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The JOBS Act Trojan Horse: A Gift to Startups with Something Else Inside?

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THE JOBS ACT TROJAN HORSE: A GIFT TO STARTUPS WITH SOMETHING ELSE INSIDE?

*Erik Gordon**

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I. Introduction

Little in the law hides as much as the names that politicians give proposed legislation in order to make it politically attractive. Just as Odysseus is said to have concealed his intentions and his soldiers in the Trojan Horse, politicians have hidden their intentions and politically unattractive proposals in Trojan Horse bills with names that divert attention from those provisions to those that are more politically acceptable.

The largest tax increase to occur during the period from 1968 to 2006[1] was not named by its sponsors "The Largest Tax Increase of the Decade Act." Instead, the increase was hidden in an act named the "Tax Equity and Fiscal Responsibility Act of 1982."[2] Similarly, sponsors of The American Jobs Creating Act of 2004[3] probably found that name more politically useful and palatable than an act titled something on the lines of the "Act that Makes it $49 Billion More Expensive to Export" or "Tax Reductions for Distillers and Whalers Act." The Act, however, did include provisions that repealed $49 billion of export tax incentives, provided tax reductions for producers of beer and liquor, and added a charitable contribution de-

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1. *See* Jerry Tempalski, *Revenue Effects of Major Tax Bills,* (U.S. Dep't of the Treasury, Office of Tax Analysis, OTA Working Paper 81, 2006), *available at* http://www.treasury.gov/resource-center/tax-policy/tax-analysis/ Documents/ota81.pdf.

2. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324.

3. American Jobs Creating Act of 2004, Pub. L. 108-357, 118 Stat. 1418.

duction for whalers.[4] The Jumpstart Our Business Startups Act,[5] too, masks the inclusion of detrimental provisions and may not be the gift to the claimed recipients that the name implies.

As it stands, it was not easy to get to that felicitous name. Sponsors of predecessor bills in the House of Representatives used titles such as "Small Company Capital Formation,"[6] "Entrepreneur Access to Capital,"[7] and "Access to Capital for Job Creators."[8] The Senate saw bills labeled "Democratizing Access to Capital Act"[9] and the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act,"[10] a painful mouthful that tortuously assembles the acronym "CROWDFUND Act." The name "Jumpstart Our Business Startups Act" is politically useful. It frames the Act as a means of aiding startups, a more acceptable goal in the political climate at the time of its passage than legislation aimed at helping big companies and large hedge funds. The fact that the bill abbreviates to "JOBS Act" is also instrumental in situating it as legislation that creates employment.[11]

Passing the Act was a rare bipartisan effort, with much discourse on small businesspeople and entrepreneurs facing adversity in their attempts to grow their startups and little spoken about big companies and large hedge funds.[12] In 2012, President Obama announced: "The JOBS Act will allow Main Street small businesses and high-growth enterprises to raise capital from investors more efficiently, allowing small and young firms across the country to grow and hire faster . . . . These proposals will help entrepreneurs raise the capital they need to put Americans back to work . . . ."[13] At the bill's signing, House Speaker John Boehner (R-Ohio) an-

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4. Kimberly A. Clausing, The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers 2, 4 (2004).

5. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) [hereinafter JOBS Act].

6. Small Company Capital Formation Act of 2011, H.R. 1070, 112th Cong. (2011).

7. Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011).

8. Access to Capital for Job Creators Act, H.R. 2940, 112th Cong. (2011).

9. Democratizing Access to Capital Act, S. 1791, 112th Cong. (2011).

10. Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act, S. 1970, 112th Cong. (2011).

11. JOBS Act, Pub. L. No. 112-106, § 1, 126 Stat. 306, 306 (2012).

12. *See, e.g.*, Press Release, House Comm. on Fin. Servs., Legislative Package Combines Financial Services Committee Bills into JOBS Act (Feb. 28, 2012), *available at* http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=282267 (describing the bills included in the JOBS Act and stating, inter alia: "The bills that make up the legislative package announced today came out of our committee with strong bipartisan support. They will empower *small businesses and entrepreneurs* to invest, hire and expand."; "The JOBS Act is designed to help *startups and entrepreneurs get off the ground,* access investors and create jobs." (emphases added) Nowhere does the press release mention large companies or hedge funds.).

13. Press Release, White House Office of the Press Sec'y, President Obama To Sign Jumpstart Our Business Startups (JOBS) Act (Apr. 5, 2012), http://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act.

nounced that "[t]he JOBS Act—a key part of the Republican jobs plan—is good news for entrepreneurs and aspiring small businesspeople struggling to overcome government barriers to job creation."[14] But, the Act's name is a Trojan Horse. That is, given the size of the entities that can utilize the Act's provisions, the Act may be as likely to result in decreased disclosure by large companies and more easily facilitated capital-raising by hedge funds as it is to result in the increased employment spotlighted by the Act's sponsors.

This Comment will analyze which provisions of the Act are consistent with the purpose that sponsors would have the public believe, that emphasized by the name "JOBS Act," and distinguish them from those provisions that serve as menacing soldiers hidden under the cover of a name that diverts attention from the Act's true purpose.

II. Not Exactly Emerging Growth Companies

A primary focus of the JOBS Act is the newly-defined concept of "emerging growth companies," or EGCs. Not only is this focus key, but the label may also have been carefully and intentionally devised. Section 101(a) defines an "emerging growth company" as an issuer that has had annual gross revenues of less than $1 billion during its most recently completed fiscal year.[15] Is a company an emerging company simply because it has less than $1 billion in annual revenue?

