options for companies and their employee compensation packages because there is already several exempt compensation forms for the 12(g) threshold.[211] One area where the increase in the threshold corresponds with the employee compensation is when employees exercise their stock options because the exemption no longer applies.[212] Thus,

---

[202] Robin Sidel, *Small Banks Get A Freer Hand*, WALL ST. J., April 23, 2012, http://online.wsj.com/article/SB10001424052702304331204577351780448668826.html.

[203] *Id.*

[204] *Id.*

[205] Vincent Ryan, *JOBS Act Opens Path to Deregistration*, CFO, Mar. 12, 2013, http://ww2.cfo.com/capital-markets/2013/03/jobs-act-opens-path-to-deregistration/.

[206] *Id.*

[207] *Id.*

[208] *Id.*

[209] Tyler Adam, *supra* note 155, at 113.

[210] *Id.* at 114.

[211] *Id.* Rule 12h–1(a) of the Exchange Act "exempts employee stock from the provisions of § 12(g)." *Id.* Furthermore, Rule 701 exempts issuers from offerings under written compensatory benefit plans. 17 C.F.R. § 230.701(c) (2012). Then, in 2007, the "SEC amended the §12h–1 to exempt stock options for issuers not subject to the Exchange Act's reporting requirements." Tyler Adam, *supra* note 155, at 115.

[212] Tyler Adam, *supra* note 155, at 115.

the increased threshold would catch those individuals.

*D. Negative Effects on Private Markets*

Many provisions of the JOBS Act reduce the amount of information that companies are required to disclose to investors. Consequentially, when disclosure requirements are reduced, there is an increased probability for fraud. For example, cases for securities fraud are already being filed against parties taking advantage of the JOBS Act provisions.[213] In one prospectus, a company claimed to be an EGC, when it was barely a company at all.[214] These statements can easily mislead investors and give rise to costly litigation. Likewise, the biggest concern for fraud may be in connection with the crowdfunding provisions of Title III, which is outside the purview of this note.[215] Fraud has a negative impact on the markets as a whole. For instance, fraud hurts investor confidence, which in turn increases the cost of capital for companies in need.[216] Thus, a potential influx of securities fraud could outweigh the benefits in capital formation under the JOBS Act.

There are also concerns about the potential of fraud associated with the proposed Rule 506 changes.[217] Eliminating the general solicitation ban could provide fraudsters easier access to investors.[218] For example, private equity and hedge funds could target less sophisticated individuals through advertising.[219] This could decrease confidence in the 506(c) market, as well as in private markets in general.[220] Furthermore, "some issuers with publicly-traded securities may use general solicitation for a purported Rule 506 offering to generate investor interest in the secondary trading markets, especially in the over-the-counter markets, which could be used by insiders to resell securities at inflated prices." This would impose additional costs on investors, and thus potentially raise the cost of capital for 506(c) issuers.[221]

There is less of a potential for fraud under Rule 144A because there is

---

[213] Floyd Norris, *Fraud Case Delayed By 2 Months*, N.Y. TIMES, Nov. 2, 2012, at B1.

[214] *Id.*

[215] *See generally* Thomas Lee Hazen, *Crowdfunding or Fraudfunding: Social Networks and the Securities Laws—Why the Specially Tailored Exemption must be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735 (2012).

[216] SEC Release 9354, *supra* note 96, at 52.

[217] *Id.*

[218] *Id.*

[219] Steven Rattner, *A Sneaky Way to Deregulate*, N.Y. TIMES (Mar. 3, 2013, 9 PM), http://opinionator.blogs.nytimes.com/2013/03/03/a-sneaky-way-to-deregulate/.

[220] SEC Release 9354, *supra* note 96, at 52.

[221] *Id.*

always an intermediary involved in the transaction.[222] The intermediaries' due diligence provides further protection from fraud.[223] Moreover, QIBs are generally sophisticated enough to identify fraudulent activity, unlike many retail investors.[224]

Although Titles V and VI of the JOBS Act will decrease the burden associated with registering securities, investors may be put in jeopardy. As mentioned above, the reason for the 12(g) reporting requirements was to provide more supervision of companies with securities traded in secondary markets. Substantially reducing the number of companies required to register has the possibility of increasing fraud and, consequentially, litigation.

Some costs associated with the new regulations are worth noting. Recall that Rule 506 offerings may be made through public solicitation as long as the issuer takes reasonable steps to verify that purchasers are accredited investors.[225] While the SEC does not list required steps to verify that a purchaser is an accredited investor, it will consider a number of factors surrounding the facts and circumstances of the transaction.[226] These circumstances include: the nature of the purchaser, the information the issuer has about the purchaser, and the nature of the offering.[227] Thus, counsel should advise their clients to establish and maintain a record keeping system, in case of any subsequent inquiries by the SEC.

### *E. Missed Opportunities*

The increased limit on the offering size under Regulation A will attract the attention of many potential investors.[228] However, the Government Accountability Office (GAO) interviewed small business owners, investors, and attorneys regarding the new class of securities and received mixed results.[229] One of the major causes of the decline in Regulation A use has been the fact that Regulation A offerings are not exempt from state blue sky laws.[230] "Identifying and addressing the securities registration requirements of individual states is

---

[222] *Id.* at 53. Intermediaries must be used because Rule 144A applies to private resales of securities to institutions. *See* 17 C.F.R. § 230.144A.

