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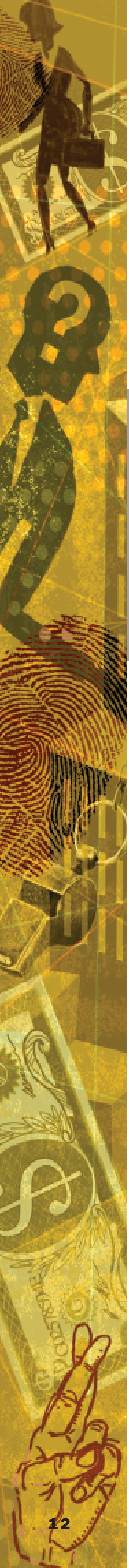

Will JOBS Act Enable More Securities Fraud?

The recently passed JOBS Act eliminates regulatory requirements in initial public offerings and loosens other reporting obligations of public companies. These changes will weaken a number of investor protections and could provide opportunities for greater securities fraud.

Early in April, President Obama signed the Jumpstart Our Business Startups (JOBS) Act that had passed Congress with bipartisan support. Many of the Act's provisions free smaller companies to raise public capital without having to comply with some of the regulatory requirements of federal and state securities laws. Other provisions lessen the regulatory burden for existing companies. The U.S. Securities & Exchange Commission (SEC) has requested public comment on several aspects of the law, and the Financial Industry Regulatory Authority (FINRA), Wall Street's self-regulatory body, will likely be required to issue implementing rules.

A number of critics have objected to the rollback of "major" securities regulations and parts of the Sarbanes-Oxley Act of 2002 (SOX). According to Eliot Spitzer, the former New York attorney general, "It shouldn't be called the JOBS Act, it should be called the Bring Fraud Back to Wall Street Act." Spitzer and other observers believe that companies will undoubtedly take advantage of the changes in the laws to return to the old unethical behaviors that are no longer legally prohibited and pursue their own self-interests at the expense of investors.

The portion of the Act that has received the most attention deals with simplifying the process for a company's initial public offering (IPO). Known as the "IPO on-ramp," it says that any company that fits the definition of an emerging growth company (EGC) can take advantage of significant reductions in the cost and time necessary to become a public company. A company can remain an EGC until (1) its revenue exceeds $1 billion, (2) it has issued more than $1 billion in debt securities, (3) five years have elapsed since its IPO, or (4) it's deemed to be a "large accelerated filer."

The Society of Corporate Secretaries & Governance Professionals published a memo on its website that details some of the benefits and exceptions that the JOBS Act provides to an EGC that aren't normally available for companies in the IPO process (www.governanceprofessionals.org/society/Jumpstart_Our_Business_Startups_Act.asp). They include:

1. An EGC can have a confidential SEC review of its draft IPO registration statement. This is intended to protect companies prior to the road show. If the company decides not to go forward, its draft statement is never made public.
2. It has to provide only two years of audited financial statements rather than three.
3. The EGC is allowed to communicate with accredited investors or qualified institutional buyers so it or its investment banker can "test the waters" and sell the deal before a registration statement is filed.
4. Analysts can publish reports on the company before, during, or after the IPO—even if the analyst's firm is participating in the offering (Title V of Sarbanes-Oxley, Analyst Conflicts of Interest, dealt specifically with changing the conduct of securities analysts whose recommendations for a securities purchase were based mainly on the fact that the analyst's employer was being compensated for marketing those very same securities products to the public, setting up an obvious conflict of interest).

There are other provisions in the Act related to investing. A section on "crowdfunding" enables start-ups and small businesses to raise up to $1 million annually over the Internet without any registration of the shares with regulators for public trading. There's also a limit on how much an unaccredited investor can invest annually. (An "accredited" investor is someone with net worth of at least $1 million, excluding their home, and is presumed to be an informed and sophisticated investor who doesn't need the protections inherent in the regulations in the IPO process). This portion of the law doesn't go into effect until 270 days after its enactment and requires the SEC to publish rules.

In other areas, the Act expands from $5 million to $50 million the permitted size of "mini" public offerings that are exempted as a private placement from regulatory requirements under SEC Regulation A. It also lifts the existing ban on general solicitation and advertising of private placement offerings, while a provision raises from 500 to 2,000 the number of stockholders of record that triggers the recognition that a company is public and must follow the reporting requirements of the SEC. The 2,000 number doesn't include accredited investors or those with shares from employee compensation plans, so the determination of "record holders" won't be easy to ascertain.