The word "emerging" is defined as "just beginning to exist or be noticed"[16] or "growing and developing."[17] Is an annual revenue of up to $999,999,999 a credible indicator that a company is "just beginning to exist or be noticed"? That seems unlikely. Companies do not generate revenue of that order of magnitude at the beginning of their existence. Nor are they just beginning to be noticed. Venture capital firms, private equity firms, and, especially, underwriters who like to take them public, track

14. Press Release, Press Office of House Speaker John Boehner, Speaker Boehner: JOBS Act Should Spark Further Bipartisan Action on the Economy (Ap. 4, 2012), http://www.speaker.gov/press-release/speaker-boehner-jobs-act-should-spark-further-bipartisan-action-economy.

15. JOBS Act § 101(a). Section 101(a) adds the definition of EGCs as new subsection (19) of Section 2(a) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(19) (2012). The $1 billion amount is indexed for inflation every five years. *Id.* An issuer that is an emerging growth company as of the first day of that fiscal year remains one until the earliest of: (1) the last day of the fiscal year in which the company has annual gross revenue of at least $1 billion (indexed for inflation); (2) the last day of the fiscal year following the fifth anniversary of the date of the first sale of common equity pursuant to a registration effected under Title 1 of the JOBS Act; (3) the date on which the issuer has, during the previous three years, issued more than $1 billion in nonconvertible debt; or (4) the date on which the company is deemed to be a "large accelerated filer" under SEC regulations. *Id.*

16. *Emerging – Definition*, Macmillan Dictionary, available at www.macmillondictionary.com/us/dictionary/american/emerging (last visited Mar. 22, 2014).

17. *English Definition of "Emerging"*, Cambridge Dictionaries Online, *available at* http://dictionary.cambridge.org/us/dictionary/american-english/emerging?q=emerging (last visited Mar. 22, 2014).

companies long before the companies attain revenues that large. Alternatively, is this revenue threshold a credible indicator that a company is growing and developing? There is no obvious relationship between earning revenue of up to $999,999,999 in a given year and a company's growth or development.[18] Because of these uncertainties, it is not clear that the Act's definition of an EGC truly matches the label and understanding of an emerging growth company.

Under the definition of EGC, as written, most companies going public qualify as emerging growth companies. The inclusiveness of the definition with respect to companies undertaking initial public offerings is inconsistent, however, with the testimony of Kate Mitchell, managing director at Scale Venture Partners and now-former chairman of the National Venture Capital Association, before the Senate Committee on Banking, Housing and Urban Affairs.[19] "To put the bill's limited scope in perspective," Mitchell testified, "if the on-ramp provisions were in effect today, they would apply to only 14 percent of public companies and only 3 percent of total market capitalization, according to the IPO Task Force estimate."[20] The IPO Task Force, whose estimates Mitchell cites,[21] is a self-appointed group, of which Mitchell is a member.[22] These figures are misleading if

18. There is no record of JOBS Act proponents citing evidence that associates an annual revenue level of $1 billion with a company's nascent existence or that indicates that the set of companies with annual revenue of up to $1 billion are more likely to provide or create employment than larger companies.

19. *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins. & Inv. of the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. 37 (2011) [hereinafter Mitchell Testimony], *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112shrg74930/pdf/CHRG-112shrg74930.pdf (prepared statement of Kate Mitchell, Managing Director, Scale Venture Partners).

20. *Id.* at 39.

21. *See id.* at 38-42.

22. IPO Task Force, Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth 4 (2011) [hereinafter IPO Task Force Report], *available at* http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf. The IPO Task Force is the result of conversation among a working group at a conference convened by the U.S. Department of the Treasury. The IPO Task Force is comprised of: three venture capitalists, including Mitchell; one person from Wasatach Advisors and one person from T. Rowe Price (identified as "public investors"); three persons identified as "entrepreneurs"; two securities attorneys; a professor at Harvard Business School, a person from the S.E.C. Institute, and a private investor and retired head of PWC Tech Practice (collectively identified as "academicians/accountants,"); and five investment bankers. *See id.* at 33-34. Per the slides accompanying the IPO Task Force's report, the Task Force receives additional support from "Investors, CEOs, NYSE, NASDAQ, [and the] NVCA[.]" IPO Task Force, Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth (Slides) 3 (2011), *available at* http://www.sec.gov/info/smallbus/acsec/ipotaskforceslides.pdf. While the group is distinguished and experienced, its composition is weighted with persons and organizations whose self-interest in increased IPO activity is noticeable. It is not obvious whether this self-interest influenced the Task Force's work. While the Task Force claims that it represents "the entire ecosystem of emerging growth companies," IPO Task Force Report, *supra*, at 1, it does not seem to include angel investors, first-time or aspiring entrepreneurs, employees of emerging growth compa-

one draws from them the conclusion that the Act's IPO provisions for emerging growth companies would affect only 14 percent of IPOs undertaken. However, the 14 percent and 3 percent figures instead refer to all existing public companies, regardless of when they went public. That is, among all currently existing public companies, including those that have been public for decades, only 14 percent would qualify as emerging growth companies under the Act.

