AN EXAMINATION OF THE JUMPSTART OUR BUSINESS STARTUPS ACT: HOW JOBS ACT EXEMPTIONS MAY HELP STARTUPS AND HURT INVESTORS

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I. INTRODUCTION

In 2012, President Obama signed into law the Jump Start Our Business Startups (JOBS) Act.[1] The primary purpose of this legislation was to provide small businesses and startups with exemptions from state and federal regulations, allowing them access to capital revenue that would otherwise be unavailable based on the cost of compliance.[2]

The most common ways for entrepreneurs to obtain capital are debt financing and equity financing.[3] In debt financing, an entrepreneur approaches a lender, usually a commercial lending institution or a bank, and obtains a loan.[4] The borrower is then required to make interest payments to compensate the lender for use of the capital.[5] The amount of interest is dependent upon market and other risk factors, and lenders are generally cautious when providing loans to businesses that do not have an established track record.[6] As a result, banks will usually charge new businesses a very high rate of interest or, if interest rates are exceedingly low, may refuse to offer loans altogether.[7]

In addition to debt financing, entrepreneurs can also utilize equity financing.[8] Equity financing involves finding investors who are willing to provide capital in exchange for a stake in the new company.[9] Equity financing as a means of obtaining capital is not without its own issues.[10] As previously discussed, new ventures carry an inherent amount of risk, and this risk provides investors with an advantageous bargaining position when dealing with entrepreneurs.[11] This leverage allows potential investors to negotiate favorable equity splits and gives them influence over business decisions.[12] The recent financial crisis has exacerbated

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1. Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012).

2. 7 ALAN R. BROMBERG, LEWIS D. LOWENFELS & MICHAEL J. SULLIVAN, BROMBERG & LOWENFELS ON SECURITIES FRAUD § 13:206 (2d ed. 2016).

3. *See* Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 60–61 (1998).

4. *See* 20 ELIZABETH S. MILLER & ROBERT A. RAGAZZO, TEXAS PRACTICE SERIES: BUSINESS ORGANIZATIONS § 28:4 (3d ed. 2015).

5. *Id.*

6. Fisch, *supra* note 3, at 60.

7. *See* Kurtis Urien & David Groshoff, *An Essay Inquiry: Will the Jobs Act's Transformative Regulatory Regime for Equity Offerings Cost Investment Bankers' Jobs?*, 1 TEX. A&M L. REV. 559, 564–565 (2014).

8. *See* 20 MILLER & RAGAZZO, *supra* note 4.

9. *Id.*

10. *See* Urien & Groshoff, *supra* note 7, at 565.

11. *See* John S. Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 611 (2013).

12. *See id.*

this problem as traditional venture capitalists have become extremely risk averse, with the result that entrepreneurs are finding it more and more difficult to obtain funding.[13] Generally, when companies take on equity investors they may opt for a corporate structure that reduces liability and tax consequences such as a partnership or Limited Liability Company (LLC), all of which come with incidental costs.[14]

Given the difficulty and expense of obtaining capital, capital funding has traditionally been reserved for well-defined companies with national or international application, leaving out a huge number of largely local or conceptual businesses.[15] The JOBS Act seeks to remedy this by providing nontraditional means of capital with the goal of funding more companies and spurring the growth of companies already in existence.[16]

The JOBS Act has three significant portions: Title I, which deals with the initial public offering (IPO) process;[17] Title II, which, subject to certain stipulations, lifts the Securities Exchange Commission's (SEC) restrictions on the solicitation and advertising of securities;[18] and Title III, which deals with funding portals and funding from unaccredited investors, again subject to certain limitations.[19]

Certain pundits and consumer protection groups say the benefits of the JOBS Act come at too high a cost.[20] They argue that the exceptions created by the JOBS Act preempt and weaken established securities regulations,[21] specifically: the Sarbanes Oxley Act;[22] the Dodd-Frank Act;[23] the Securities Act of 1933;[24] the

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13. *See generally*, *The Cost of Repair*, ECONOMIST (Oct. 7, 2010), http://www.economist.com/node/17173933 [http://perma.cc/WL8J-XFD6].

14. *See generally*, ROBERT A. RAGAZZO & FRANCES S. FENDLER, CLOSELY HELD BUSINESS ORGANIZATIONS, CASES, MATERIALS, AND PROBLEMS (2d. ed. 2012).

15. Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve A Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 973–74 (2011).

16. *See generally*, Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012).

17. *Id.* §§ 101–108.

18. *Id.* § 201.

19. *Id.* §§ 301–305.

