

V. ***JOBS Act—Modifications to Pre- and Post-IPO Process for “Emerging Growth Companies”***

A. **Introduction**

On April 5, 2012, President Barack Obama signed into law the Jumpstart Our Business Startups Act (“JOBS Act” or the “Act”).¹ The JOBS Act seeks to reduce the regulatory compliance costs for a newly defined category of public company: the emerging growth company (“EGC”).² Title I of the Act, known as the “IPO On-Ramp,” lays out a simplified initial public offering (“IPO”) process for EGCs.³ Since the mid-1990s, IPOs have decreased in size and in number.⁴ Proponents of the JOBS Act attribute this decline to increasingly burdensome financial regulation, which may have discouraged smaller companies from entering the public capital markets.⁵ Under the JOBS Act, EGCs benefit from relaxed requirements before, during, and after an IPO.⁶ While the Act’s supporters are optimistic that such measures will stimulate the economy and promote job growth, critics worry that it scales back

¹ Press Release, Office of the Press Secretary, Statement by the Press Secretary on H.R. 3606 (Apr. 5, 2012); *see also* Jumpstart Our Business Startups Act, Pub. L. No 112-106, 126 Stat. 306 (to be codified in scattered sections of 15 U.S.C.).

² Jeffrey W. Rubin, *The JOBS Act: An Overview—What Every Business Lawyer Should Know*, BUS. L. TODAY, May 25, 2012, at 1, <http://apps.americanbar.org/buslaw/blt/content/2012/05/article-01-rubin.pdf>.

³ Samuel Wolff, *The JOBS Act, Part 4: Further Lessons from the Legislative History*, 34:7 SEC. & FED. CORP. L. REP. (2012) (referring to Title I as the “Onramp” provision).

⁴ In 1996, 768 U.S. companies went public; by 2008, the number had dropped to twenty-two. DAVID A. WESTENBERG, INITIAL PUBLIC OFFERINGS: A PRACTICAL GUIDE TO GOING PUBLIC §1:5 (2d ed. 2011); *see id.*, Fig. 1-3 (showing a dramatic difference in the number of IPOs between the late nineties and the first decade of the 21st century).

⁵ IPO TASK FORCE, REBUILDING THE IPO ON-RAMP, at 8, Chart F (Oct. 20, 2011), *available at* http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

⁶ Bonnie J. Roe, *IPO On-Ramp: The Emerging Growth Company*, BUS. L. TODAY, May 25, 2012, at 1, <http://apps.americanbar.org/buslaw/blt/content/2012/05/article-04-roe.pdf>.

necessary regulation that protects investors.⁷ Without sufficient investor protections, the potential for fraud increases, and investors could lose confidence in the market.⁸

The purpose of this article is to examine how the JOBS Act changes the IPO process to ease EGCs' access to public capital markets. Part B will explain how the JOBS Act defines EGCs. Parts C and D will review how the JOBS Act amends the Pre- and Post-IPO Process for EGCs. Part E will discuss the Act's potential impact on investors.

B. What Qualifies as an Emerging Growth Company?

Although the definition of an EGC captures a large number of companies, EGC status and its accompanying benefits are temporary. An issuer qualifies as an EGC if it has less than \$1 billion in total annual gross revenues for its most recently completed fiscal year.⁹ Estimates suggest that the \$1 billion threshold would have included 98% of IPOs since 1970.¹⁰ Additionally, in order to qualify

⁷ Compare Glenn R. Pollner et al., *The JOBS Act: What It Means for Capital Markets Practices and Capital-Raising Strategies*, RECENT DEV. IN SEC. L., 2012 WL 3279513, at *1 (2012) (announcing that “companies will be able to grow and expand their business”), with Rubin, *supra* note 2, at 2 (observing “concerns about the potential for fraud and investor exploitation that could result from the relaxed regulatory requirements”).

⁸ Letter from Mary Schapiro, Chairman, SEC, to Tim Johnson, Chairman, and Richard C. Shelby, Ranking Member, S. Comm. on Banking, Hous., and Urban Affairs 1-2 (March 13, 2012), http://www.aicpa.org/advocacy/issues/downloadabledocuments/404b/3-13-12_sec_chm_schapiro_letter_to_johnson.pdf.

