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The JOBS Act Creates Opportunities and Risks

The JOBS Act will dramatically change the legal and regulatory landscape across the U.S. by encouraging IPOs through relaxed regulation. But what are the potential effects of reduced regulatory burden and increased risk of securities fraud litigation?

By Michael W. Stocker & Rachel A. Avan

The Jumpstart Our Business Startups (JOBS) Act, which sailed through Congress with broad, bipartisan support, should dramatically change the legal and regulatory landscape for financial professionals across the United States.

Intended to foster economic growth by encouraging startups and initial public offerings, the legislation will alter key internal control and audit requirements for a new category of "emerging growth companies" and will encourage the controversial practice of crowdfunding. The repercussions will be far-reaching for public companies, auditors, underwriters and investors.

The premise of the JOBS Act is that investor protection regulations have been an impediment to the ability of companies to raise cash from the public — and that rolling back these rules will permit entrepreneurs to expand their business and hire more Americans.

Among other things, the JOBS Act will: (1) create an IPO "on-ramp" so that emerging growth companies — those with less than $1 billion in annual revenue — have up to five years to comply with reporting requirements set out in the Sarbanes-Oxley Act of 2002; (2) relax regulatory restrictions on the way startups communicate with investors, including through the use of social media; and (3) remove the "Chinese wall" that sought to curb conflicts of interest between analysts, their banking colleagues and investors.

Some have questioned whether relaxing investor protection regulations will do much to promote economic growth. It is true that the number of IPOs has been declining over the course of the last 15 years, even accounting for cyclical variations. However, the connection between this drop and Sarbanes-Oxley is far from clear. While Sarbanes-Oxley tightened reporting requirements and limited pre-IPO activities for prospective new issuers — potentially making it more expensive for some companies to go public — the decline in IPOs preceded Sarbanes-Oxley by several years.

A more likely explanation is that IPOs have simply become less profitable with the diminished role of traditional broker-

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dealers who lent critical support to unknown stocks and the use of decimalization, which priced stocks in cents rather than fractions and removed profits from trading that previously, had given brokers an incentive to list small companies.

Though the JOBS Act may ultimately do little to stimulate the economy, there is little doubt that its provisions will change the way many public companies operate.

The IPO 'On-Ramp'

The IPO on-ramp component of the JOBS Act creates an exemption for emerging companies from the reporting and auditing requirements set out in Section 404(b) of Sarbanes-Oxley.

Section 404(b) of Sarbanes-Oxley, which was enacted in the wake of the Enron Inc. scandal, requires companies in annual reports to have chief executive officers and chief financial officers attest to "the effectiveness of the internal control structure and procedures of the issuer for financial reporting" and to have outside auditors test their internal controls and give an opinion on their effectiveness.

Compliance with these provisions can be costly for smaller corporations with decentralized structures, but the rules provide an important revenue stream for external auditors.

A company qualifies as an emerging growth company if its revenue is less than $1 billion or its market capitalization is less than $700 million. Companies retain emerging growth status until the earliest of the following criteria:
1) The first fiscal year after its annual revenues exceed $1 billion;
2) The first fiscal year following the fifth anniversary of its IPO;
3) The date on which the company has, during the previous three-year period, issued more than $1 billion in non-convertible debt; and
4) The first fiscal year in which the company achieves "large accelerated filer" status.

Pursuant to the JOBS Act, emerging growth companies have five years from the date of their IPOs to fully comply with SEC accounting standards, including the hiring of an independent auditor. It also allows such companies to produce only two years of audited financial statements prior to their public offerings (instead of three years) and exempts such entities from provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that require a nonbinding shareholder vote on executive compensation.

Significantly, the vast majority of companies currently initiating public offerings will qualify for "emerging growth company" treatment. According to Kathleen Smith, chairman of IPO investment and tracking firm Renaissance Capital, told *Investors Business Daily* in March that this relief will apply to more than 90 percent of the companies going public. According to a March 8 report in *The Wall Street Journal*, 98 of 107 U.S. IPOs in 2011 would have qualified for relief under the JOBS Act.

The IPO on-ramp provision will have substantial effects on the markets independent of its goal of promoting new businesses. It may hurt business prospects for outside auditors as their services may not be needed for five years. Even more significantly, it may also increase the dangers for risk managers.

Companies may not devote as much attention and resources to compliance and auditing issues on the assumption that they have an extended period to conform with Sarbanes-Oxley, only to be surprised when revenues unexpectedly surge.

Moreover, despite this relaxation of some provisions of Section 404(b), the IPO on-ramp provision does not shield CEOs and CFOs from liability for fraud during the contemplated five-year period. Senior management must still ensure that the companies' accounting systems meet the standards introduced in 2002 under Sarbanes-Oxley.

And, without an independent audit, corporate executives may be more at risk for failing to identify a material weakness, which could lead to increased exposure to fraud litigation.

As Brian Margolis, a corporate partner at Orrick, Herrington & Sutcliffe LLP, recently cautioned in an April *Reuters* report: "Management that uses this for carte blanche to not have internal controls is really missing the boat."

