The JOBS Act Represents An Important Step in the Right Direction

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On Tuesday, the House passed the Senate-amended JOBS Act (the "**Act**"), a piece of legislation designed to promote economic growth by improving small business accessibility to public and private capital markets. The Act could dramatically change the playing field for small businesses, giving them significantly more flexibility in raising capital, as well as the ability to preserve capital by easing regulatory burdens.

As passed, as is the case with most legislation, the Act is not perfect. In some areas, the Act may have gone too far, while in others, it may not have gone far enough. Still, imperfect or even problematic as certain provisions of the Act may be, it is an important step in the right direction, a very visible acknowledgement of the fact that improving access to capital and reducing the regulatory burden for small and emerging companies is long overdue.

"Emerging Growth Companies". The Act establishes a new category of publicly-held company known as "emerging growth company" ("**EGC**"), defined as businesses with less than $1 billion in revenue, and exempts such businesses from certain costly regulatory and disclosure obligations. Such companies could maintain their status as EGCs for a period of up to five years after going public. Easing disclosure and reporting obligations for smaller companies is necessary to encourage such companies to go public and go on to contribute significantly to job creation. The Act, however, fails to go far enough in that regard. Reduced regulatory burdens should be tied to a company's size—not necessarily the number of years it has been public. Only emerging companies that have completed initial public offerings ("**IPOs**") since December 11, 2011, are in the process of completing IPOs, or are planning to undertake IPOs, are eligible to qualify for EGC status; for the most part, the EGC definition excludes existing small public companies, regardless of the number of years they have been public. In addition, the $1 billion in revenue threshold may allow certain significant companies to escape more stringent regulation necessary for investor protection. Similarly, relaxing certain disclosure obligations pertaining to financial statements may increase the likelihood of fraud or unintentional errors in financial reporting, leading to restatements. Finally, reducing the cost of going public or staying public does nothing to solve the market's structural problems. The one-size-fits-all stock trading model (derived from trading rules that reduce commissions and stock spreads making it unprofitable for traders and brokers to focus on smaller-cap equities) still undermines incentives to trade in small- and micro-cap company equities. The lack of financial information—perhaps precisely due to reduced disclosure obligations—could be perceived to increase risk in and thus further inhibit small-cap trading.

Raising Shareholder Threshold from 500 to 2,000. The Act amends Section 12(g) of the Securities Exchange Act of 1934 (the "**1934 Act**"), which requires private companies with over 500 shareholders of record and $10 million in total assets to become reporting companies under the 1934 Act. Section 12(g) may effectively force companies to go public at times when doing so may not be in their or their shareholders' best interests. To provide relief in this area, the Act increases the threshold to 2,000 shareholders of record or 500 persons who are not accredited investors. Though the ideal threshold may be debatable, it is clear that the current threshold of 500 shareholders of record—which was established in 1964—is no longer appropriate. The world is a very different place than it was in 1964; the market functions under a fundamentally different framework where everything from market regulations, trading rules, incentives, investment vehicles and arguably even principles, have changed. A related issue unaddressed by the Act goes to how shareholders are counted for purposes of Section 12(g). In 1964, shares of public companies tended not to be held in street name, and for all practical purposes, shareholders of record were the beneficial holders. Today a public company could easily have fewer shareholders of record than a private company, but many more beneficial shareholders, with the result being that the public company could be subject to less regulation than the private company.

Regulation A and Regulation D Offerings. The new legislation increases the limit on Regulation A offerings from $5 million to $50 million, thereby making the rarely utilized regulation more attractive. However, although increasing the ceiling to $50 million is a move in the right direction, such offerings are likely to remain unattractive because they would still be subject to separate regulation by the securities regulators in each state in which the offering is made. Regarding the Act's changes to Regulation D, permitting general solicitation in Rule 506 offerings where all purchasers are accredited investors, thereby correctly focusing on the nature of the investors and not on how they were obtained, will enable emerging companies to cast a wider net when seeking capital. Still, when generally soliciting a broader audience, startups must carefully consider the risk of overly exposing information about their businesses, trade secrets, and intellectual property.

Crowdfunding. One of the more controversial pieces of the Act is the new safe harbor for "crowdfunding" under Section 4 of the Securities Act of 1933. The new Section 4(6) exempts from registration offerings made through a broker or "funding portal" without regard to investor status if such offerings are under $1 million in the aggregate over a 12-month period. While crowdfunding may conceptually be a good idea, enabling small entrepreneurs otherwise unable to access capital to obtain seed funding, as a practical matter, presents certain significant issues. Most importantly, crowdfunding may open doors for fraudsters to more easily take advantage of unsophisticated investors over the internet. While limiting the size of the offering and the size of individual investments may limit potential losses, it will do nothing to prevent fraud. The potential for disparate impacts is also worth considering: $10,000 for someone who makes $100,000 or less a year may be a much more significant loss than $100,000 for someone who makes $1 million or more a year. In addition, the administrative costs involved in managing hundreds of shareholders could be significant. And more importantly, crowdfunded startups may have difficulty attracting follow-on funding from venture capitalists and other professional investors given the issues arising from having many unsophisticated investors. As a final note, the Act's crowdfunding rules themselves may prove too unwieldy and uncertain for a startup to maintain compliance without the assistance of securities counsel—potentially undermining the economics.

With any important endeavor, there are competing interests and a required balancing of risks and benefits. The task of facilitating the growth of emerging companies while protecting investors is no exception. Perhaps a part of the answer is a greater emphasis on enforcement. As it stands now before President Obama, the JOBS Act is not perfect. But the Act contains several provisions that could significantly improve the landscape in which emerging companies operate—necessarily moving us in the right direction.

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