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ViewPoint

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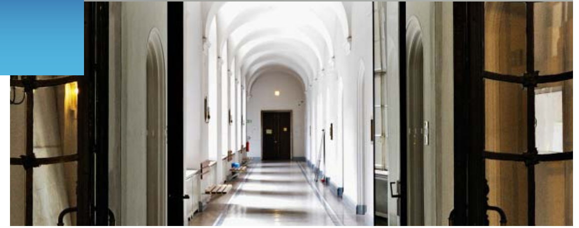
The JOBS Act: An Overview and Investor Perspective



At a time when consensus-building among policymakers is at a critical low, one package of proposals recently received overwhelming support on both sides of the aisle. The JOBS Act, short for Jumpstart Our Business Startups Act, was signed into law by President Obama on April 5, just weeks after it won bipartisan approval in both the House and the Senate.

As its name implies, the law is designed to spur the growth of small businesses, startups and entrepreneurs. To that end, it redefines some of the provisions around initial public offerings (IPOs), expands permissible advertising for private investment products and facilitates access to startup capital. By setting out parameters for newly labeled "emerging growth companies" (EGCs), the JOBS Act aims to allow aspiring ventures the opportunity to make themselves public more efficiently, thereby aiding the economy by supporting job creators and bolstering the capital markets by presenting investors with new opportunities in promising businesses.

The law has been criticized by some regulators and market participants for relaxing certain financial regulations at a time when discipline, oversight and investor protection are deemed more critical than ever. As an investment manager and a fiduciary for individual and institutional investors, we believe the JOBS Act encourages capital formation while incorporating important protections. In this *ViewPoint*, we summarize the key components of the law and offer an investor's perspective.

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Genesis of the JOBS Act

Before discussing the specific parameters of the JOBS Act, it is helpful to review why the measure has earned the support of so many policymakers. The importance of capital formation to the economy, and the importance of businesses to capital formation, cannot be overstated. Businesses need investment capital to grow and thrive, thereby allowing them to increase both the material capital (goods and services) and human capital (jobs) they contribute to the economy. For smaller businesses, investment capital is harder to attract given the rules and costs associated with attaining it. In many cases, the red tape is sticky enough to preclude some smaller businesses from seeking the necessary capital and going public. For those small businesses that are able to take their ventures public, the costs to comply with Sarbanes-Oxley and other regulatory requirements have proved a significant drain on their finances and profitability. Inadvertently, by limiting a company's ability to grow, the system is depriving prospective investors of rich new investment prospects and, in so doing, denying the economy a potential catalyst for growth.

Figure 1: Bipartisan Support Enabled Swift Passage of JOBS Act

March 8

- House of Representatives passed JOBS bill by a vote of 390 to 23.

March 22

- Senate passed House bill with Merkley-Brown "crowdfunding" amendment by a vote of 73 to 26. *(Read more on this on page 3.)*

March 27

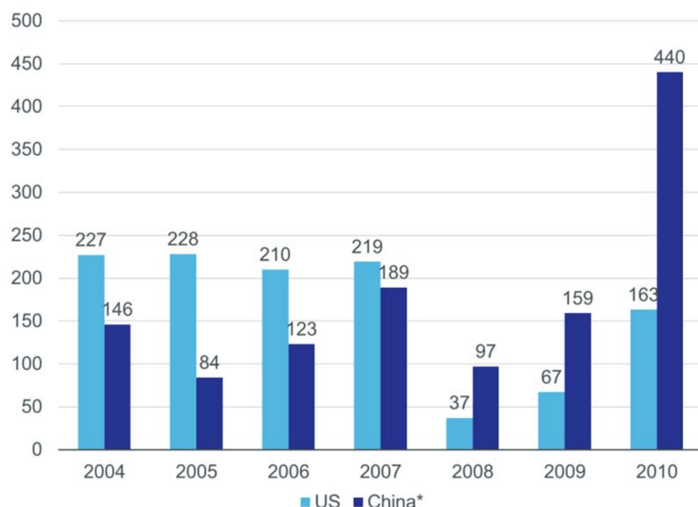
- House passed bill as amended by the Senate by a vote of 380 to 41.

April 5

- President Obama signed the JOBS bill into law.

The opinions expressed are as of May 2012 and may change as subsequent conditions vary.

Figure 2: Number of IPOs, US and China



* Based on IPO activity on Greater China exchanges (Hong Kong, Shanghai, Shenzhen — SME and Shenzhen — ChiNext).
Sources: Dealogic, Thomson Financial, Ernst & Young.

Some argue that, as a consequence of all of this, the US is losing its competitive edge. According to a March 2011 working paper issued by the National Bureau of Economic Research (NBER), "IPO activity in the US has fallen compared to the rest of the world, and US firms go public less than expected based on the economic importance of the US."[1] Figure 2 illustrates trends in IPO activity in the United States versus those in the world's fastest-growing economy, China.