20. *See e.g.*, Letter from William Samuel, American Federation of Labor and Congress of Industrial Organizations, to Sen. Tim Johnson and Rep. Richard Shelby (Feb. 29, 2012), http://www.aflcio.org/content/download/11531/143881/file/capital_formation022912.pdf) [http://perma.cc/75XF-BVEM].

21. *Id.*

22. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002).

23. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

24. 15 U.S.C. § 77a (2015).

Securities Exchange Act of 1934;[25] and various State Blue Sky Laws.[26] All of these pieces of legislation were aimed at preventing investor fraud as well as curbing specific unethical practices such as "boiler rooms,"[27] insider trading, and analyst advocacy.[28] Thus, critics fear that the cumulative effect of weakening these pieces of legislation is that investors, especially elderly investors, will be put at risk.[29] They argue that these risks are made even greater by the JOBS Act's implicit reliance on the Internet, a resource whose global reach and anonymity make it ripe for fraudulent activity.[30]

The questions raised by the passage of the JOBS Act are numerous. Is the act even necessary? Will the exceptions it creates actually reduce the costs associated with capital funding and registration? Certainly some startups received funding even before passage of the JOBS Act, so whom exactly will the act benefit? Is the risk of fraud as great as critics say? This article seeks to answer all these questions by analyzing three distinct areas. Part I will examine the various pieces of legislation preempted by the JOBS Act, focusing on their functions, legislative histories, and the impact that they have had on entrepreneurs and startups. Part II will examine whether the JOBS Act has actually had the effect that Congress intended in passing it, specifically focusing on how it has affected the startup market, venture capitalists, and the secondary market for securities. Part III will analyze how the recently finalized rules promulgated by the SEC on the JOBS Act Title III crowdfunding provision are likely to affect industry and investors moving forward, as well as examining the difficulties and delays the SEC has faced in trying to adopt specific regulations for Title III. Finally, Part IV will conclude that the JOBS Act, while set back by delays and potentially subverted by some of its own provisions,

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25. 15 U.S.C. § 78a.

26. TEX. REV. CIV. STAT. ANN. art. 581–33 (West 2010).

27. A "boiler room" is an operation where a large number of brokers utilize telephone solicitation and high-pressure sales tactics to peddle speculative or even fraudulent securities on unwary investors. Susan Heinemann, *Reviewing the Current State of Government Regulation of Investment Advisors*, 42 DUQ. L. REV. 113, 121 n.86 (2003).

28. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010); 15 U.S.C. § 77; 15 U.S.C. § 78; TEX. REV. CIV. STAT. ANN. art. 581–33.

29. Editorial, "*They Have Very Short Memories*," N.Y. TIMES, Mar. 10, 2012, at SR10. (discussing how the JOBS Act's exemptions of even very new Securities Laws, such as the Dodd Frank Act, demonstrate the SEC's apparent lack of concern for consumer protection or for the JOBS Act's potential for abuse, especially of elderly investors).

30. Fisch, *supra* note 3, at 58.

still represents a significant tool for entrepreneurs moving forward.

This article contributes in several aspects. First, it examines how entrepreneurs have actually applied the JOBS Act since its inception. Second, it analyzes how the JOBS Act is affecting not just entrepreneurs, but also venture capitalists and how securities are exchanged in secondary markets. Finally, it examines the SEC's continued delays in adopting set regulations for Title III and how the new finalized rules may affect the industry moving forward.[31]

II. LEGISLATION PREEMPTED BY THE JOBS ACT

A. *The Securities Act of 1933*

After the stock market crash of 1929 and the ensuing Great Depression, Congress was compelled to enact federal legislation to regulate the offer and sale of securities.[32] The legislation that was enacted was the Securities Act of 1933.[33] The Act functions as the congressional grant of authority from which the SEC derives its power, and proscribes that any offer or sale of securities using the instrumentalities of interstate commerce, which is to say all offers or sales, must be registered with the SEC.[34] The main purpose of the act is disclosure.[35] It requires all issuers to provide information that a reasonable stockholder would deem pertinent in determining whether or not to invest.[36] These disclosures include, at minimum, a registration statement, prospectus, and audited financial statements.[37] The Act also created the animus for modern day due diligence by making the issuing company and any

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31. *See* Lawrence A. Hamermesh & Peter I. Tsoflias, *An Introduction to the Federalist Society's Panelist Discussion Titled "Deregulating the Markets: The Jobs Act"*, 38 DEL. J. CORP. L. 453, 467–68 (2013) (referencing the panel discussion of SEC Commissioner Daniel Gallagher).

32. *See generally* Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1340–41 (1966).

33. 15 U.S.C. § 77a.