[223] SEC Release 9354, *supra* note 96, at 53.

[224] *Id.*

[225] *Id.* at 11.

[226] *Id.* at 14.

[227] *Id.*

[228] *See* GAO, SECURITIES REGULATION, *supra* note 118, at 16.

[229] *Id.*

[230] *Id.* at 17. Blue sky laws, as they are commonly referred to, are state securities regulations. *See generally id.*

both costly and time-consuming for small businesses . . . ."[231] Furthermore, the qualifying process is a detriment to Regulation A and the new class of securities.[232] According to the GAO, interviewees claimed that working with the SEC is "time-consuming and costly."[233] For example, the "process of receiving and addressing comments from [the] SEC could entail multiple rounds that involve[] attorneys and accountants . . . ."[234] The average review process takes approximately 288 days to complete from the day the offering statement was filed.[235] Such a lengthy process adds costs and uncertainty to the offering. So long as other offering exemptions preempt state laws, have less burdensome filing requirements, and offer unlimited offering sizes, Regulation A and the new class of securities akin to Regulation A will continue to be underutilized.

While the JOBS Act reduces the regulatory burden associated with capital formation, it fails to address other causes associated with the decline in IPOs.[236] Many authors have claimed that the decline in IPOs stemmed from the Sarbanes-Oxley requirements. Other authors have argued that the "ecosystem" of underwriters and investors has created benefits focusing on large capital companies, leaving small capital companies out.[237] While the primary reasons for the decline can be argued, it's clear that both, and even others, have an effect on the number of IPOs. To the extent that regulations hinder small companies from going public, the JOBS Act will alleviate some of the effect through Title I. However, the JOBS Act itself does little to change the IPO ecosystem.[238] Section 106(b) of the JOBS Act requires the SEC to conduct a study of the effect of tick sizes. The failure to account for the effects of decimalization will substantially reduce the effectiveness of the JOBS Act in growing the IPO market.

## V. CONCLUSION

The passage of the JOBS Act signified a bipartisan effort to restore United States capital markets, especially the IPO market.[239] Over the last decade, the number of IPOs has significantly decreased, thanks to a number of factors.

---

[231] *Id.*

[232] *Id.* at 16.

[233] *Id.*

[234] *Id.*

[235] *Id.* at 12.

[236] Jay R. Ritter et al., *Where Have All the IPOs Gone?* 1 (Working Paper, 2013) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954788.

[237] *Id.* at 2.

[238] JOBS Act, *supra* note 58, § 106(b). For more information regarding tick sizes, see Part I.

[239] *See* Part I.

First, the reporting requirements increase to costs and risks of conducting an IPO.[240] Second, changes in the securities and investment fields, such as decimalization, have decreased incentives for underwriters and investors when it comes to small emerging companies. And finally, small public companies have produced below-average returns for investors, shifting investor focus away from small capital IPOs.[241] On top of this, studies have shown that IPOs produce numerous jobs, a statistic that is emphasized in a United States' economy desperate for growth.[242]

Title I of the JOBS Act provides a so-called "On-Ramp" for emerging growth companies with less than $1 billion in revenue.[243] This On-Ramp reduces the disclosure requirements associated with conducting an IPO, while also permitting more communications between the issuer and others involved in the IPO process.[244] Research has shown that qualifying companies are taking advantage of the IPO On-Ramp and specifically the provisions allowing a company to opt-out of changes in the accounting standards.[245] Thus, it seems like the IPO On-Ramp provides the required incentives to foster EGC IPOs.

While the On-Ramp provides a basis for small companies to go public, other titles of the JOBS Act create incentives for companies to stay private longer. For example, Title II removes the general solicitation ban on Rule 506 offerings. This makes the most used registration exemption even more valuable. Issuers will now be able to advertise their offerings and avoid the expense of hiring an intermediary. Thus, if a company does not need the benefits of going public, Rule 506 is still a great option for increased investment.

Titles IV, V, and VI also decrease the incentives to go public and foster an environment to stay private. Title IV increases the rarely-used Regulation A dollar amount from $5 million to $50 million. However, Regulation A offerings still must comply with state blue sky laws, which inhibit the effect and use Regulation A actually has. Titles V and VI increase the shareholder-of-record threshold from five hundred to two thousand persons under Section 12(g) of the Exchange Act. Increasing the limit, as explained above, has the effect of keeping more companies outside the purview of SEC reporting. Thus, there is a greater incentive to conduct exempt offerings instead of conducting an IPO.

While the JOBS Act is a start at reforming many outdated securities laws, it doesn't solve many other issues. For example, decimalization will still have a

---

[240] *See* Part I.

[241] *See* Ritter, *supra* note 236, at 2.

[242] *See* Part I.

[243] *See* Part III.A.

[244] *See* Part III.A.

[245] *See* Part III.A.

profound effect on small company IPOs. There just is not a large enough incentive for research analysts and underwriters to focus on these companies. Until the SEC focuses on systematic changes in the public markets, it is unlikely that IPO markets, and consequently the jobs market, increase.