⁹ This amount is indexed for inflation every 5 years. Jumpstart Our Business Startups Act, Pub. L. No 112-106, §101(a), 126 Stat. 306, 307 (2012) (to be codified at 15 U.S.C. 77b).

¹⁰ *Spurring Job Growth Through Capital Formation While Protecting Investors, Part II: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 12–14 (2012) (testimony of Lynn E. Turner, Managing Dir, LitiNomics, Inc.), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5aaabb66-36eb-4b1e-8195-3cbeda832814; Luis A. Aguilar, Comm’r, SEC, Public Statement: Investor Protection is Needed for True Capital Formation (March 16, 2012), available at <http://www.sec.gov/news/speech/2012/spch031612laa.htm>.

as an EGC, a company must not have already made a registered sale of common stock on or before December 8, 2011.¹¹

An EGC automatically loses its status after five years.¹² Alternatively, an EGC loses its status once it fails to qualify as an EGC by either achieving \$1 billion in annual gross revenues, issuing more than \$1 billion in bonds, or becoming a “large accelerated filer.”¹³ An EGC can also opt-out of any benefits it would receive under the JOBS Act without losing its status.¹⁴

C. How Does the JOBS Act Change the Pre-IPO Process for EGCs?

A public company faces significant reporting requirements and heavily regulated communication with investors.¹⁵ The JOBS Act eases these restrictions for EGCs in order to facilitate their raising capital on the public markets.¹⁶ Specifically, EGCs may disclose less financial information in their initial registration statement and communicate privately with the U.S. Securities and Exchange Commission (“SEC”) and investors before their IPO.¹⁷ The JOBS Act also scales back the limits on sell-side analyst communications.¹⁸

1. Reporting Requirements

Before selling its stock to investors through an IPO, a company must disclose material information about its business in an initial registration statement.¹⁹ In general, a company files this

¹¹ Jumpstart Our Business Startups Act §101(d), 126 Stat. at 308 (to be codified at 15 U.S.C. 77b).

¹² *Id.* §101(a), 126 Stat. at 307 (to be codified at 15 U.S.C. 77b).

¹³ *Id.* Rule 12b-2 of the Securities Exchange Act of 1934 defines a large accelerated filer as “a seasoned issuer with at least \$700 million in common equity market capitalization held by non-affiliates.” Roe, *supra* note 6, at 1.

¹⁴ Rubin, *supra* note 2, at 3.

¹⁵ IPO TASK FORCE, *supra* note 5, at 12.

¹⁶ Rubin, *supra* note 2, at 1.

¹⁷ Andrew L. Fabens et al., *JOBS Act Changes the Public & Private Capital Markets Landscape*, 16:5 Wallstreetlawyer.com: Sec. Electronic Age 12 (May 2012).

¹⁸ *Id.*

¹⁹ Randall Smith & Emily Chasan, *JOBS Act Jolts Firms to Action*, WALL ST. J., Apr. 13, 2012, at C2.

statement several months before its road show, where the company first presents its stock to investors at the IPO price.²⁰ Typically, the statement contains two years of audited balance sheets and three years of audited statements of income and changes in financial position.²¹ Under Title I of the JOBS Act, however, an EGC is only required to submit two years of audited financial statements in its initial registration statement.²² Moreover, EGCs may delay these disclosures until twenty-one days before their road show.²³

2. Early Communication

One of the challenges companies face in raising funds through public capital markets is the uncertainty that an IPO will be successful.²⁴ Because the cost of each filing is so high, the uncertainty serves as an additional disincentive, especially for small companies.²⁵ The JOBS Act provides EGCs with greater ability to gauge the potential for a successful IPO by permitting communication with the SEC and investors prior to filing the initial public registration statement.²⁶

The SEC normally comments on the initial registration statement once it has been publicly filed.²⁷ However, the JOBS Act permits an EGC to submit a confidential draft statement, which the SEC reviews privately.²⁸ An EGC still must file a registration statement publicly, at least twenty-one days before the road show, to complete its IPO.²⁹

A company is normally not permitted to communicate with investors before publicly filing its registration statement.³⁰ The JOBS Act “Test the Waters” provisions ease this restriction and allow EGCs, or anyone acting on their behalf, to communicate with potential investors prior to filing publicly.³¹ However, the Act limits

²⁰ *Id.*

²¹ Roe, *supra* note 6, at 2.