34. *See id.* § 77e(c). The SEC has interpreted all sales of securities as using the instrumentalities of interstate commerce and thus all securities offered and sold in the United States fall under the Act. *Id.*

35. *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1269 (1999) (referencing the Act's focus on disclosure and quoting Justice Brandeis's famous adage that "sunlight is said to be the best of disinfectants. . . .").

36. 15 U.S.C. § 77g.

37. *Id.*

underwriters strictly liable for any inaccuracies in the disclosed information.[38]

The JOBS Act modifies the Securities Act of 1933 in several ways.[39] The most prominent change was the creation of a new type of issuer, the "EGC" or emerging growth company. An issuer may qualify as an EGC if they have total annual gross revenues of less than $1,000,000,000 during their most recently completed fiscal year.[40] Any issuer that is classified as an emerging growth company as of the first day of that fiscal year shall continue to be deemed an emerging growth company 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 (as such amount is indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, setting the threshold to the nearest 1,000,000) 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 to an effective registration statement under the Securities Act of 1933; (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.[41]

Companies classified as EGCs under the JOBS Act face less stringent compliance requirements both during their IPO and for several years after going public.[42] Specifically, EGCs are only required to provide two years of audited financial statements as opposed to the Securities Act's ordinary three year requirement. The Securities Act's requirements are further reduced for EGCs in that they are only required to provide financial data as far back as the earliest audit period presented in their Securities Act registration statement. This means that the only data EGCs are

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38. *Id.* § 77k.

39. Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306, 307 (2012).

40. *Id.*

41. *Id.*

42. *See* Rouzhna Nayeri, *Did the Jobs Act Do Its Job? Analysis of The Emerging Growth Company's Classification, Impacts, Criticisms, Implementation, and Recommendations for Improvement*, 42 SEC. REG. L. J. 317, 327 (2014).

required to disclose is their present financial data at the time of filing.[43]

In addition to the creation of EGCs, the JOBS Act also created several new exemptions to go along with the ones already found in the Securities Act of 1933. Section 302 of the JOBS Act modifies section 4 of the Securities Act of 1933 by providing an exemption for:

> [T]ransactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that (A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12–month period preceding the date of such transaction, is not more than $1,000,000; (B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12–month period preceding the date of such transaction, does not exceed (i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.[44]

This exemption would allow companies to raise up to $1,000,000 in capital annually in increments of $2,000–$10,000 (depending on whether the investor was accredited[45] or unaccredited) all with very little in terms of financial or operational disclosures to the SEC.[46]

Another JOBS Act provision that significantly modifies the Securities Exchange Act is section 201(a)(2) which stipulates:

> [T]he Securities and Exchange Commission shall revise its rules issued in section 230.506 of title 17, Code of Federal

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43. *Id.*

44. Jumpstart Our Business Startups Act § 302.

45. The Jobs Act defines an "accredited investor" as a natural person who: has earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or, has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence). 17 C.F.R. § 230.501(a). An "accredited investor" may also be an entity such as a bank, partnership, corporation, nonprofit or trust, when the entity satisfies certain criteria. Jumpstart Our Business Startups Act §§ 105, 302; 17 C.F.R. § 230.501(a) (2016).

46. *See* Bromberg, Lowenfels & Sullivan, *supra* note 2.

> Regulations, to provide that the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors. Such rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission.[47]

This modification lifts the general ban on the advertising of securities and allows for general solicitation as long as sales are limited to accredited investors.[48] While this modification may seem inconsequential, the SEC and Financial Industry Regulatory Authority (FINRA) have traditionally taken an extremely expansive view of what constitutes solicitation/advertising.[49] The result of this broad application is that a large number of companies have been penalized for inconsequential violations.[50] Companies whom the SEC determines have violated the ban on advertising are barred by the Securities Act from making any sale offers or sales for a proscribed "cooling off period."[51]

Finally, section 401(a) of the JOBS Act modifies the Securities Act by creating an exemption from the more stringent section 77 auditing requirements for securities with an aggregate offering amount of no more than $50,000,000 for the prior 12-month period.[52]

B. *The Securities Exchange Act of 1934*

The Securities Exchange Act of 1934 is similar to the Securities Act of 1933 except that instead of regulating the primary market and issuance of securities it regulates the secondary market for securities.[53] As such, the 1934 Act primarily deals with regulations for brokers and exchanges.[54]

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47. Jumpstart Our Business Startups Act § 201(a)(1).

48. *See* Hamermesh & Tsoflias, *supra* note 31, at 458 (discussing the SEC lifting the general ban on the advertising of securities).

49. *Id.* at 485–86.

50. *Id.*

51. *Id.*

52. Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 401(a), 126 Stat. 306, 323–24 (2012).

53. *See* 15 U.S.C. § 78b (2015).