In her testimony, Mitchell referenced Ford Motor Company as a public company that would not today qualify as an emerging growth company eligible for on-ramp treatment.[23] Neither would companies such as Dow Chemical Company and ExxonMobil.[24] Yet, it is not clear why these companies would figure in the denominator of a ratio offered in support of the idea that the $1 billion in annual revenue definition of an emerging growth company limits the application of the JOBS Act IPO provisions to a small proportion of the relevant companies: those that are conducting an IPO. By contrast, a report from Latham & Watkins contains numbers that seem more relevant, because they are not predictions, but rather actual numbers gathered from SEC filings and reports for the current time period. The report states that "[n]early 75% of issuers that priced a US IPO after April 5, 2012 [sic] [the effective date of the JOBS Act] identified themselves as EGCs."[25] An Ernst & Young analysis asserts that "approximately 83% of the IPOs that went effective since April 2012 were filed by EGCs."[26] Yet another report says that over 90 percent of IPOs in 2011 would have qualified for JOBS Act relief, had the provisions of the Act been available.[27] Despite the attempt by the IPO Task Force to downplay the proportion of companies that would benefit from the JOBS Act provisions,[28] these

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nies, accountants to smaller companies, lenders to emerging growth companies, or public or private agencies that provide grants, incubator or accelerator services to emerging growth companies.

23. Mitchell Testimony, *supra* note 19, at 39.

24. Both companies are large and long established publically traded firms with revenue over $1 billion. *See* Dow Chemical Co., Annual Report (Form 10-K) (Feb. 14, 2014); Exxon Mobil Corp., Annual Report (Form 10-K) (Feb. 26, 2014).

25. Latham & Watkins LLP, The JOBS Act After One Year: A Review of the New IPO Playbook 2 (2013) [hereinafter New IPO Playbook], *available at* http://www.lw.com/thoughtLeadership/jobs-act-after-one-year-review-of-new-ipo-playbook; *see also* Paul, Weiss, Rifkind, Wharton & Garrison LLP, The JOBS Act: One Year Later 9 (2013), *available at* http://www.paulweiss.com/media/1602366/15apr13-jobs.pdf ("In the past year, approximately 75% of U.S. IPOs have been by EGCs.").

26. Ernst & Young LLP, The JOBS Act: One-Year Anniversary 4 (2013), http://www.ey.com/Publication/vwLUAssets/The_JOBS_Act:_One-year_anniversary/$FILE/JOBSActAnniversary_CC0368_9April2013.pdf.

27. Willis, JOBS Act Analysis 1 (2012), *available at* www.willis.com/Documents/Publications/Industries/Financial_Institutions/June-2012-Issue-22-JOBS-ACT.pdf.

28. For example, the provisions scaling back the accounting disclosures required to do an IPO (JOBS Act Sec. 102); relieving EGCs from the internal controls audit requirements of Sec. 404(b) of the Sarbanes-Oxley Act (JOBS Act Sec. 103); loosening the restrictions on communications with or by securities analysts (JOBS Act Sec. 105); providing a mechanism

figures indicate that a majority of companies engaging in initial public offerings after the Act's enactment are, in fact, qualified to take advantage of its exemptions. And, given the $1 billion revenue threshold, these statistics are not very surprising.

Some of the companies going public may readily be suspected of not truly being emerging growth companies for reasons beyond the large revenues that they were generating at the time of their IPOs. According to the Latham & Watkins report, of the 101 emerging growth companies that priced IPOs in the time period covered,[29] ten were real estate investment trusts and eleven were master limited partnerships.[30] Neither category, real estate investment trusts or master limited partnerships, is likely to include many companies that are emerging growth companies in the common sense understanding of the term.[31] During the same timeframe, five formerly public companies that had gone private priced IPOs as emerging growth companies under the Act, and two more were in registration at the time of the report.[32] In similar fashion, these companies' re-entrance to the public market is not likely to have been an emergence from anything other than ownership by private equity funds, bolstering the notion that not all companies meeting the technical definition of an EGC are, in fact, emerging growth.

Proponents of the Act and, more specifically, the notion of "emerging growth companies" included therein, justified their necessity by making much of the decline in the number of IPOs. For example, the report of the IPO Task Force says, "[d]uring the past 15 years, the number of emerging growth companies entering the capital markets through IPOs has plummeted relative to historical norms."[33] The Task Force attributed the decline, in part, to expensive regulatory provisions[34] that disproportionately burden the small companies that provide job growth.[35] "[T]he IPO Task Force has concluded that the cumulative effect of a sequence of regulatory actions, rather than one single event, lies at the heart of the crisis."[36] In response to these conclusions, the Task Force proposed a number of rollbacks to these regulatory actions.[37] In addition to the regulatory costs im-

for confidential filing of drafts of a company's IPO registration statement (JOBS Act Sec. 106); allowing EGCs to "test the waters" before going public by communicating with specified potential investors prior to or after the filing of a registration statement (JOBS Act Sec. 105).

29. *See id.* at 18 n.2.

30. New IPO Playbook, *supra* note 25, at 4.

31. *See supra* notes 15-17 and accompanying text.

32. New IPO Playbook, *supra* note 25, at 4.

33. IPO Task Force Report, *supra* note 22, at 1.

34. *Id.* at 9-10 (citing the Sarbanes-Oxley Act and the Dodd-Frank Act).

35. *Id*. at 8; *see also* Mitchell Testimony, *supra* note 19, at 6-7 (statement of Kate Mitchell, Managing Director, Scale Venture Partners).