²² *Id.*

²³ Smith & Chasan, *supra* note 19.

²⁴ Roe, *supra* note 6, at 2.

²⁵ *Id.* at 3.

²⁶ *Id.*

²⁷ See Schapiro, *supra* note 8, at 4.

²⁸ Pollner, *supra* note 7, at 2.

²⁹ *Id.*

³⁰ Fabens, *supra* note 17.

³¹ *Id.*

such communications to sophisticated investors, and EGCs can still be held liable for making fraudulent statements.³²

3. Sell-side Analyst Communications

In addition to easing restrictions on EGC communications, the JOBS Act also encourages communication between investment banks and research analysts in an effort to stimulate investor interest in EGCs.³³ Prior to the JOBS Act, the distribution of any research report about a company undergoing an IPO was considered an “offer” to sell the company’s securities, and as such was prohibited prior to the release of the company’s initial registration statement.³⁴ The JOBS Act permits analysts and broker-dealers to publish research on an EGC without it being construed as an offer.³⁵ This provision applies to investment banks and underwriters even if they participate in the IPO themselves.³⁶

One of the contributing factors to the 1990s dot-com bubble was conflicts of interest created by certain investment firm practices. During this period, underwriters would work with analysts to inflate internet companies’ stock prices by publishing positive research on the burgeoning dot-com businesses.³⁷ When the bubble burst, it severely weakened investor confidence in the market³⁸ and quickly provoked a legislative response.³⁹ In passing the Sarbanes-Oxley Act,⁴⁰ Congress instructed the SEC, registered securities associations, and the national securities exchanges to promulgate rules that addressed such conflicts of interest.⁴¹ In addition to Sarbanes-Oxley, various securities regulators, including the SEC and a precursor to the Financial Industry Regulatory Authority (“FINRA”), entered into a “Global Settlement” with the country’s

³² *Id.*

³³ Roe, *supra* note 6, at 3–4.

³⁴ *Id.* at 3.

³⁵ Pollner, *supra* note 7, at 3.

³⁶ Roe, *supra* note 6, at 3.

³⁷ Telis Demos, *Stocks to Get Boost, Again, From Research*, WALL ST. J., Sept. 20, 2012, at C1.

³⁸ Aguilar, *supra* note 10.

³⁹ Demos, *supra* note 37.

⁴⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

⁴¹ Fabens, *supra* note 17.

largest investment firms.⁴² The terms of the settlement required the firms to pay a substantial penalty and to restructure their practices to ensure adequate separation between their banking and research departments.⁴³ Ultimately, many firms other than the actual parties to the Global Settlement decided to adopt these practices.⁴⁴

The JOBS Act explicitly prohibits the SEC and other rule-making bodies from adopting any rule that prevents analysts from communicating with an EGC when investment bankers are also present.⁴⁵ This prohibition amends Sarbanes-Oxley's instructions and appears to allow research analysts to be "brought over the wall" erected by the Global Settlement.⁴⁶ However, the extent to which the JOBS Act overrules the Global Settlement remains unclear. Only an SEC or FINRA rule or a court order can alter the Global Settlement, and any formal change must explicitly delineate the portion of the settlement it affects.⁴⁷

D. How Does the JOBS Act Change an EGC's Responsibilities After an IPO?

After the initial public offering, an EGC continues to benefit from more lenient financial reporting standards and communication restrictions. Additionally, the JOBS Act exempts EGCs from auditor attestation of their internal controls reports, eases standards for complying with the Dodd-Frank Act's executive compensation requirements,⁴⁸ and eliminates the previously mandated quiet period on research publication after an EGC's IPO.⁴⁹ These provisions are geared toward reducing an EGC's administrative costs and maintaining investor interest once the EGC has gone public.

