VOLUME 27, No. 3
APRIL 2013

Small Business Notes

Minnesota Department of Employment and Economic Development (MN DEED)

In this issue:

Congressional Witnesses Chide Securities and Exchange Commission for Slowness in Development of Rules for Securities Law Amendments to 2012 JOBS Act

On April 11 the U.S. House of Representatives Small Business Subcommittee on Investigations, Oversight and Regulations heard testimony from both the Securities and Exchange Commission (SEC) and interested and affected private parties on the slow pace of SEC rule promulgation on various substantive changes to federal securities law effected by the JOBS Act signed by the President in April 2012. The Act contained deadlines of from ninety to two-hundred-seventy days for rulemaking on sections of the new law but the SEC has developed proposed rules on only one section.

Jean Peters, Board member of the Angel Capital Association, addressed the one area in which the SEC has offered proposed rules—removal of the ban on general solicitation of accredited investors. That rule, Peters testified, leaves both investors and entrepreneurs in "a deeply uncertain position" because it requires issuers "to take reasonable steps to verify" the accredited status of investors but provides no uniform standards for "reasonable steps" and instead provides for the SEC to determine on "a case by case basis" whether the test has been met. Peters noted that an Angel Capital Association survey of its members found that angels were "not likely to invest if they find a cumbersome, expensive verification process acting as a 'gate' against the extraordinary work that angels do." Peters went on to note that angels have been advised by counsel not to invest in advertised offerings if there is no safe harbor on the accredited investor determination issue. Such slowdown of angel investments would be, Peters continued, the exact opposite of Congressional intent.

William G. Klehm III, Chairman and CEO of Fallbrook Technologies, applauded the JOBS Act's increase in the limit a company can raise under Regulation A offerings from $5 million to $50 million without sustaining the costs of filing a federal registration statement, costs which Klehm continued can amount to hundreds of thousands of dollars. But, he continued, "innovative companies all across the country in various tech sectors…are robbed of that benefit until the JOBS Act Regulation A rules are implemented. That means that new, well-paying jobs aren't created, new technologies sit dormant, and the public misses out on new products that could change their lives and advance the common good."

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The most critical comments came from James J. Angel, professor of finance at Georgetown University, who noted that under the Act the SEC had two hundred seventy days to adopt rules for crowdfunding but, "A year has gone by and the Commission has not even published proposed rules. What it has done is put out a chilling message saying that crowdfunding is illegal until the SEC decides to make it legal by adopting rules." Angel went on that this delay was not the result of the SEC taking "extra time because it was intently studying the issue." Rather, he continued, the SEC had ignored opportunities to speak with experts and practitioners on the issue, what he termed a "pattern of ignoring the intellectual contributions happening outside the Commission something due in part, in his testimony, to the SEC staffing itself with "lots of attorneys who engage in hairsplitting minutiae while missing the big picture."

The SEC, through the testimony of Lona Nallengara, Acting Director Division of Corporate Finance, indicated that the delay was due in part to the number of related studies it was required by the Act to complete, by the already existing significant volume of rulemaking it was engaged in with regard to the Dodd-Frank Act, and by its review of a large volume of pre-rulemaking comments received from interested and affected parties. Noting that the SEC staff "are moving forward on the various rulemakings required by the JOBS Act", Director Nallengara concluded her testimony with, "We look forward to completing the remaining provisions as soon as practicable."

SEC Provides No-Action Letters to Two Online Venture Capital Operators But Limitations Remain

At the end of March the U.S. Securities and Exchange Commission (SEC) issued no-action letters to two venture capital online funding platforms, Founders Club (in a letter of March 26) and Angel List LLC (in a letter of March 28). In the letters the SEC indicated that it will not require Founders Club or Angel List to register as a broker dealer in order to qualify potential investors as accredited investors and in order to connect those investors with private investment funds which are formed by Founders Club and Angel List as separate, special purpose entities so long as Founders Club and Angel List do not engage in broker dealer-like activities such as receiving transaction based compensation or holding customer funds or securities. In the case of both letter recipients, the firms will receive compensation in the form of a carried interest, that is in the form of a specified percentage of profits on sale of the investment by the investment fund; a bank or trust company will serve as custodian of funds and securities.

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It is important to note, however, the limitations of these no-action letters:

- The no-action letters extend only to investments made in investment funds *not in the underlying companies.* There are no standards described in the letters for online platforms that may wish to invest directly in individual companies.
- The no-action letters are limited to services to accredited investors only.
- The no-action letters are totally unrelated to any rules that will be developed by the SEC under the crowdfunding provisions of Title II of the JOBS Act.
- The no-action letters are not rules and are specific to the firms receiving them and the conditions described in the letter. The SEC can modify or revoke the position stated in the letters at any time in the interests of investor protection.

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