36. IPO Task Force Report, *supra* note 22, at 1.

37. *Id.* at 17-18.

posed on IPO candidates, the IPO Task Force report claims that the rise of short-term, high-frequency trading makes it more difficult for small companies to go public.[38] The claimed chain of causation is that the move from fractional to decimal prices for shares (a regulatory change) and the rise of electronic markets (a technological change) has driven the increase in short-term, high-frequency trading.[39] Such trading has shifted the attention of investment banks and brokers who formerly sold IPOs of small, emerging companies (and their analysts who followed those emerging companies) away from emerging company IPOs and toward the higher returns that can be made in trading.[40]

Although regulatory actions are under the spotlight and partially blamed for the decline in IPOs,[41] no studies of the sort commonly used by regulatory agencies to buttress claimed economic effects of proposed actions are cited in support of this claim. Despite asserting that decimal pricing has had a negative effect on emerging company IPOs, the IPO Task Force does not recommend reverting to fractional pricing of shares instead of decimal pricing. Nor does the Task Force recommend restrictions on the high-frequency trading it claims has diverted the attention of investment bankers from small company IPOs.[42] Given the Task Force's attention on "rebuilding the IPO on-ramp" and on the damage done to IPOs by high-frequency trading, the omission of any recommendations that would directly address such trading and potentially shift the balance of investment bank profitability back toward IPO activity is surprising.

The claims of Act proponents in favor of rollbacks of selected provisions of existing securities law ultimately boil down to these: certain rollbacks are needed, and such rollbacks will result in the consummation of a greater number of IPOs of companies that are emerging and are growing, all of which will have the intended result of creating more jobs. So far, the data is not highly supportive of the proponents' second claim that securities law rollbacks will increase the number of IPOs. According to an article informed by Dealogic analytics, an average of 33 IPOs per quarter were done in the year prior to the effective date of the IPO on-ramp provisions of the Act, and 31 per quarter in the year after.[43] With regard to

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38. *Id.* at 13.

39. *Id.*

40. *Id.* at 14.

41. IPO Task Force Report, *supra* note 22, at 13-15.

42. *Id*. The IPO Task Force also does not consider the possibility that while larger spreads and commissions could fund more analyst research, there is no assurance that it would fund research in emerging growth companies where the opportunities to earn commissions is lower than in shares of the large-capitalization companies favored by high-frequency traders. Nor does the Task Force consider the possibility that larger spreads and commissions would impose costs on purchasers of shares in emerging companies.

43. *See* Steven M. Davidoff, *A Year Later, the Missed Opportunity of the JOBS Act*, N.Y. Times DealBook (Jun. 11, 2013, 5:19 PM), http://dealbook.nytimes.com/2013/06/11/a-year-later-the-missed-opportunity-of-the-jobs-act/?_php=true&_type=blogs&_php=true&_type=blogs&_r=1.

IPOs that raised less than $100 million—more likely to be IPOs of smaller, emerging companies than are higher dollar value IPOs—an average of 15 per quarter were done prior to the Act, and only 13 per quarter after the Act.[44] The proponent's insistence that more lenient treatment of emerging growth companies under the securities laws will spur IPO activity by those companies, then, has simply not proved true.

III. Reducing the Audit and Other Disclosures Required of Emerging Growth Companies

Title I of the Act, captioned "Reopening American Capital Markets to Emerging Growth Companies," scales back the accounting disclosures that companies are required to make upon launching initial public offerings.[45] The section also exempts EGCs from the internal controls audit requirements of Section 404(b) of the Sarbanes-Oxley Act,[46] as well as any future rules that may require either audit firm rotation or supplements to auditor reports, thereby necessitating the provision of additional information about the audit and the company's financial statements.[47] Finally, it loosens the restrictions on communications with or by securities analysts with respect to initial public offerings of emerging growth companies.[48]

Prior to the passage of the Act, all companies filing for an IPO were required to provide audited income statements and cash flow statements for the preceding three years and audited balance sheets for the preceding two years.[49] Under the JOBS Act regime, emerging growth companies must submit only two years of audited income, cash flow and balance sheet statements.[50] Again, in contrast to past requirements, Title I now permits emerging growth companies to draft "management discussion and analysis"[51] for only the periods for which they provide audited statements.[52] This relief is not trivial. The so-called "MD&A" is management's detailed discussion and analysis of the reporting period's financial performance, along with forward-looking information about the possible effects of future events and conditions.[53] Drafting the so-called "MD&A" is "usually the most challenging portion of the [IPO] prospectus to

44. *Id.*

45. *See* JOBS Act, Pub. L. No. 112-106, § 102, 126 Stat. 306, 308 (2012).

46. *See id.* § 103.

47. *Id.* § 104.

48. *Id.* § 105.

49. SEC Reg. S-X, 17 C.F.R. § 210.3-02(a) (2013).

50. JOBS Act § 102(b)(1).

51. SEC Reg. S-K, 17 C.F.R. § 229.303(a) (2013) (requiring "management discussion and analysis" which consists of laborious drafting, reviewing, and revision by top management, with the involvement of legal counsel, accountants, and investment bankers).

52. JOBS Act § 102(c).

53. *See* Joshua Rosenbaum &Joshua Pearl, Investment Banking 24 (2d ed. 2013).

draft."[54] The MD&A in the prospectus for the Twitter IPO—Twitter went public as an "emerging growth company"—is 36 pages long.[55]

The Act also eliminates various disclosures regarding executive compensation,[56] which had been imposed two years earlier in the Dodd-Frank Act.[57] Furthermore, while it is not clear that the wording of the JOBS Act requires it, the SEC has taken the reasonable position that an emerging growth company that is required to provide only two years of audited statements when seeking to go public will be similarly required to provide only two years of the "selected financial data" required in Item 301[58] of Regulation S-K.[59]

This rollback of requirements with respect to audited financial statements,[60] management discussion and analysis,[61] and disclosures of executive compensation[62] could save substantial accounting fees and management effort for EGCs that go public under the provisions of the Act. An analysis conducted by PricewaterhouseCoopers LLP of over 380 IPOs between January 1, 2009, and June 30, 2012, indicates that, for issuers with annual revenue below $100 million, pre-JOBS Act external audits cost an average of $800,000.[63] For issuers with at least ten times that annual revenue, the average cost was $1.2 million.[64] These audit costs undoubtedly burden small issuers disproportionately: they constitute a larger portion of a small issuer's revenues and, if an issuer is profitable, a larger portion of its profits.

