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at

Hearings Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform and the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services

The JOBS Act

September 13, 2012

Washington, D.C.

Chairman McHenry, Chairman Garrett, Ranking Member Quigley, Ranking Member Waters, and Members of the Subcommittees:

Thank you for the opportunity to testify about the JOBS Act, its effect on capital formation, and obstacles faces by entrepreneurs and emerging businesses. JOBS provides far-reaching legislative reforms in what it means to be a public company or to make a public offering. It provides two new exemptions to the registration requirements of the Securities Act of 1933 (the '33 Act) (an act for which new exemptions have rarely been created over its almost 80 year history) and substantially expands the reach of a third exemption, Rule 506, which is already the most heavily used exemption under the Act. In addition the JOBS Act broadens the space outside the regulatory reach of the Securities Exchange Act of 1934 ('34 Act) by raising the threshold that triggers '34 Act reporting obligations from 500 shareholders of record to 2000 (if most are accredited investors) and has facilitated IPOs (Initial Public Offerings) by permitting a new category of companies, Emerging Growth Companies, to avoid various regulatory requirements for up to five years after they go public.

In these various formulations, Congress acted to facilitate access to capital while at the same time protecting investors. More specifically, the paths chosen by Congress in the JOBS Act are well within the familiar template of securities regulation strategies: mandatory disclosure; agency review; a greater regulatory focus when sales pressure is more intense; and liability to spur due diligence by intermediaries and others. For example, crowdfunding includes a focus on intermediaries and section 12(a)(2)-like liability. Regulation A+ makes use of traditional disclosure, agency review, and Section 12(a)(2) liability. Efforts to evaluate the steps being taken to implement the Act ought to reflect this template.

I. Crowdfunding

Crowdfunding, as reflected in the bill produced by Chairman McHenry and this subcommittee reflects the innovative premise of seeking to harness the "wisdom of crowds" to separate the good business plans from the deficient. The bill as passed by Congress caps the amount an issuer can raise at $ 1 million over a twelve month period and has limits on what individual investors can invest. The challenge in this area is that when you are raising $ 1 million or less, any fund raising and regulatory cost will quickly capture a large share of the amount to be raised. If regulatory bars are lowered to what seems like a cost-effective number, entrepreneurs will be able to seek out small investors who share their entrepreneurial (if sometimes risky) dream, but in this early-stage setting where firms don't have an operating history, the chances of fraud also increase. The JOBS Act takes both of these concerns into account, but the economic reality of the overlap between the two seems to leave little room for robust use of this exemption. As the SEC looks for the path that would satisfy these concerns, perhaps the best focus would be encouraging a small number of registered portals who will be able to satisfy the SEC they have a sufficient plan for dealing with the inevitable temptations for abuse including possible fraud, exploitation of investor ignorance, and violation of issuer and investor caps. Such portals may be able to achieve some economics of scale in processes to deal with those concerns. To the extent these portals have a social welfare function and an interest in this area they may have additional incentives or resources to develop solutions to this challenge.

II. Regulation A+

The JOBS Act directs the SEC to promulgate a new set of rules under section 3(b) for offerings up to $50 million, building on the current "mini-registration" process under Regulation A (17 C.F.R. §230.251 et seq.). As with crowdfunding it is important to focus on the economic realities that will hinder robust use of this exemption. The existing Regulation A (limited to $5 million offerings) has shrunk to a point where it is seldom used today. For issuers it is a balance of the amount that can be raised, the costs to raise it, and the alternative routes to obtaining the same capital and the costs of those alternatives. The disclosure and other requirements of Regulation A are scaled to the smaller size, but issuers are also subject to state registration requirements which adds additional costs. The tenfold increase in the amount that can be raised in the new exemption, as compared to existing Regulation A, will permit more economies of scale than in the present regulation and may change the cost/benefit calculus for issuers thinking about using this exemption, at least at the upper reaches, but the comparison will always be made (and probably adversely) to either raising capital through 506 (newly expanded as discussed below) or a registered public offering.