In its memo, the Society of Corporate Secretaries & Governance Professionals also describes additional governance rollbacks provided for EGCs by the JOBS Act, which include:

- No reporting on internal control over financial reporting (currently required by SOX).
- No say-on-pay vote required for three years.
- No pay-ratio or pay-for-performance disclosure (currently required under the Dodd-Frank Act).
- No requirement to comply with mandatory audit firm rotation or auditor discussion and analysis (if enacted).
- No requirement to comply with any future Public Company Accounting Oversight Board (PCAOB) rules unless the SEC mandates them as "in the public interest."

One example of a recent high-profile EGC is Groupon, which has found its IPO path somewhat rocky. Groupon had to restate downward its previously reported earnings for its first quarter as a public company. This occurred despite Groupon's compliance with all of the current IPO regulations designed to protect investors and offset management's natural interest in maximizing the offering price. In a "town meeting" of employees, CEO Andrew Mason described the financial revision as "the latest in a string of just us making an example of how bad we are at being a public company. We have to get good at this" (Shira Ovide, "Groupon Must Avoid Taking 'Stupid Risks,' CEO Says," *The Wall Street Journal*, April 26, 2012). The company's share price plummeted 12% on the restatement news, closing the month of April at $10.71, well below its $20 offering price. What might have happened if the Groupon IPO had taken advantage of the reduced regulatory oversight allowed in the JOBS Act?

Further, Groupon declared it had a material weakness in internal controls over financial reporting. Its Form 10-K report set forth the internal control problems the company faced:

- "We did not maintain financial close process and procedures that were adequately designed, documented and executed to support the accurate and timely reporting of our financial results."
- "We did not maintain effective controls to provide reasonable assurance that accounts were complete and accurate and agreed to detailed support, and that account reconciliations were properly performed, reviewed and approved."
- "We did not have adequate policies and procedures in place to ensure the timely, effective review of estimates, assumptions and related reconciliations and analyses."

These developments have been enough to spur shareholder suits.

According to Anthony H. Catanach, Jr., a business professor at Villanova University and coauthor of the Grumpy Old Accountants (GOA) blog, these kinds of blunders aren't unusual at young companies "whose growth outpaces internal operating systems, including those that relate to financial reporting." This is especially true when top financial and accounting executives are just getting settled at a company. "This fact does not condone the horrendous financial reporting busts we have witnessed," Catanach said. "What is surprising, though, is the lack of 'good' counsel the company has received on these matters from both their own independent auditors as well as their investment bankers."

Critics contend that the intense interest in passing the JOBS Act was because the investment banking development and sale of IPOs is the most profitable aspect of Wall Street. People see danger in easing restrictions because some of the most flagrant ethical violations occurring in the pre-Enron era involved sell-side brokers being financially incentivized to push poor-quality investment products that their investment bank employers were involved in bringing to market. This was the very unethical conflict-of-interest behavior that led to passage of SOX Title V. It's hard to imagine that Wall Street actions won't revert to the behavior of the past now that this part of Sarbanes-Oxley is gone.

The New York Times addressed the debate over the JOBS Act in an April 4 article titled "Wall Street Examines the Fine Print in a Bill for Start-Ups." It described how some see the new law as a positive benefit for entrepreneurs, while others forecast "a return to the boiler rooms of the days gone by where brokers peddled worthless stock to unassuming investors." In the article, Mary Schapiro, chairman of the SEC, is quoted warning of the dangers of the deregulated past, saying, "Collusive behavior between analysts and bankers cost investors huge sums, shattered confidence in the integrity of research, and damaged the markets themselves."

Time will tell whether the JOBS Act will create new jobs and have an overall beneficial effect for investors as well as entrepreneurs or whether it will just result in lower risk and greater profitability for the Wall Street IPO business. Reduced regulatory oversight may create the potential for more flawed IPOs such as Groupon.

Investing in newer and smaller companies involves more opportunity for fraud as well as greater inherent risk, which makes you think they should be the focus of greater regulatory oversight, not less. The JOBS Act flies in the face of this doctrine. **SF**

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