⁴² Pollner, *supra* note 7, at 3.

⁴³ *See id.* at 4 (listing the Global Settlement terms).

⁴⁴ *Id.*

⁴⁵ Jumpstart Our Business Startups Act, Pub. L. No 112-106, §105(b), 126 Stat. 306, 311 (2012) (to be codified at 15 U.S.C. 78o-6).

⁴⁶ Roe, *supra* note 6, at 3.

⁴⁷ Dana G. Fleischman, *JOBS Act on Research: Strong Buy?*, BUS. L. TODAY, May 25, 2012, at 2, <http://apps.americanbar.org/buslaw/blt/content/2012/05/article-05-fleischman.pdf>.

⁴⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951, 953, 124 Stat. 1376, 1899-1900, 1903-04 (2010) (codified as amended at 15 U.S.C. §§ 78n(i), 78n-1 (Supp. V 2011)).

⁴⁹ Fleischman, *supra* note 47, at 2.

1. Report on Internal Controls

The accounting scandals of Enron, World-Com, and others prompted Congress to draft Section 404(b) of Sarbanes-Oxley.⁵⁰ The provision requires companies to have an independent auditor attest to and approve the company's assessment of its internal control structure and procedures for financial reporting.⁵¹ "Smaller reporting companies," which have a market capitalization less than \$75 million, are exempt from the internal controls audit requirement. The JOBS Act extends the exemption for smaller reporting companies to EGCs as well.⁵² Notably, this broader exemption does not eliminate the requirement for the EGC to maintain internal control over their financial reporting, but merely eliminates the requirement for an independent audit.⁵³ The JOBS Act anticipates future exemptions by requiring any new auditing rules affecting EGCs to be approved by the SEC only if the agency finds them necessary and appropriate to the public interest.⁵⁴

2. Executive Compensation

The Dodd-Frank Act mandates that public companies must hold a non-binding shareholder proxy vote to approve executive compensation (a "say-on-pay" vote) at least once every three years.⁵⁵ This is complemented by a say-on-frequency vote at least once every six years, which determines how often a say-on-pay vote should take place.⁵⁶ The Dodd Frank Act also requires shareholders to approve any "golden parachute compensation"—that is, any executive compensation arrangement that is based on a company's dissolution.⁵⁷ The JOBS Act states that an EGC does not need to hold a shareholder proxy vote on any of the above executive compensation matters until at least three years after its IPO.⁵⁸ Thus,

⁵⁰ Aguilar, *supra* note 10.

⁵¹ Fabens, *supra* note 17.

⁵² Roe, *supra* note 6, at 2; *see* Aguilar, *supra* note 10.

⁵³ Roe, *supra* note 6, at 2.

⁵⁴ Fabens, *supra* note 17.

⁵⁵ BRENT A. OLSON, PUBLICLY TRADED CORPORATIONS: GOVERNANCE & REGULATION §8.26 (3d ed. 2012).

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

EGCs must hold their first say-on-frequency vote after three years or, alternatively, one year after they cease to qualify as an EGC.⁵⁹

The Dodd-Frank Act instructs the SEC to enact rules requiring public companies to disclose information about the pay ratio between their CEOs and median employees, as well as the relationship between payment and work performance.⁶⁰ Once the SEC proposes and implements such rules, the JOBS Act will exempt EGCs from the disclosure requirements.⁶¹ EGCs may opt to be treated like smaller reporting companies for the purpose of executive compensation disclosure, and thus benefit from scaled-down requirements.⁶² For example, EGCs would not need to provide a discussion and analysis of compensation, and may provide compensation data for fewer executives and fewer years.⁶³

3. Elimination of Quiet Periods

Current FINRA rules ban the publication of analyst research on a company for forty days following the company's IPO, and for fifteen days prior to the expiration of a lock-up agreement.⁶⁴ A typical lock-up agreement restricts the transfer of the initial IPO shares for a 180-day period, and as a result the expiration of the lock-up usually marks the release of a large number of shares on the market.⁶⁵ Prior to the FINRA rules preventing such communications, investment banks would issue positive recommendations on a company near the lock-up expiration, a practice referred to as a "booster shot."⁶⁶

The JOBS Act prohibits the SEC and FINRA from maintaining these restrictions on communication in connection with an EGC.⁶⁷ Thus, it seems analysts may publish research reports on an EGC "before, during, and after the IPO."⁶⁸ The SEC recently confirmed that the Act effectively ends the "booster shot ban" for

⁵⁹ *Id.*

⁶⁰ Fabens, *supra* note 17.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Fleischman, *supra* note 47, at 2; Demos, *supra* note 37.