The cost savings to smaller companies that results from the Act's diminished audited financials requirement, and therefore reduced accounting fees, is likely to be proportionally larger than one might expect. The

54. David A. Westenberg, Initial Public Offerings: A Practical Guide to Going Public § 13.2.1.J (2d ed. 2013).

55. *See* Twitter, Inc. Prospectus, Registration No. 333-191552 (Nov. 6, 2013) *available at* http://www.sec.gov/Archives/edgar/data/1418091/000119312513431301/d564001d424b4.htm.

56. *Id.* § 102(a).

57. Securities Exchange Act of 1934 § 14A(e), 15 U.S.C. § 78n–1(e) (2012) (amending 15 U.S.C. § 78n-1(e) (2010)) (expanding the exemptions to emerging growth companies).

58. Item 301 of Reg S-K generally requires companies to provide five years of "selected financial data" that includes, inter alia: net sales or operating revenues; income or loss from continuing operations; income of loss from continuing operations per common share; total assets; long-term obligations; and cash dividends declared per common share. SEC Reg. S-K, 17 C.F.R. § 229.301 (2013).

59. *Jumpstart Our Business Startups Act Frequently Asked Questions, Question 11*, U.S. Sec. Exch. Comm'n (April 16, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfj-jobsactfaq-title-i-general.htm.

60. JOBS Act § 102(b).

61. *Id*. § 102(c).

62. *Id*. § 102(a).

63. PricewaterhouseCoopers LLP, Considering an IPO?: The Costs of Going and Being Public May Surprise You 6 (2012), *available at* http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf.

64. *Id.* at 8.

reason is two-fold. First, it is more difficult, and thus more expensive, for accounting firms to conduct the tests required to certify financial statements when such tests involve matters further in the past. Second, it is unlikely that the older accounting records of small, growing companies, collected at a time when such companies were even smaller, are in the same condition as their more recent records. The reduction to two years of audited income and cash flow statements and of selected financial data required by Item 301[65] is, therefore, consistent with the claims of the Act's proponents that the costs of preparing an IPO can be disproportionately high for small companies and, so, ought to be mitigated. On the other hand, applying the reduction to companies that generate hundreds of millions of dollars in revenue, and yet still meet the criteria for emerging growth companies, is not consistent with that claim.[66]

Act proponents' belief that compliance with the internal controls audit requirements of Section 404(b) of the Sarbanes-Oxley Act is an impediment to going public, despite both the existing exemption for companies with a public float of less than $75 million and the existing compliance transition period for all new public companies,[67] is similarly well-founded. Smaller, private companies considering an IPO have rarely spent the money and time required to establish the processes and controls required of public companies by the Sarbanes-Oxley Act. While the absolute costs may be less for small companies than for large companies, there is a floor on the cost of implementing the requisite controls that creates a disproportionate impact on small companies.[68] This provision of the Act is, too, inconsistent with the goals of its proponents.

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65. *See Jumpstart Our Business Startups Act Frequently Asked Questions, Question 11,* U.S. Sec. Exch. Comm'n (April 16, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfj-jobsactfaq-title-i-general.htm.

66. It is unclear what proportion of larger companies will, in actuality, be helped by the Act's rollback of financial requirements. Many such companies will have taken in venture capital or obtained large commercial loans. Venture capital investors and lenders of large sums of money often require certified financial statements. If the investment or loans were made more than two years prior to an IPO, the company may already have three years of audited statements and paid the fees that attend their preparation, therefore escaping any reduction in audit expense at the time of the IPO. This assumes that the audits have been performed by CPA firms acceptable to the underwriters of the IPO. If the audits have been performed by local CPA firms that the underwriter is not familiar with, for example, the company's statements may have to be re-audited, in which case the Act provisions would save the company at least some re-audit fees.

67. Mitchell Testimony, *supra* note 19, at 8.

68. *See* PricewaterhouseCoopers, *supra* note 63, at 13 (estimating that the pre-IPO costs of preparing for compliance with Sarbanes-Oxley as a whole, not just Section 404, are to be between $100,000 and just under $500,000, that is likely that smaller companies are on the low end of the range, and that large companies with complex or distributed operations are on the high end).

IV. Easing the Restrictions on Communications During the IPO Process

In the period leading to the Act's passage, JOBS Act proponents claimed that investment research coverage had decreased in prior years, and that the decrease had "adversely impact[ed] trading volumes, company market capitalizations and the total mix of information available to market participants."[69] They did not explain, however, how such lower trading volumes caused a reduction in the number of emerging growth company IPOs (ostensible job generators) or the link between decreased research coverage of companies and their lower market capitalizations. Nor did the Act proponents provide evidence to support their claim that less coverage by investment banker or brokerage-based analysts has resulted in "less transparency and visibility into emerging growth companies for investors . . . ."[70]

Their claim is not self-evident, particularly in an era of constant television and online investment news and punditry. These pundits and newscasters arguably provide as much insight as analysts, whose reports, especially on smaller companies, often consist mainly of rehashing and distributing to clients information already made public by company management. Nevertheless, companies considering launching an IPO often do consider analyst coverage important, particularly when selecting underwriters.[71] In fact, the perceived importance of favorable and influential analyst coverage of a company considering an IPO led over time to the phenomena of analysts becoming active players in the sales pitches that investment bankers made to prospective IPO clients and analyst compensation and career advancement becoming directly linked to the investment bankers' success in attracting business.[72]

The perceived abuses related to the conflict of interest between analysts' provision of informational reports and their compensation in conjunction with investment bankers' attraction of business resulted in

69. IPO Task Force Report, *supra* note 22, at 26.

70. *Id.* at 14.