The passage of the JOBS Act suggests to us that there is a growing recognition that limiting small companies' growth potential is tantamount to limiting economic growth and job creation, particularly as the US continues to emerge from the worst recession and equity bear market since the Great Depression. Policymakers recognize rapidly growing startup companies as a key source of job creation, and their intention is to facilitate the growth of these companies so as to also stimulate growth in employment and in the broader economy.

Key Provisions of the JOBS Act

The JOBS Act includes several provisions that together are intended to support small businesses, entrepreneurs and startups by creating opportunities for these key job creators. The Act defines a new type of issuer, emerging growth companies (EGCs), and reduces restrictions in certain regulatory rules so that these smaller companies can more easily clear hurdles in the IPO process, advertise their offerings and obtain the capital required to grow their businesses. In the following pages, we address four central components of the JOBS Act:

- IPO On-Ramp
- Expansion of Permissible Advertising for Private Investment Products
- Crowdfunding
- Increased Private Shareholder Limits

IPO On-Ramp

The new legislation amends the Securities Act of 1933 to establish guidelines for what constitutes an EGC. As defined in the Act, an EGC is a company with annual gross revenues of less than $1 billion. A company can remain an EGC until the earliest of the following:

- Five years from its IPO.
- It reaches $1 billion in revenue for a given fiscal year.
- It issues more than $1 billion in non-convertible debt over a three-year period.
- It is deemed a "large accelerated filer," defined as having $700 million or more in outstanding common equity held by non-affiliates.

Amendments Enhance Market Access for EGCs

To ease the IPO process, an EGC may:

- Engage in pre-IPO marketing and communication with institutional accredited investors and qualified institutional buyers to gauge investor interest.
- File a confidential draft IPO registration statement with the SEC for review.
- Include only two years (rather than three) of audited financial statements in IPO registration statements.

Public company reporting and accounting requirements are relaxed:

- Audit of internal controls under Section 404(b) of the Sarbanes-Oxley Act is not required.
- Shareholder approval of executive compensation is not immediately required; EGCs subject to less stringent compensation disclosure requirements.
- Requirements to comply with new or revised accounting standards will be delayed.
- EGCs are exempt from future rules around mandatory audit firm rotation.

Parameters around investment bank research and communication are amended:

- EGCs may communicate orally or in writing with prospective investors before and after filing an IPO registration statement.
- Restrictions on communications by research analysts with EGCs and potential IPO investors are lifted. Research analysts may attend meetings along with investment banking personnel and may publish research on EGCs before and after their IPOs.
- Investment banks may publish and distribute research reports about EGCs, even if they are underwriters of the offering.

1 Doidge, Craig; Karolyi, G. Andrew; and Stulz, Rene M. "The US Left Behind: The Rise of IPO Activity Around the World," NBER Working Paper No. 16916, March 2011.

The goal in establishing the EGC construct is to enhance and facilitate IPO on-ramping and, in turn, improve the efficiency of capital formation. The Act removes certain restrictions around the IPO process for EGCs and eases reporting obligations. For example, EGCs may confidentially file a draft IPO registration statement with the Securities and Exchange Commission (SEC) for review prior to public announcement of an IPO. They also may engage in communication with potential investors, assuming they are qualified and accredited investors, to gauge interest prior to filing a registration statement. Certain public company reporting requirements set out under Sarbanes-Oxley also are amended for EGCs. The sidebar "Amendments Enhance Market Access for EGCs" summarizes the on-ramp provisions designed to help facilitate the growth of IPOs.

For Some, Research Rule Raises Ire

"(The Act) would weaken important protections related to 1) the relationship between research analysts and investment bankers within the same financial institution by eliminating a number of safeguards established after the research scandals of the dot-com era and 2) the treatment of research reports prepared by underwriters of IPOs."

SEC Chairman Mary Schapiro,
Letter to Senate Banking Committee,
March 13, 2012

"It is a bad sequel to a bad movie. It shouldn't be called the JOBS Act, it should be called the Bring Fraud Back to Wall Street Act."

Former New York attorney general Eliot Spitzer,
The New York Times DealBook*, April 4, 2012*

Some controversial aspects of the Act include the changes around three-way communication among research analysts, investment banks and an issuer. In setting out to improve the availability of information, some fear investor confusion and misinformation may result. Previously, company research reports issued by investment banks could be considered offers of sale of securities and were heavily restricted. That is no longer the case, even for investment banks that are underwriting the offering. Under the Act, analysts, investment banks and the issuing company have greater freedom to communicate with and provide basis for more informed decision-making, others view it as an opportunity for miscommunication and coercive marketing. We believe research reports should be used as one factor in the overall investment decision process and should not be relied upon as the sole source of information for investors.