54. *See id.*

Section 304 of the JOBS Act modifies section 3 of the Securities Exchange Act of 1934 by creating exemptions for SEC approved funding portals, i.e. crowdfunding websites, from broker/dealer registration requirements.[55] This means that any intermediary may broker the sale of securities for capital funding up to $1,000,000 per company annually as long as the intermediary is subject to the authority of the SEC and registers as a member of the national securities association.[56]

Section 12(g)(1)(a) of the Securities Exchange Act is also modified by section 501 of the JOBS Act.[57] Section 501 alters the requirements for when an issuer must register their securities with the SEC, increasing the pre-reporting maximum total assets to $10 million and maximum shareholders of record from 500 to 2,000.[58]

C. *The Sarbanes-Oxley Act*

The Sarbanes–Oxley Act (SOX) was enacted in 2002 in the wake of the Enron and WorldCom scandals and was aimed at ensuring regular reporting of publically traded companies' auditing and accounting practices.[59] The most significant provision of the Sarbanes-Oxley Act is section 404: Management Assessment of Internal Controls.[60] This section requires that the management of a company provide an internal control report as part of its annual disclosures under the Securities Exchange Act.[61] Section 404(b) of SOX has proven to be an exceedingly expensive compliance requirement with large companies (those with revenue in excess of $5 billion) paying on average .06% of their total revenue to comply with SOX and smaller companies (those with revenue less than $100 million) paying on average 2.55% of total revenue on compliance.[62]

One of Congress' specific goals in passing the JOBS Act was to increase the annual number of IPOs in the United States by

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55. Jumpstart Our Business Startups Act § 304.

56. *Id.* § 302.

57. *Id.* § 501.

58. *Id.*

59. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat 745; Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523, 1567 (2005).

60. Sarbanes-Oxley Act of 2002 § 404.

61. *Id.*

62. Advisory Committee On Smaller Public Companies, Final Report (2006) http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf [http://perma.cc/6VRU-KPEH].

alleviating some of the costs of section 404(b).[63] The EGC exception found in section 103 of the JOBS Act specifically addresses section 404(b) of SOX and provides for significant reductions in accounting and auditor attestation disclosures for an EGCs first five years.[64] Given that the average cost of compliance with 404(b) is $2.3 million per year, this savings represents a significant reduction in the cost of compliance.[65]

D. *The Dodd-Frank Act*

The Dodd-Frank Act was passed in 2011 in response to the Mortgage Crisis and "Great Recession." The majority of the bill reenacts a weakened version of the Glass-Steagall Act's prohibitions on proprietary trading by depository banks. Allowing depository banks to trade only up to 3% of their tier 1 capital.[66] As it pertains to this topic, however, the most important part of the Act is Title IX, which covers shareholder votes on executive compensation and "proxy access," allowing shareholders to modify corporate proxy statements, submitting their own nominations for directors.[67] Section 951 of the Dodd Frank Act requires that companies hold,

> [n]ot less frequently than once every 3 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives....[68]

Additionally, section 951 also requires that companies hold,

> [n]ot less frequently than once every 6 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the

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63. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012).

64. *Id.* § 101–04.

65. Emily Chasan, *Small Companies Still Wonder if Sarbanes-Oxley Is Worth It*, WALL ST. J., July 26, 2012, http://blogs.wsj.com/cfo/2012/07/26/small-companies-still-wonder-if-sarbanes-oxley-is-worth-it/ [http://perma.cc/YU3C-SBDP].

66. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376, 1627 (2010).

67. *Id.* at 1822, 1915.

68. *Id.* at 1899.

> Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to determine whether votes on the resolutions required under paragraph (1) will occur every 1, 2, or 3 years.[69]

However, under the JOBS Act, any company that qualifies as an EGC is exempted from conducting an executive compensation vote, frequency vote, or any internal pay equity disclosures until one year after they lose their EGC status.[70] This softening of the executive compensation disclosure requirements represents a significant shift in the SEC's objectives, especially given the rise in lawsuits related to executive compensation plans.[71]

E. *State Blue Sky Laws*

State Blue Sky Laws are regulations aimed at preventing the sale of fraudulent securities to the public by requiring registration with state regulatory agencies.[72] The term Blue Sky is a reference to the Supreme Court opinion penned by Justice Joseph McKenna, in which, referencing the practice of selling speculative securities, he stated, "[t]he name that is given to the law indicates the evil at which it is aimed; that is, to use the language of a cited case, 'speculative schemes which have no more basis than so many feet of "blue sky"....'"[73] Generally, these laws mirror the 1933 federal legislation; however, they differ materially in that, while the Securities Act requires pertinent information be disclosed to the public, State Blue Sky laws require disclosure to the commissioner of the state regulatory agency.[74] The commissioner then performs a merit review of the disclosed documents and determines whether to issue a permit authorizing the issuance of the security.[75] Section 302 of the JOBS Act affects State Blue Sky laws by exempting

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69. *Id.*

70. Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 102, 126 Stat. 306, 308–10 (2012).