71. David A. Westenberg, Initial Public Offerings: A Practical Guide to Going Public 10 (2013) ("The caliber and reputations of the research analysts employed by prospective managing underwriters often sway a company's decision.").

72. NYSE/NASD IPO Advisory Committee, Report and Recommendations of a committee convened by the New York Stock Exchange, Inc. and NASD at the request of the U.S. Securities and Exchange Commission 2 (2003).

legislation,[73] enforcement action, including the 2003 Global Settlement,[74] and rule making[75]—each of which was designed to reduce the problems inherent in the noted conflicts of interest. The JOBS Act has loosened the extensive restrictions on the manner and timeframes within which analysts and others are permitted to communicate with management and potential buyers of emerging growth company IPO shares. For example, the Act adds Section 15D(c)(2) to the Securities Exchange Act of 1934.[76] Section 15D(c)(2) limits the applicability of existing Section 15D(a) of the Securities Exchange Act of 1934 to emerging growth companies. Section 15D(a) broadly separates research analysts from investment bankers.[77] Under new Section 15D(c)(2), however, neither the SEC nor any national securities association registered under Section 15A[78] can adopt or maintain any rule or regulation with respect to the IPO of an emerging growth company that restricts an analyst from participating in any communications with company management that also is attended by an investment banker.[79] Nor can the SEC or any national securities association restrict an investment banker from arranging for communications between an analyst and a potential investor.[80]

Because the JOBS Act does not expressly overrule the 2003 Global Settlement, it is possible that the major investment banks that settled under that agreement may be unable to avail themselves of the return to past practices signaled by the Act's passage, whereby investment bankers could bring analysts to meetings with prospective IPO clients or send them to talk to potential investors in an emerging growth company's IPO. Yet,

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73. See Section 15D of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-6 (2012), added by the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745, 791 (2002). Section 15D(a) mandates, inter alia, the adoption of rules to establish institutional and structural safeguards to assure that analysts are separated by appropriate informational partitions within their firms from review, oversight or pressure from investment bankers. It also mandates the adoption of rules that restrict the prepublication clearance or approval of research reports by investment bankers or others not directly responsible for investment research, that keep investment bankers out of analyst compensation decisions, and that forbid investment bankers from retaliating or threatening to retaliate against analysts who produce unfavorable reports that may adversely affect existing or prospective investment banking relationships.

74. *See, e.g.*, *2003 Global Settlement*, Fin. Industry Reg. Authority, http://www.finra.org/Industry/Enforcement/DisciplinaryActions/2003GlobalSettlement/
(The global settlement requires, inter alia, the settling investment banks to physically separate investment bankers from analysts, keep investment bankers out of compensation and assignment decisions regarding analysts, and to prohibit analysts from participating in efforts to solicit investment banking business, including IPO business, and including analyst participation in IPO roadshows.).

75. *See e.g.,* NYSE Rule 472; NASD Rule 2711; 17 C.F.R. §§ 242.501-.502 (2014).

76. *See* JOBS Act, Pub. L. No. 112-106, § 105(b), 126 Stat. 306, 311 (2012).

77. Exchange Act § 15D(a), 15 U.S.C. § 78o-6(a).

78. *Id.* § 78o-3.

79. JOBS Act § 105(b).

80. *Id.*

Act proponents recommend a return to such practices,[81] precisely those associated with the unsavory and allegedly illegal practices that helped float the emerging company IPOs of the dot-com era. A return to looser boundaries between research analysts, investment bankers, and investors may or may not increase the number of IPOs and, therefore, instigate job creation, as proponents suggest. However, in either case, the reversion legitimized by the Act is an affront to the protections that were imposed in the wake of revelations of past practices that were shocking, at least to persons not familiar with investment banking culture. It is with good reason, then, that sponsors of the JOBS Act did not title it the "Repeal the Protections We Gave You After We Discovered What Investment Bankers Did During the Dot-Com Boom Act," though this is evidently what the Act has accomplished in one respect.

In addition to renewed interactions between analysts and investment bankers, the timing of analyst reports has also changed significantly post-JOBS Act. Under federal securities law, analyst research reports are considered offers of securities.[82] It is unlawful to offer to sell a security prior to filing a registration statement with the Securities and Exchange Commission.[83] The result, prior to the JOBS Act, was the imposition of "quiet periods"[84] before, during, and after registration of an IPO, during which analysts were not permitted to release research reports.[85] The prohibition on release of analyst reports began prior to the filing of a registration statement and persisted for up to 40 days after the offering for a managing underwriter (or 25 days for other underwriters), as well as for 15 days before and after the expiration of an underwriter lock-up period.[86]

The JOBS Act removed the "quiet period" prohibitions on research reports regarding emerging growth companies, including those from the underwriters of a company's IPO, both with respect to reports published prior to the filing of a registration statement[87] and reports published after the IPO has gone effective.[88] As a result, reports with information con-

81. IPO Task Force Report, *supra* note 22, at 28-29.

82. Securities Act of 1933 § 2(a)(3), 15 U.S.C. § 77b(a)(3) (2012) (defining "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The section has been interpreted broadly to include reports issued by brokers, because these reports are published to produce commissions.).

