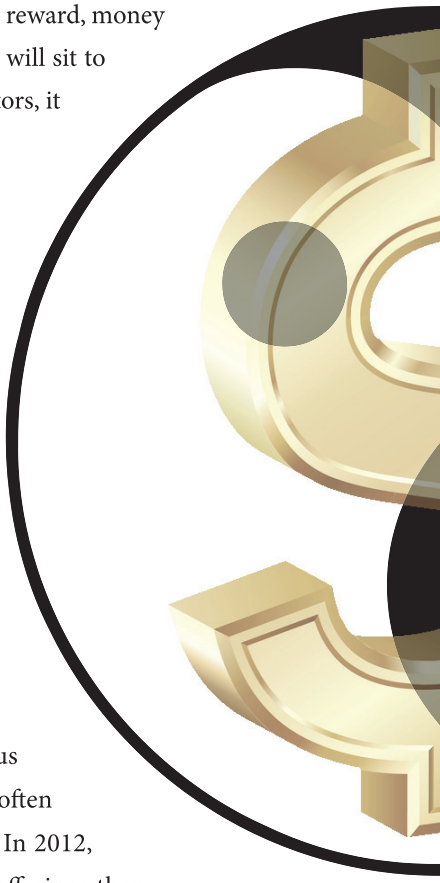
Risk v. Reward – Why the JOBS Act Isn't Living Up to its Name

By Cory D. Olson

Cory D. Olson is a trial attorney with Anthony Ostlund Baer & Louwagie P.A., a 20-attorney litigation boutique in Minneapolis. Cory represents clients in a variety of business disputes, with a significant portion of his practice focused on representing securities professionals and firms in regulatory investigations and arbitrations. A graduate of the University of Minnesota, Cory has written and spoken on employment, shareholder and securities matters. Visit www.aoblaw.com or email colson@aoblaw.com for more information.



Risk and reward are the yin and yang of investing. Increase the reward, money will pour into the market. Increase the risk, and the money will sit to the side. Although this basic concept is known well by investors, it seems to have escaped Congress and the SEC.

At issue is the Jumpstart Our Business Startups (JOBS) Act. The JOBS Act is a rare instance of Washington bipartisanship, receiving the support of 380 representatives and 73 senators. At the April 2012 bill signing, President Obama touted the act as "exactly the kind of bipartisan action we should be taking in Washington to help our economy" and "a potential game changer."

What was this game changer? The JOBS Act gave the SEC 90 days to eliminate an 80-year-old ban on public solicitation of the most common type of Regulation D, or Reg D, offerings. Under the Securities Act of 1933, any offer to sell securities must be registered with the SEC. Reg D contains three exemptions to the registration requirement, allowing companies (or issuers) to offer and sell securities without the same onerous reporting requirements on registered securities. Entrepreneurs often use Reg D to raise significant capital for their startup companies. In 2012, more than **four times** as much capital was raised through Reg D offerings than through IPOs.

There are two primary restrictions on Reg D offerings. First, the securities can be sold only to accredited investors (typically an investor with a net worth exceeding $1 million or an annual income exceeding $200,000) and no more than 35 unaccredited investors. This limits the number of potential investors in Reg D offerings; only 7 percent of households qualify as accredited investors. Second, issuers cannot sell securities through general solicitations or advertisements. That makes finding the 7 percent much more difficult.

The JOBS Act called for lifting the solicitation ban for Rule 506 offerings. Once lifted, issuers would be able to promote their shares on television, radio, and the Internet. That would make it easier for issuers to raise capital, expand operations and hire new workers. But, there was a trade-off. Out of concern for fraud or abuse, Congress instructed that new rules require issuers "to take reasonable steps to verify that [all] purchasers of securities are accredited investors." This would be more stringent than existing rules, which required issuers to "reasonably believe" an investor was accredited.

So far, the JOBS Act has not lived up to its name. The first problem is timing. The SEC did not issue final rules until July 2013, more than a year after Congress' deadline. Final implementation of the new rules did not occur until September 23, 2013, meaning the new rules are just a few weeks old. Second, now that we have the rules, issuers need to ask themselves, is it really worth it?

To carry out the JOBS Act, the SEC created a new subdivision, subdivision (c), to Rule 506. Issuers and promoters of Rule 506(c) offerings may publicly solicit investments; however, they must also verify each investor's accredited status. An issuer is deemed to have done so if it (1) reviews tax returns to verify an investor's income; (2) calculates an investor's net worth from third-party statements of assets and liabilities; or (3) obtains written confirmation from an attorney, accountant, investment adviser, or public accountant that the investor is accredited. While subdivision (c) specifically states that these

are "non-exclusive and non-mandatory methods," they set the benchmark for compliance.

Bear in mind, the SEC's amendment did not rewrite existing provisions of Rule 506, which remain available to issuers. So in deciding which exemption to use, issuers and promoters must determine whether the increased exposure to investors, less the cost of compliance, is worth the risk of getting something wrong. Does the reward justify the risk?

It very well may not. Take the cost of verifying an investor's status. Do entrepreneurs want to spend their time or money reviewing IRS returns or account statements to ensure each investor meets the required thresholds? And once issuers receive sensitive financial information, do they want the potential liability associated with maintaining them so they can prove they are complying with Rule 506(c)? There is also increased risk of unintentional violations. Under Rule 506(b), issuers need only "reasonably believe" an investor was accredited. Even if an investor did not qualify, the rule allowed for as many as 35 unaccredited investors. But Rule 506(c) requires **every** investor to be accredited. A single mistake would mean the offering no longer complies with Reg D. That poses significant risk to issuers and promoters.

To make matters worse, on the same day the SEC issued the new 506(c), it issued proposed rules that, if enacted, will **increase** the risk and expense to issuers. As written, the rules require issuers to complete an expanded Form D at least 15 days before the first general solicitation and no more than 30 days after the termination of an offering. If an issuer violates the new Form D requirements, the issuer will be prohibited from relying on Rule 506 for a one-year period. Issuers will need to place the investment equivalent of a surgeon general's warning on solicitations and file solicitations with the SEC before using them in public.

The SEC claims the new rules are necessary to review and analyze the changes prompted by the JOBS Act and inform investors about the increased risks typically associated with Reg D offerings. Those are laudable goals. But, if the rules create significant risk and expense, as these rules do, then issuers will forgo Rule 506(c) and the benefits of increased publicity.

Risk must be balanced with the reward. If the JOBS Act is going to fulfill its potential, then the enacting rules must encourage the flow of capital, not impede it. Unless the SEC reduces the risk or increases the reward of Rule 506(c) offerings, the JOBS Act will not meet its potential.