III. Expanded Use of Rule 506 with the Removal of the Ban on General Solicitation

The largest impact of capital raising from the JOBS Act is likely to be in the expanded use of offerings under Rule 506. Offerings under this exemption have grown substantially even before the JOBS Act changes. Empirical data from SEC economists shows that for 2010 and the first part of 2011 issuers raised more money through private offerings of various types than through registered public offerings.[1] Regulation D, and more particularly Rule 506 under Regulation D, was the largest component of the private offering realm. The JOBS Act makes this route even more attractive, directing the SEC to remove ban on general solicitation for Rule 506 offerings to accredited investors (and the great majority of all Regulation D offers today are made only to accredited investors). With the demise of this ban, we can expect more aggressive selling than we have had in the past, including more selling via the internet. I will focus on two points about this new 506 world: first, how a series of relaxations of the requirements for private offerings have occurred since the promulgation of Rule 506 and Regulation D in 1982 even while the threshold of accredited investors continues to have the same dollar threshold as three decades ago so that there is reason to ask if the concept of accredited investor has been stretched too far. Second this expanded space for 506 has an unexpected downstream effect in facilitating a growing resale market for such securities free of any investor protections from the '33 or '34 Act.

A. *The Private Offering Exemption now reaches a much broader section of the investor population than in 1933 or 1982 with fewer investor protections*

Private placements have been a part of the '33 Act from its enactment. James Landis, a principal drafter of the '33 Act and the SEC's second chair, explained the Section 4(2) exemption by reference to "sale of an issue to insurance companies or to a limited group of experienced

[1] See VLAD IVANOV & SCOTT BAUGUESS, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION (February 2012) available at http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf

investors."[2] There could only be a small number of offerees (25 in the earliest period), and they had to be linked to the issuer by access or relationship that would practically preclude an offering to a large number of investors. A ban on general solicitation of offerees was implicit in the approach to private placements from the beginning. Offers made to the public could not fit within an exemption specifically defined as non-public.

This early reading of the Section 4(2) exemption meant that such deals were negotiated, not sold. When a concentrated group of sophisticated purchasers negotiate with the issuer, they are in a position to bargain for information and its credibility, through the use of representations and warranties. But this early conception of what constituted an exempt private offering was ambiguous as well as limiting to entrepreneurs. In the 1970s and early 1980s, SEC rule-making provided a safe-harbor that effectively widened the exemption. The SEC's dramatic step came through a definition of "accredited investors" to create a class of persons whose wealth alone would satisfy this standard. The term included banks and institutional investors, but also individual investors with what were then distinctly upper class incomes ($200,000 per year) or net worth ($1,000,000).

Capital raising transactions under Rule 506, if directed solely at accredited investors, did not mandate disclosure, did not require sophistication or an offeree representative, and could be directed at an unlimited number of potential purchasers, without any upper dollar limit. Not only did this shift to wealth as a metric lessen the likely sophistication that purchasers would bring to the transactions, but it made salesmanship an attractive possibility. However, there were limitations that blunted the impact of this shift at the time of its adoption, limitations that

[2] James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 37 (1959-60).

have since eroded or fallen away. First was the dollar figure in the definition of accredited investor: in 1982, an income of $200,000 or millionaire status in terms of net worth covered a relatively limited number of very well-off people, and did not affect all that many retail investors. That dollar amount hasn't changed in the three decades since even though inflation has brought more and more individuals within its definition, effectively extending its reach deeper into the cohort of those with smaller real incomes. Indeed measured as a percentage of the pool of individual taxpayers, the number of individuals whose income is above $200,000 is now 20 times larger than at the time of enactment of Regulation D.[3]

A second change in the post 506 universe was the Supreme Court's 1995 decision in Gustafson v. Alloyd Co. (513 U.S. 561) that excluded private offerings from the reach of Section 12(a)(2) under the '33 Act, a change that relegated those transactions to a fraud-only regime under Rule 10b-5 or common law fraud. Such a liability regime could well be justified in a negotiated transaction with a small group of concentrated investors, but less so in a world where there is aggressive selling to a large number of unconnected investors. In addition, as discussed more below, Rule 506 offerings were restricted as to resale for a fairly lengthy period, meaning that those inclined to trade their securities would not be much interested in these kinds of transactions. At the time of Rule 506's promulgation, there was the possibility that state blue sky regulation would apply, which has since been preempted by federal law. Finally

[3] Justin Bryan, High-Income Tax Returns for 2009 Stat. Income Bull, spring 2012 available at http://www.irs.gov/pub/irs-soi/12insprbulhignincome.pdf (reporting that $200,000 in 1981 dollars would be $319,508 in 2009 and that individual income tax returns at or above $200,000 made up 0.145% of filed returns in 1981 versus 2.793% of returns in 2009. Thus the $200,000 level corresponds to a percentage of individual income tax returns that is about twenty times higher than it was when the number was put into Regulation D in 1981.

there was the ban on general solicitations, removed by the JOBS Act as to offerings made only to accredited investors.