83. Securities Act § 5(c), *id.* § 77e(c).

84. *See generally* Securities Act § 2(a)(3), *id.* § 77b(a)(3); Securities Act § 5(c), *id.* § 77e(c); FINRA Manual § 2711(f).

85. *See* FINRA Manual §2711(f).

86. *Id.*

87. JOBS Act, Pub. L. No. 112-106, § 105(a), 126 Stat. 306, 310 (2012) (amending Section 2(a)(3) of the Securities Act of 1933 by adding language that says that the publication of a research report about an emerging growth company that is proposing an IPO of its common stock is not an offer to sell a security for the purposes of Section 5(c) of the Securities Act).

88. *Id.* § 105(c) (amending Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (2012), by adding subsection (d)).

cerning an emerging growth company may now be issued to the public prior to the filing of a registration statement and after the registration is deemed effective and the IPO is sold, all without the previously imposed blackout periods.

This change helps the companies going public that really are too small to attract attention from analysts other than those associated with the companies' underwriters. Prior to the change, the IPOs of those companies suffered from a lack of attention and interest from prospective buyers of the IPO shares because they could not easily obtain information about the companies that would facilitate making a decision to purchase the shares.[89] The only analysts who had a reason to invest in producing reports about such small companies were the analysts of the underwriter, and they were prohibited from publishing reports during the quiet period.

V. Confidential Filing of Draft Registration Statements

While certain provisions of the JOBS Act represent reductions to the stringency of regulations previously imposed on companies seeking to go public, at least with respect to emerging growth companies, the Act also added an entirely new process to the regulatory framework, which permits EGCs to submit a draft of its registration statement to the SEC for review on a confidential basis.[90] The confidential draft, and all amendments thereto, must be publicly filed at least 21 days prior to commencement of any IPO road show.[91] Though referred to as a "draft," the confidential submission should not be incomplete. The SEC has indicated that it expects drafts to both be substantially complete and include a signed audit report of the registered public accounting firm that prepared the required financial statements.[92]

Act proponents claim that companies are reluctant to undertake the process of going public because doing so requires publicly filing information that might be useful to competitors prior to knowing whether the SEC is likely to declare the company's registration statement effective.[93] The new procedure offers some relief by permitting a company to privately embark on the registration statement comment and response period with

89. See the similar observations made by the IPO Task Force. IPO Task Force Report, *supra* note 22, at 13-15.

90. *Id.* § 106(a) (amending Section 6 of the Securities Act of 1933, 15 U.S.C. § 77f, by adding subsection (e)).

91. "Road show" is defined as an offer (other than a statutory prospectus or portion thereof) that contains a presentation regarding an offering by one or more members of the issuer's management and includes discussion by a member of management of the issuer (the company), the securities being offered, or of the management, itself. See 17 C.F.R. § 230.433(h)(4) (2014).

92. *Jumpstart Our Business Startups Act Frequently Asked Questions, Question 7*, U.S. Sec. Exch. Comm'n (April 16, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

93. IPO Task Force Report, *supra* note 22, at 29.

the SEC to gauge whether such negotiations are likely to be successful, and to abandon the process if they are not, without releasing confidential information to the public or competitors.[94] If the company does proceed with its IPO, the information is released when the formerly confidential information is filed publicly.[95]

The need for confidential draft filing provisions, though available only to EGCs, seems to be unrelated to a company's status as emerging or growing. The companies that are likely to legitimately use the provisions, if their purpose is truly to encourage companies to go public, are companies with peculiar characteristics that make it difficult for the actors involved in the IPO process—namely, experienced accountants, attorneys, and investment bankers—to predict issues that are likely to require negotiations and result in delays during the SEC's process of reviewing the filing, and possible resolutions of them. Problems and difficulties that may cause a company to abandon its effort to go public do not necessarily arise because of a company's size; rather, they arise because a company wishes to use disclosure methods and materials that differ from traditional disclosures.[96]

The types of companies that tend to use nontraditional disclosures typically exist in fields where there are new business models for which traditional methods of analysis are insufficient, and where new risks and other types of material information are present. For example, consider a company that (1) is not generating revenue, (2) has no definitive plan for generating revenue, and (3) is adding non-revenue-generating users who are expected to be "sticky,"—that is, because of network effects, they are expected to remain users over an extended period. The company may contend that having such a network is a valuable asset that can be monetized in some way in the future. What exactly should the company be allowed to disclose about the potential value of the network? It is precisely this lack of certainty about what should and can be disclosed about this network in

94. Mitchell Testimony, *supra* note 19, at 42 (prepared statement of Kate Mitchell, Managing Director, Scale Venture Partners). It is important to note that the confidential filing of a draft registration statement is not considered the filing of a registration statement under Section 5(c) of the Securities Act of 1933. Therefore, care should be taken not to make an offer to sell stock prior to a non-confidential filing of a registration statement with the SEC.

95. JOBS Act § 106(a) (amending Section 6 of the Securities Act of 1933, 15 U.S.C. § 77f, by adding subsection (e), under which the initial confidential filing and all amendments must be publicly filed not later than 21 days prior to the date the issuer conducts a road show).