Crowdfunding Provisions

Another stated goal of the JOBS Act is to bring capital-raising efforts in line with 21st century practices. One way it seeks to do so is by legalizing the previously forbidden practice of equity crowdfunding; that is, the mass sale of equity interest in startups to unsophisticated retail investors.

Current regulations forbid startups from issuing general solicitations to unaccredited investors — small "retail" investors with lower incomes and fewer assets — without making significant disclosures about their business.

Under the JOBS Act, startups can raise up to $1 million over a 12-month period by pitching their businesses to thousands of small-scale investors online — without making the currently-required disclosures. Investors are limited to contributing either the greater of $2,000, or five percent of income or a maximum of $10,000 depending on whether they are under or over a $100,000 threshold in annual income or net worth.

Companies seeking to raise $100,000 or less must provide investors with tax returns and a financial statement certified by a company principal. Those raising up to $500,000 must share financial statements that are reviewed by an independent certified public accountant. Companies may raise more than $500,000 if they publish audited financial statements.

The legislation contemplates the adoption of a whole new regulatory scheme applicable to third-party intermediaries, or "funding portals," in the form of websites managing crowdfunding shares. These intermediaries are charged with performing background and securities enforcement regulatory history checks on the issuers.

Funding portals must register with the SEC, but will likely not be subject to the type of full-blown broker-dealer registration required by the Financial Industry Regulatory Authority (FINRA). It may be necessary for the SEC to create a self-regulatory organization to

oversee the standards and credibility of funding portals.

The IPO on-ramp provision will have substantial effects on the markets. It may also increase the dangers for risk managers. Companies may not devote as much attention and resources to compliance and auditing issues on the assumption that they have an extended period to conform with Sarbanes-Oxley, only to be surprised when revenues unexpectedly surge.

Crowdfunding is fraught with risk for both investors and startups, however. Startups that have to resort to crowdfunding will likely be those that are too risky to attract investment from venture capital and angel investors. Such ventures make little sense for retail investors with little capacity to bear loss and limited experience in assessing investment risk.

Even startups that eventually turn a profit may suffer as a result of earlier crowdfunding efforts. Because venture capitalists and angel investors are likely to look skeptically at companies that already have a vast number of minority shareholders, the crowdfunding route to raising capital may limit future options.

Elimination of the 'Chinese Wall'

As a result of the JOBS Act, banks will also be less restrained in the interactions between their research and investment banking counterparts. Following the burst of the dot-com bubble in 2003, then-New York Attorney General Eliot Spitzer spearheaded an effort to establish a "Chinese wall" — a firewall or ethical barrier — to reduce conflicts of interest between research analysts and investment bankers.

On April 23, 2008, the SEC, the National Association of Securities Dealers, Inc. (now known as FINRA), the New York Stock Exchange and state regulators announced a global settlement with 10 of the nation's top investment firms to settle enforcement actions involving conflicts of interest.

Under the terms of the global settlement, the firms were required to insulate their banking and analysis departments from each other physically and with Chinese walls. In addition, underwriters were restricted from issuing earnings forecasts or research reports for companies whose offerings they underwrote during a 40-day "quiet period."

At the time, regulators contended that analysts were influenced by their investment banking counterparts who sought to win lucrative business from startup companies. The settlement barred any communication between bankers and analysts unless accompanied by a compliance officer, a move aimed at reducing the influence of bankers on research.

The JOBS Act has all but eviscerated this Chinese wall for qualifying companies — allowing analysts to create interest in a stock that is the subject of an offering even as their firms profit from underwriting the offering. The JOBS Act also will allow banks to publish research reports about these companies while the bankers are helping take them public — permitting underwriters to use research to drum up interest in a stock, which is then sold to retail investors.

Although pre-offering research distributed by investment banks is immune from strict liability under the Securities Act, it is not exempt from investor suits under the Exchange Act — if investors can demonstrate that analysts drafted intentionally deceptive research.

Moreover, increased scrutiny of banks and conflicts of interest in recent months — for example, Goldman Sachs Group's dual roles in the El Paso Corp. merger with Kinder Morgan Inc. — suggests that analysts and underwriters should tread with caution.

Industry-wide Implications

In the next year, the financial markets may see other surprising consequences of the JOBS Act. If the legislation works as intended, there will generally be fewer acquisitions of startup companies, because it will be possible for these companies to generate capital through the public markets.

Indeed, IPO mania may take hold in certain sectors, like technology, in which it will be easier to raise equity on a smaller scale.

The act's easing of investor protection provisions may place considerable additional burden on already strained regulators such as the SEC and FINRA, which will likely need to expand their monitoring capacities.

The JOBS Act's effect on the world view of the U.S. capital markets may be the greatest concern. U.S. markets have enjoyed a competitive advantage over exchanges in competing nations for decades due to the perception that issuers on U.S. exchanges are subject to effective regulations.

Companies that chose to satisfy the hurdles for listing in the U.S. benefited from this belief by receiving a premium for their shares, allowing them to raise capital in a more effective and less expensive manner. The JOBS Act's relaxation of these regulatory requirements may, perversely, increase the cost of raising capital as a result.

Although the new legislation is only a few months' old, financial professionals throughout the U.S. have their work cut out for them. Understanding this capital formation legislation — and the raft of regulations that will follow — will be key for negotiating the new economy.

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