Certainly the concept of accredited investor has taken on more weight than it carried when it was put into Regulation D in 1982 and there is reason to ask if carries more weight than it should. Although the SEC's proposed rule-making in August stays close to the narrow charge from the JOBS Act to remove the ban on general solicitation, the cumulative effect of this change on the overall reach of Rule 506 illustrates the important need for the SEC to revisit its current numerical thresholds of the definition.

B. The Resale Market for Private Offerings

The removal of the ban on general solicitation also contributes to an as yet unrecognized impact on the growth of the resale market for securities initially issued in private offerings. Historically, shares issued via a private offering were difficult to resell so an investor bought them expecting to hold. This reflected market conditions as to the difficulty of matching buyers and sellers in a small and sometimes unique market, but it also reflected regulation. A resale could destroy the issuer's original exemption thus threatening the economic benefit of the exemption. The SEC did create a safe harbor in the early 1970s via Rule 144, but the holding period required to get into this safe harbor for stock that was not listed on a stock exchange or regularly traded was long enough (three years) to realistically discourage an initial investor buying with an intent to resell. However, things have changed, one market-driven and the other regulatory. Twice in the last 15 years, the SEC has reduced the holding period—from three years to two and then from two years to one- so that today an investor who buys in a Rule 506 offering need only hold the shares for 12 months before being able to resell free of traditional ’33 Act restrictions. Second, a market has developed for these securities. The demand for shares in Facebook prior to its IPO earlier this year brought attention to platforms like SecondMarket and SharesPost that provided a resale opportunity for Facebook shareholders and owners of other shares acquired in private offerings. The combination of market innovations and regulatory changes has meant that many more shares now change hands in a venue without mandatory disclosure or other investor protection. While this comes under the domain of the ’34 Act discussed below, the expansion of Rule 506 after the lifting of the ban on general solicitation, will likewise expand the size of this resale market.

IV. Changes to Section 12(g) of the ‘34 Act increasing the space for resales of securities outside of the ‘34 Act regulatory space.

The three changes I have discussed so far turn on when issuers have to take on the obligations of the ’33 Act, a threshold measured by whether they have made a registered public offering or instead come within the various exemptions provided by the ’33 Act. In contrast, the obligations of the 1934 turn on being a reporting company, a status that has a more complex structure. Crossing any one of three thresholds requires a company to take on the obligations of the ’34 Act. First being listed on a securities exchange, such as the New York Stock Exchange or Nasdaq, makes one a reporting company. Second, a company that makes a registered public offering, (even if it were not to then listed on an exchange) must meet most of the obligations of the Act. Third, a non-exchange, non-IPO company must still meet these obligations if it crosses the threshold as to size and number of shareholders. From 1964 until the JOBS act, the number was 500 shareholders of record. The JOBS Act bumps that number by a factor of four to 2000, as long as not more than 499 are non-accredited. The result is that a company can grow much bigger without having to submit to the regulatory structures of the ‘34 Act. The practical effect of this change in 2012 is limited. Because of the three separate ways into the Act, only companies that choose not to list on the stock exchange or not to make a registered public offering can take advantage of this new unregulated space and most companies of that size still prefer the capital that can be raised from an IPO and the liquidity for shareholders that comes from an exchange listing. But as observers of changes in capital markets know, those financial facts are in a state of flux. Private equity and venture capital now provides a greater share of capital needs. And as the previous part of my remarks illustrate, the use of these sources via 506 is likely to accelerate. Similarly the platforms mentioned earlier, like SecondMarket and SharesPost can provide liquidity outside of an exchange listing, so that these two definitions will be less of a binding constraint going forward. We are looking at having an increased volume of shares traded in the resale market without the disclosure and other protections of the ’34 Act.

There is also the greater possibility of evasion. The statutory standard since 1964, and even after JOBS, remains shareholders of record. This is the number of shareholders reflected on the corporation’s share records. Since the back office crisis of the late 60s, there has been a massive switch to how securities are held with the shares in publicly held corporations almost always held in street name of a few large depository companies who in turn hold the shares for brokerage houses or banks, with the true beneficial owners never reflected in this count. It is also possible to use a corporation or trust as an entity to aggregate a larger number of owners, an issue that got a flurry of attention as to Facebook in the year before its IPO. The JOBS Act contains a provision calling for a SEC study, but the increase to 2000 may well push this study off anyone radar screen for the foreseeable future. The likely result is an increase of companies that have a sufficiently large footprint as to affect the overall economy and have a large number of shares being traded in the resale market, but for which there is no mandatory disclosure. The discussion about capital raising while important to our economy, should not block a focus on the resale market and the value to capital raising that comes from a strong transparent resale market in shares.