96. For example, a company whose business prospects cannot be measured by traditional means and wishes to instead use supplemental, nontraditional measures that, at the time are new, to the SEC. For example, GrubHub used the metric "Daily Average Grubs." *See* GrubHub Inc., Prospectus, Registration No. 333-194219 (April 1, 2014), *available at* http://www.sec.gov/Archives/edgar/data/1594109/000119312514125249/d647121ds1a.htm. Twitter used the metrics "Tweets per day" and "impressions of Tweets." *See* Twitter, Inc. Prospectus, Registration No. 333-191552 (Nov. 6, 2013) *available at* http://www.sec.gov/Archives/edgar/data/1418091/000119312513431301/d564001d424b4.htm.

the offering statement filed with the SEC that makes the hypothetical company uncertain as to whether it will actually complete an IPO. Where uncertainty such as this exists, confidential submission is well-suited. However, the metric that allows a company to qualify as an EGC and, therefore, to take advantage of the new confidential draft procedure is based on annual revenue and unrelated to the relevant uncertainty that troubles companies. That makes the metric unlikely to accurately sort companies into those that need the benefit of the confidential draft procedure in order to go public, and those companies that would go public with or without the benefit of the confidential draft procedure. As such, the metric is poorly-crafted to accomplish the stated goal of encouraging companies with peculiar uncertainties to go public.

VI. Testing the IPO Waters

As part of its "IPO on-ramp," the JOBS Act also includes a provision that allows emerging growth companies to "test the waters" before going public by communicating with certain potential investors, those that are qualified institutional buyers[97] or institutions that are accredited investors,[98] either prior to or following the filing of a registration statement. Prior to the JOBS Act, companies could not test the waters with potential investors before going through the expense and effort of preparing and filing a registration statement.[99] The specific purpose of this allowance appears to be to give emerging growth companies the opportunity to determine whether such investors might be interested in the IPO.[100]

Despite its goal, this provision seems unlikely to succeed in helping small, emerging companies because the size of their public offering, and, therefore, the public float of their stock, is likely to be too insubstantial to attract many institutional investors. When coupled with the fact that there is no limit on the size of an emerging growth company's IPO, the provision might instead make life easier for underwriters and issuers of public offerings that are large enough to be attractive to institutional investors (though they may still be considered EGCs). Indeed, underwriters will be able to begin sounding out their stable of institutional investors at an earlier point in the process, thus enabling the investment banks to give companies more accurate predictions about the likely IPO price and size that the market will be willing to accept. Even if this is the case, it remains unclear whether providing more accurate predictions to a company at an earlier point in the IPO process will result in the consummation of more public offerings, as the Act's proponents claim, or will lead to fewer IPOs. That is, in contrast to the proponents' beliefs, if companies can abandon

97. 17 C.F.R. § 230.144A (2013).

98. *Id.* § 230.501(a).

99. Securities Act of 1933 § 5(c), 15, U.S.C. § 77e(c) (2012).

100. JOBS Act § 105(c) (amending Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (2012), by adding subsection (d)).

the IPO process earlier with less sunk costs as a result of enhanced information about the offering's prospects, they may actually be less likely to continue the IPO process to completion.

Another point of uncertainty resides in the fact that it is also not clear that underwriters will disclose to investors information that is negative and, at that time, still confidential, during the "testing the waters" phase.[101] Underwriters may instead be tempted to withhold information regarding a disclosure disagreement with the SEC in the hope that it will be resolved before the company has to reveal the disagreement in its public filing. The feedback that the underwriters get from potential investors during the confidential phase may, then, be more positive than the reaction that they receive after the public filing of the confidential draft and all amendments thereto reveals the disagreement.[102] Under this chain of events, the information that the company obtains from testing the waters under the confidential filing process may be far less accurate than it would be had the filing simply been public. Thus, another potential consequence, unforeseen perhaps by Act proponents, of making public offering decisions on the basis of information from testing the waters is that those decisions may be of lower quality.

VII. Conclusion

The JOBS Act is a political amalgamation of at least five bills, three of which originated in the House of Representatives[103] and two of which originated in the Senate.[104] Supporters of the JOBS Act, both Democrat[105] and Republican,[106] claimed that the intention of the Act was to stimulate job creation. And, at least facially, the provisions discussed in this Comment—reducing the cost and burden of financial disclosures; easing restrictions on analyst communications during the IPO process; al-

101. The waters could be tested under JOBS Act Section 105(d) at a time when the only filings are confidential drafts permitted under JOBS Act Section 106(a).

102. JOBS Act § 106(a) (adding subsection (e)(1) to Section 6 of the Securities Act of 1933, which requires the public filing with the SEC of the initial confidential draft and all amendments no later than 21 days before the commencement of the company's road show); *see also supra* note 88.

103. Small Company Capital Formation Act, H.R. 1070, 112th Cong. (2011); Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011); Access to Capital for Job Creators Act, H.R. 2940, 112th Cong. (2011).

104. Democratizing Access to Capital Act, S. 1791, 112th Cong. (2011); Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act, S. 1970, 112th Cong. (2011).

105. Press Release, White House Office of the Press Sec'y, President Obama To Sign Jumpstart Our Business Startups (JOBS) Act (Apr. 5, 2012), http://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act.

106. Press Release, Press Office of House Speaker John Boehner, Speaker Boehner: JOBS Act Should Spark Further Bipartisan Action on the Economy (Ap. 4, 2012), http://www.speaker.gov/press-release/speaker-boehner-jobs-act-should-spark-further-bipartisan-action-economy.

lowing emerging growth companies to file confidential drafts of their registration materials; and testing the IPO waters—seem to be related to that stated goal. However, examination of those provisions in light of the new meaning of "emerging growth company," a company with annual gross revenues of less than $1 billion during its most recently completed fiscal year,[107] reveals that the Act is less what it is claimed to be—a job creator—and more a Trojan Horse. Hidden in this Trojan Horse of a bill is the very real possibility that companies that are neither startups, nor emerging, nor the job creators that proponents of the Act touted, may benefit from the law more than anyone else.

107. JOBS Act, Pub. L. No. 112-106, § 101(a), 126 Stat. 306, 307 (2012).