Expansion of Permissible Advertising

Policymakers have also recognized the need to facilitate the means by which private companies may attract investor capital. To that end, the JOBS Act removes the "general solicitation" requirement when executing private placements under Rule 506 of Regulation D. This will allow companies to make public statements in connection with private placements. Importantly, the law requires that companies take reasonable steps to verify that the investors in the private company are accredited investors, defined as having at least $1 million in investible assets or income of more than $200,000 annually. The SEC is charged with determining the parameters around customer solicitation and is required to amend Rule 506 with such provisions by July 4, 2012.

An ancillary effect of this portion of the JOBS Act is its impact on private investment vehicles, which previously had limited scope to advertise. While investment managers can talk about and provide information on registered mutual funds, they have been unable to provide similar information on hedge funds or other private funds.

BlackRock supports the removal of the prohibition on "general solicitation" and "general advertising" under Regulation D provided for in the JOBS Act, as we believe this prohibition has unnecessarily limited the methods by which issuers can reach sophisticated investors. We believe private funds such as hedge funds and private equity funds can be important sources of diversification in an investor's portfolio and, therefore, should be readily accessible to investors who are eligible to invest. Investors are better served by having access to more information about private funds, not less. BlackRock has expressed its views on this provision in a May 3 letter to the SEC.

Capital Access Through Crowdfunding

The term "crowdfunding" has its origin in the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (the CROWDFUND Act). Crowdfunding is essentially a method of raising capital that pools resources from many smaller investors to create a larger investible sum. The funds are generally solicited over the Internet.

Crowdfunding allows for a new source of capital raising for startups. The crowdfunding provision in the Act reflects an amendment to the original bill after a proposal put forth by Senators Brown and Merkley, and allows private companies to raise up to $1 million in any 12-month period from the pooled investments of small investors seeking to support America's promising startups and entrepreneurs. In an effort to protect these small investors, the law incorporates several safeguards, including capping the amount an investor can invest; imposing restrictions on transferring securities for one year, subject to certain exceptions; requiring issuers to disclose financial information to potential investors; requiring a person acting as a broker or crowdfunding intermediary to register with the SEC and any applicable self-regulatory organization; and establishing issuer liability for material misstatements and omissions.

Summary of Merkley-Brown Amendment

Under the Merkley-Brown Amendment, startups may solicit small investments from investors through Internet intermediaries. The aggregate amount of such investment may not exceed $1 million in any 12-month period, with a maximum investment per investor of:

- the greater of $2,000 or 5% of the investor's annual income or net worth if either the annual income or net worth of the investor is less than $100,000, or
- 10% of the annual income or net worth, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.

Increased Private Shareholder Limits

Another provision of the JOBS Act is the expansion of the number of investors permitted to own shares in a company before it has to register with the SEC and publicly provide periodic financial reports. This provision allows a fast-growing company to issue shares to employees and investors but better control the timing for its entry into the public markets. The prior limit of 500 has been increased to 2,000, allowing more companies to remain private. Likewise, additional investors are permitted in other private investment vehicles.

Conclusion

The JOBS Act addresses a number of important issues related to capital formation and US competitiveness. The overwhelming bipartisan support that led to its swift passage is notable, especially in the current partisan climate. While some objections have been raised, we believe substantial investor protections have been retained in the Act. In addition, BlackRock and other institutional investors use a combination of proprietary research and sell-side research and "think for themselves" in making investment decisions. Importantly, certain information (e.g., audited financial statements) is still required to protect investors and, of course, the SEC and Financial Industry Regulatory Authority (FINRA) retain powers to impose rules on research. We would also note that the JOBS Act does not relax fraud rules, nor does it ease restrictions on using research analysts to solicit IPO business. Notably, investors can still bring lawsuits against investment banks under Rule 10b-5 if they can prove the research report knowingly intended to mislead or was reckless.

To date, both issuers and investors have embraced the JOBS Act. Within days of its April 5 enactment, the SEC reported the receipt of two confidential submissions for IPOs, indicating that some firms are moving to capitalize on the new EGC rules. Likewise, the National Venture Capital Association (NVCA) and other private equity investors have been vocally supportive of the JOBS Act as a means of providing capital to entrepreneurs. The various provisions enable a company to go from startup through IPO, providing early-stage capital via crowdfunding, improving liquidity of private placements and making IPOs more efficient and cost-effective.

The JOBS Act presents the opportunity for promising businesses to access public capital and contribute to US economic and employment growth. It reduces the compliance burden and expense that have long precluded or discouraged small companies from accessing the market.

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