71. *See generally id.* (discussing how an emerging growth company shall be exempt from disclosure requirements).

72. *See generally* TEX. REV. CIV. STAT. ANN. art. 581–33 (West 2001)(discussing that the purpose of Blue Sky laws are to indemnify victimized purchasers by encouraging compliance with the Act's regulatory and disclosure provision).

73. Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).

74. TEX. REV. CIV. STAT. ANN. art. 581–7 (2010).

75. *Id.* art. 581–10.

crowdfunding portals from State Blue Sky review.[76] The benefit of this exemption is tempered, however, by the fact that funding portals are still required to prepare detailed disclosure documents for investors even though these documents are no longer subject to state and federal review.[77]

III. EFFECTS OF THE JOBS ACT

While the JOBS Act is still very much in its infancy, with Title I and II less than three years old, and Title III only finalized in recent months as of this writing, there are already certain trends emerging that can provide an indication of how the legislation will affect EGCs, venture capitalists, and investors, as well as what portions of the legislation will be the most utilized.[78]

A. *IPO On-Ramp Provision*

By far the most widely utilized provision of the JOBS Act as of this writing is the so-called "IPO On-Ramp" provisions.[79] This is evidenced by the fact that since the JOB Act was passed in 2012, 78.9% of issuers in IPO companies have received EGC classification.[80] The IPO On-Ramp consists of four provisions: the confidential SEC review, the "testing the waters" provision, the relaxed financial disclosures, and the securities analyst publications.[81]

The first of these provisions, confidential SEC review, is found in section 106 of the JOBS Act, and provides that,

> [a]ny emerging growth company, prior to its initial public offering date, may confidentially submit to the Commission a draft registration statement, for confidential nonpublic review by the staff of the Commission prior to public filing, provided that the initial confidential submission and all

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76. *See* Samuel S. Guzik, *On Federal Preemption of State Securities Regulation and the Future of Capital Formation for Small Business-the Dawn of a New Era at the SEC*, 46 TEX. J. BUS. L. 101, 106 (Fall 2014).

77. *See id.*

78. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012).

79. *See* Todd Blakeley Skelton, *2013 Jobs Act Review & Analysis of Emerging Growth Company IPOs*, 15 TRANSACTIONS: TENN. J. BUS. L. 455, 456, 496 (2014).

80. *Id.* at 496.

81. *Id.* at 456–57.

> amendments thereto shall be publicly filed with the Commission not later than 21 days before the date on which the issuer conducts a road show.[82]

Essentially this provision allows EGCs who are considering a public offering to submit their registration statement to the SEC without first disclosing them to the public,[83] allowing the company to begin the SEC compliance process without the pressure of public scrutiny and without having to release sensitive proprietary information to competitors.[84]

The second part of the IPO On-Ramp is the so-called testing the waters provision.[85] This provision essentially eliminates the gun-jumping rule from the Securities Act of 1933.[86] The gun-jumping rule of the Securities Act prohibited communication with investors regarding an IPO until there was a registration statement on file with the SEC.[87] It also limited written communication with potential investors until after the creation of a preliminary prospectus.[88] The JOBS Act eliminates these requirements and allows EGCs to communicate with certain institutional investors to determine how much interest there would be in a potential IPO.[89] While this exemption is very useful on paper, in practice it has not proven to be very effective.[90] Institutional investors have not been very receptive to hypothetical discussions and companies have been hesitant to provide any written materials because of the potential for liability associated with any materials disseminated to investors that have not been reviewed by the SEC.[91]

The third part of the IPO On-Ramp is the relaxing of the financial disclosure requirements found in the Securities, Exchange, and Sarbanes-Oxley Acts.[92] As discussed previously, the EGC exemptions created by Title I of the JOBS Act require only two years of financial disclosures from EGCs as opposed to the three-year disclosure requirements found in the Securities Act of 1933 and the Exchange Act of 1934.[93] The majority of companies