⁶⁵ Demos, *supra* note 37.

⁶⁶ *Id.*

⁶⁷ Fleischman, *supra* note 47, at 1-2.

⁶⁸ Schapiro, *supra* note 8, at 2.

EGCs, and instructed FINRA to officially eliminate the ban.⁶⁹ However, the SEC has not commented on the elimination of the forty-day quiet period, which practitioners have characterized as a potentially more significant change.⁷⁰

E. Potential Investor Impact

Ultimately, investors must decide to invest in EGCs in order for the JOBS Act to achieve its goals.⁷¹ However, reducing the costs of raising capital for EGCs may be at odds with promoting investor confidence.⁷² In particular, EGC investors face more information and less time to analyze it, risk factors that are unique to EGCs, and increased obscurity regarding blank check companies that take advantage of the JOBS Act.

1. More Information, Varying Reliability, Less Time

The JOBS Act provisions regarding “Test the Waters” communications and sell-side analyst research publications are intended to gauge and stimulate investor interest.⁷³ However, “Testing the Waters” can lead to an “uneven” distribution of information, because only certain investors are permitted to engage in early communications with an EGC.⁷⁴ Additionally, because there will be less time to review the publicly filed materials, investors may be tempted to rely increasingly on “Test the Waters” materials and sell-side analyst research.⁷⁵ Early communications and research

⁶⁹ Demos, *supra* note 37.

⁷⁰ *Id.*

⁷¹ Aguilar, *supra* note 10.

⁷² Testimony of Professor John C. Coates *quoted in* Aguilar, *supra* note 10 (suggesting that the JOBS Act changes “the balance that existing securities laws and regulations have struck between the transaction costs of raising capital . . . and the combined costs of fraud risk and asymmetric and unverifiable information”).

⁷³ Roe, *supra* note 6, at 3 (characterizing small companies as “stock market orphans, with little or no analyst coverage and typically less investor interest as a result”).

⁷⁴ Shapiro, *supra* note 8, at 3.

⁷⁵ *See* Smith & Chasan, *supra* note 19; Schapiro, *supra* note 8, at 3.

publications are not subject to the same accountability that attaches to publicly filed statements.⁷⁶

2. EGC Risk Factors

Practitioners have reported that the SEC emphasized a need for more disclosure, in its responses to the first confidential draft submissions it received, particularly in the area of a company's risk factors.⁷⁷ As a result, companies began to include their EGC status itself as a risk factor, on the grounds that an EGC's reduced disclosure requirements could result in a lower stock price.⁷⁸ While such general risk disclosures may defend an EGC against accusations of a low sales price, they do not adequately inform investors about the specific business risks for each company, which is normally the goal of a public registration statement.⁷⁹ This could ultimately increase the potential for securities litigation, because such vague disclosures will not insulate EGCs from claims arising from actual, undisclosed business risks.⁸⁰ On the other hand, if all EGCs include such blanket risk statements, it would reduce adverse reactions to individual companies, although it may work against restoring market confidence in general.⁸¹ The trend could easily become a self-fulfilling prophecy if EGCs continue to anticipate investor wariness in lieu of making meaningful disclosures.⁸²

⁷⁶ Schapiro, *supra* note 8, at 3.

⁷⁷ Lynn Cowan, *Warning to Investors: We're an 'Emerging' Company*, WALL ST. J., Sept. 4, 2012, at C4.

⁷⁸ *Id.* (“[S]imply being an emerging-growth company could make the stock less attractive to investors, given their exemptions and reduced disclosure requirements.”).