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82. Jumpstart Our Business Startups Act § 106.
83. *See id.*
84. *See* Skelton, *supra* note 79, at 458.
85. *See id.* at 460–61.
86. *See id.* at 460.
87. *Id.*
88. 15 U.S.C. § 77e (2015).
89. *See* Skelton, *supra* note 79, at 460–61.
90. *See* Hamermesh & Tsoflias, *supra* note 31, at 466–67.
91. *Id.*
92. *See* Skelton, *supra* note 79, at 459–60.
93. *Id.*

going into an IPO have elected to comply with the previous more stringent disclosure requirements of the 1933 and 1934 Acts.[94] Companies are hesitant to limit the amount of financial information available to potential investors in an effort to appear financially stable.[95]

Title I of the Jobs Act also exempts EGCs from the exceedingly costly 404(b) disclosures of the Sarbanes-Oxley Act.[96] EGCs are not required to disclose executive compensation, create Compensation Discussion and Analysis (CDNA) disclosures[97] or undergo internal controls auditing.[98] These exemptions have been widely utilized by companies going through the IPO process in recent years, including prominent companies such as Manchester United Football Club, Twitter, and Ophthotech.[99]

The fourth and final provision of the IPO On-Ramp deals with publications and disclosures by financial analysts.[100] Prior to the passage of the JOBS Act, section 12(a)(1) & (2) of the Securities Act mandated that there be a "quiet period" after a company's initial public offering. During this quiet period the Act mandated that there be a restriction on, "the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff."[101] This rule was mandated to ensure that securities analysts would not be able to influence, either negatively or positively, the perception of a newly issued security during the IPO process or sales in the secondary market for securities.[102] This provision, however, has not been widely utilized by EGCs or underwriters.[103] Like the test the waters provision, EGCs and securities analysts have been hesitant to publish any materials to investors that are outside those materials normally offered under the Securities Act because they are afraid of potential liability.[104]

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94. Hamermesh & Tsoflias, *supra* note 31, at 466–67.

95. *See* Nayeri, *supra* note 42, at 11.

96. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 103, 126 Stat. 306, 310 (2012).

97. A CDNA is one of the most time consuming and expensive disclosures that companies are required to make under section 404(b) of the SOX Act. *See* Hamermesh & Tsoflias, *supra* note 31, at 495.

98. *See* Jumpstart Our Business Startups Act § 102–03.

99. *See* Skelton, *supra* note 79, at 496–500.

100. *See id.* at 461–62.

101. 15 U.S.C. § 78o-6 (2015).

102. *See id.*

103. *See* Hamermesh & Tsoflias, *supra* note 31, at 462–63.

104. *See id.*

B. *Increase in Annual IPOs*

While numerous companies have certainly utilized the IPO On-Ramp provisions and EGC exemptions in the last several years, it remains to be seen whether the JOBS Act as a whole has actually had the effect that Congress intended in passing the Act.[105] One of the main goals of the Act was to increase the number of annual IPOs in the United States, and the JOBS Act has certainly had that effect.[106] In 2012, the year the JOBS Act was passed, there were 102 IPOs in the United States.[107] Since then, there has been a steady increase annually in the number of IPOs with 178 IPOs in 2013 and 244 IPOs in 2014.[108] Additionally, of those 524 IPOs since the JOBS Act went into effect, over 88% utilized the confidential SEC review provision, and over 94% utilized the exemption from filing corporate compensation documents.[109] However, just because there has been an increase in the number of IPOs and those IPOs have been utilizing JOBS Act exemptions, does not mean the increase in the number of IPOs is due to the passage of the Act.[110] Various market factors, namely record high levels for the S&P 500 and Dow Jones Industrial Average indices, as well as investor appetite for new debt and equity issues could also explain the increase in IPOs.[111]

C. *Unintended Consequences of Section 501*

The JOBS Act was aimed at making it easier and less expensive for companies to go public.[112] However, there is a possibility that the JOBS Act may be causing the complete

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105. *See* Samuel, *supra* note 20.

106. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012); *see also* Wilmer, Cutler, Pickering, Hale, and Dorr LLP, *2015 IPO Report*, WILMERHALE.COM (Mar. 27, 2015), https://www.wilmerhale.com/uploadedFiles/shared_content/editorial/publications/documents/2015-wilmerhale-ipo-report.pdf [http://perma.cc/J9TA-FMNH].

107. Wilmer et al., *supra* note 106 (detailing the U.S. market for IPOs in 2015 and illustrating how passage of the JOBS Act has increased the number of IPOs in the United States).

108. *See id.* at 2.

109. *See id.* at 9.

110. *See generally* Samuel, *supra* note 20 (referencing concerns that the JOBS Act could potentially reduce the number of IPOs).

111. *See* Wilmer et al., *supra* note 106, at 5.

112. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012) (noting the Act creates procedural and substantive changes lowering the cost of going public by reducing filing fees and raising the minimum mandatory filing threshold).

opposite effect.[113] That is to say, rather than making it easier for companies to go public, the JOBS Act is possibly encouraging them to stay private.[114]

Section 501 of the JOBS Act increases the amount of total assets and the number of shareholders a company may have before being required to register with the SEC, increasing the maximum non-reporting threshold of total assets to $10 million and the number of shareholders to 2,000.[115] While this change may not seem significant, it could have serious implications on the securities market.[116] Despite substantially increasing the shareholder-reporting threshold, the JOBS Act retains a shareholder of record standard.[117] This means that a single nominee is counted as one shareholder even though they may be holding shares for several investors.[118] As a result, companies can obtain a tremendous amount of capital from private entities and venture capitalists but still come in under the 2,000 shareholder cap for annual reporting, as mandated in the Securities Exchange Act.[119]

Essentially, companies can obtain as much capital as they want without ever having to go public and subject themselves to the reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934.[120]

IV. FINALIZED TITLE III RULES

Titles I, V, and VI became effective immediately upon passage of the JOBS Act.[121] Additionally, Title II went into effect on July

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113. *See* Hamermesh & Tsoflias, *supra* note 31, at 458 (discussing what crowdfunding is and how the SEC's proposed rules for Title III are likely to be implemented, and also noting incidents of fraud are likely to be relatively low as the funding portals will have strong economic incentives to ensure that bad actors do not shake issuer and investor faith in a marketplace).

114. *See id.*

115. Jumpstart Our Business Startups Act § 501(A).

116. Pope, *supra* note 15, at 996–97.

117. *Id.* at 997–98.

118. *See* Jumpstart Our Business Startups Act § 601(a)(1)(B) (illustrating that a shareholder of record is counted as one individual for the purposes of the Act but one shareholder of record can represent and hold the interests of multiple individuals).

119. *See id.* § 501.

120. *See id.* § 501.

121. *See* Testimony on "JOBS Act Implementation Update," SEC.gov (April 13, 2013), https://www.sec.gov/News/Testimony/Detail/Testimony/1365171515996 [http://perma.cc/ANR9-GAT4] (testimony by SEC Acting Director Lona Nallengara and SEC Acting Director John Ramsey about how the SEC has sought to implement the JOBS Act in 2012 and 2013).

10, 2013.[122] However, Title III, was continuously delayed by the SEC, despite the fact that the legislation itself included a mandate that the SEC complete rulemaking on all three titles within 270 days of the Acts passage.[123] These delays were largely the result of the passage of the Dodd-Frank Act in July of 2010.[124]

After the passage of the Dodd-Frank Act, the SEC was required to create twenty times the normal amount of rules, and as a result, other rulemaking was put on the SEC's back burner.[125] These delays were met with a tremendous amount of criticism by entrepreneurs who felt that a lack of rules was restricting the startup market even further as entrepreneurs weighed the risks of moving forward with traditional means of funding.[126] Finally, in October of 2015, the SEC released the finalized rules for Title III of the JOBS Act.[127]

The new rules issued by the SEC outline the registration process for broker dealer portals.[128] They also contain a significant number of provisions aimed at reducing fraud and ensuring a cost efficient registration process for funding portals.[129]

The process for portal registration under the finalized rules is relatively straightforward. The rules require that any person wishing to act as an intermediary in a crowdfunding transaction must be registered with the Commission as a broker under Exchange Act section 15(b) or as a funding portal pursuant to section 4A(a)(1) and proposed rule 400 of Regulation Crowdfunding.[130] Since intermediaries are required to register as brokers, they are limited in how they can interact with the issuers

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122. *See Press Release, U.S. Sec. & Exch. Comm'n, SEC Approves JOBS Act Requirement to Lift General Solicitation Ban (July 10, 2013)* https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782#.Ue7Y_z44Vx8 [http://perma.cc/4WTG-RAEH] (detailing removal of a ban on general advertising proscribed under the JOBS Act).

123. Jumpstart Our Business Startups Act § 106(c).

124. *SEC delays consideration of JOBS Act rule*, REUTERS (August 21, 2012, 5:37 PM), http://www.reuters.com/article/us-financial-regulation-ban-idusbre87k10u20120821 [http://perma.cc/WFS9-CS2E].

125. Symposium, *Daniel M. Gallagher Keynote Speech, Fordham Journal of Corporate & Financial Law's Annual Symposium*, FORDHAM L. REV. (2015) (discussing how the passage of the Dodd-Frank Act in 2010 has completely taken over the SEC's rulemaking resources).

126. *See generally* Corporate Stock Transfer, Inc., Comment Letter on Proposed Rule: Crowdfunding (Jan. 15, 2014), https://www.sec.gov/comments/s7-09-13/s70913-117.pdf [http://perma.cc/2FCX-78K5] (providing a ninety-day public-comment period following the proposals' publication in the Federal Register).

127. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules To Permit Crowdfunding (Oct. 30, 2015), http://www.sec.gov/news/pressrelease/2015-249.html [http://perma.cc/9FAP-J5TR] (announcing finalized crowdfunding rules).

128. *Id.*

129. *Id.*

130. *Id.*

and investors involved in crowdfunding transactions. Specifically, brokers may not,

> (A) offer investment advice or recommendations; (B) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (C) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (D) hold, manage, possess or otherwise handle investor funds or securities; or (E) engage in such other activities as the Commission, by rule, determines appropriate.[131]

These restrictions limit the ways in which crowdfunding portals can profit off of the transactions they broker. Portals are essentially limited to charging a small set fee for each transaction (similar to online listing services such as eBay and Craigslist) or to investing in the issuers alongside other users.[132] The fact that funding portals can only profit through a high volume of transactions or by investing in the securities being offered on their site creates both an economic incentive and a personal interest in reducing fraud.[133]

The new rules have several provisions aimed at reducing fraud in portal funding transactions. Specifically, portals must ensure that there is a minimal amount of communication between potential investors and issuers.[134] This includes the ability to view feedback from investors who are already committed to the issuer, as well as the ability to post questions to an issuer's account, all of which is subject to SEC review.[135] The committed-issuer communications are especially beneficial because they provide potential investors, especially unaccredited investors, with

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131. 15 U.S.C. § 78c(80) (2015).

132. While Title III's finalized rules prohibit any officers, directors, or partners of an intermediary from having any financial interest in an issuer using its services, the funding portal or intermediary itself is not barred from purchasing securities from issuers on the portal. This means that the entity itself can purchase securities just like any other investor as long as they do so pursuant to the stipulations of the Act. Like any company, portals can of course compensate their employees via salary and benefits so while the employees cannot personally hold any stake in securities offered on the portal they are not completely removed from any potential benefits.

133. *See generally,* Hamermesh & Tsoflias, *supra* note 31, at 453–76. *But see*, Samuel, *supra* note 20.

134. *See* Patrick Archambault, *How the SEC's Crowdfunding Rules for Funding Portals Save the Two-Headed Snake: Drawing the Proper Balance Between Integrity and Cost*, 49 SUFFOLK U. L. REV. 61, 64 (2016).

135. *See id.* at 78.

valuable information from backers with more experience in securities transactions.

The new rules also provide incentives for the funding portals themselves to prevent fraud. Funding portals are required to provide a reasonable basis for concluding that an issuer has complied with Section 4A(b) of the Securities Act of 1933.[136] The portals then must post these "reasonable basis" reports publically on their sites.[137] As a result, funding portals will have serious economic incentives to implement additional anti-fraud measures or else risk driving away investors and issuers who are unwilling to utilize a portal with a track record of fraud and abuse.[138]

The new rules are also extremely beneficial because they significantly reduce the cost of filing and registering with the SEC.[139] The SEC, in its finalized rules, estimated that funding portals would save as much as $353,000 in startup costs and over $175,000 in annual fees.[140] This in turn will benefit the entire startup industry as the low startup and annual cost will ensure a competitive market, pressuring operators to act reasonably and in the best interests of both issuers and investors.[141]

V. CONCLUSION

The simple fact is that the JOBS Act is just too new to make any serious conclusions as to whether or not it has had the effect that Congress intended in its passage. IPOs have increased, but with only a three year data set, any conclusions as to the JOBS Act's effect on the number of annual IPOs in the United States is simply too speculative. Even so, there are still at least two things that can be said definitively about the JOBS Act. First, section 501's increase in the amount of total assets and number of shareholders a company can have before triggering the Securities Act's mandatory annual reporting is a dangerous precedent. Disclosure is the foundation on which the U.S. securities market is built, and creating a potentially huge loophole for companies to avoid annual reporting is troublesome to say the least. Second, the JOBS Act, regardless of its overall effects, has created more tools

136. *See id.* at 79.

137. *See id.*

138. *See* Samuel, *supra* note 20.

139. Archambault, *supra* note 134, at 82–83 (discussing the "Efficient and Manageable" requirements for funding portals specifically, the SEC's estimates for cost savings by funding portals found in the finalized rules for Title III of the JOBS Act).

140. *Id.*

141. *See id.* at 64.

for entrepreneurs to utilize when trying to fund their companies, and that will probably be a good thing in the long run. The confidential SEC review provisions, especially, demonstrates that even the SEC is capable of adapting to the unforeseen consequences of securities laws when necessary.

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