⁷⁹ Sarah Johnson, *A New Risk Factor: The JOBS Act*, CFO.COM (May 15, 2012), http://www3.cfo.com/article/2012/5/regulation_jobs-act-risk-disclosures-ipo.

⁸⁰ See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SECURITIES AND EXCHANGE COMMISSION (last visited Oct. 12, 2012) <http://www.sec.gov/about/whatwedo.shtml> (“Investors who purchase securities and suffer losses have important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.”).

⁸¹ Cowan, *supra* note 77.

⁸² *Id.* (“[T]he problem with the JOBS Act is it reduces the amount of information investors can rely upon to assess whether these emerging-growth companies are actually good investments.”).

3. Blank Check Companies

Shell companies known as “blank checks” have also taken advantage of EGC benefits under the JOBS Act.⁸³ A “blank check,” also known as a Special Purpose Acquisition Company (SPAC), is a company that purchases the assets of a defunct business with money raised from investors.⁸⁴ It is unlikely that Congress intended the JOBS Act to benefit such companies.⁸⁵ Blank check companies may be harmless; indeed, in the best-case scenario, they may create healthy businesses out of failing ones.⁸⁶ However, it is possible for a company not otherwise qualifying as an EGC to benefit from JOBS Act provisions through a reverse merger with a blank check company.⁸⁷ Thus, investors should be wary of blank-check EGCs that do not disclose details about their future business targets.⁸⁸

F. Conclusion

Based on early evidence, the JOBS Act appears to have had some initial success in encouraging smaller companies to go public.⁸⁹ However, in order for the JOBS Act to be an effective stimulus for

⁸³ Emily Chasan, *Meet the JOBS Act's Jobs-Free Companies*, WALL ST. J., June 5, 2012, at B1.

⁸⁴ Robert Stammers, *Should You Write A Blank Check for a Great Idea?*, FORBES (Aug. 27, 2012), <http://www.forbes.com/sites/cfainstitute/2012/08/27/should-you-write-a-blank-check-for-a-great-idea>.

⁸⁵ Chasan, *supra* note 83.

⁸⁶ Stammers, *supra* note 84.

⁸⁷ Chasan, *supra* note 83.

⁸⁸ See Jim Allen, *U.S. JOBS Act Sans Jobs*, MARKET INTEGRITY INSIGHTS (June 7, 2012) <http://blogs.cfainstitute.org/marketintegrity/2012/06/07/u-s-jobs-act-sans-jobs> (“[I]nvestors in [EGCs] will be investing in the “investment decisions” of the company’s principals, hoping that the acquisitions they make aren’t mechanisms to help insiders dump money-losing duds on unsuspecting investors.”).

⁸⁹ Chris Hitt, *Is the Emerging Growth Company provision of the JOBS Act really encouraging IPOs?*, BLOGMOSAIC (Sept. 13, 2012) <http://blogmosaic.knowledgemosaic.com/2012/09/13/is-the-emerging-growth-company-provision-of-the-jobs-act-really-encouraging-ipos>. As of November 2, 2012, the number of EGCs was approaching 600. Email from Chris Hitt, Knowledge Mosaic, to Sarah Pickering, Student at Boston University School of Law (Nov. 5, 2012, 17:46 EST) (on file with author).

the economy, investors must have confidence in EGCs.⁹⁰ Ultimately, EGCs must strike a cost-effective balance where they benefit from the reduced costs of the JOBS Act, but disclose sufficient information to keep investors engaged.⁹¹

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⁹⁰ Schapiro, *supra* note 8, at 1.

⁹¹ Some EGCs have been balancing disclosure costs with investor confidence by selecting certain JOBS Act benefits and opting out of others that are not as necessary. *See e.g.*, Michael Cohn, *Manchester United May Take Advantage of JOBS ACT Audit Exemptions*, ACCOUNTINGTODAY (Aug. 10, 2012), <http://www.accountingtoday.com/news/manchester-united-ipo-jobs-act-sarbanes-oxley-audit-exemptions-63617-1.html>.

⁹² Student, Boston University School of Law (J.D. 2014).