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U.S. Initial Public Stock Offerings and the JOBS Act

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Summary

Over the past decade, many sources have reported a precipitous decline in the number of initial public offerings (IPOs) in the United States. These statistics raise several questions: what has caused such a decline? What are the implications for the U.S. economy, and particularly for job creation? At the same time as IPOs appear to have fallen, the amount of private stock offerings has increased, suggesting growth in an alternative source of equity financing.

This report analyzes factors contributing to the decline in IPOs, differences between an IPO involving the sale of shares to the public versus a private stock offering limited to sophisticated investors, and potential economic implications of such a rise in private versus public stock offerings. It also provides analysis of the causes and implications of the stagnation in public IPOs.

The decline is particularly noticeable for IPOs by small companies. Because startups are usually small, and have been widely associated with job creation, there are concerns that whatever is causing such a drop in IPOs is hindering job creation. While research finds support for a link between startups and job creation, there does not appear to be a consensus among academics that the form of financing that a startup uses to grow—that is, through acquisition, through an IPO, or through the issuance of private shares to sophisticated investors—affects job creation. Indeed, while the number of IPOs has dropped, the number of private placements of restricted shares sold only to qualified investors has risen markedly, especially in 2009 and 2010.

Central to the question of how best to stimulate capital formation and IPOs is what has led to the decline in IPOs. Researchers and market participants cite several possible causes. These include regulatory factors, such as the Sarbanes-Oxley Act in 2002 (P.L. 107-204); the costs of initial and ongoing disclosure to investors; a relaxation of the mandatory holding period for restricted shares by the SEC, which may have fostered liquidity in the alternative private placement market; and the costs of filing with individual states for certain securities offerings. Other research points to changes in securities market infrastructure as causes of the IPO decline. Such changes include the cost of underwriting IPOs; reduced trading fees for mainline securities firms stemming from the rise of online discount brokerage firms; a change in the SEC's order-handling rules; the decimalization of traded securities, thereby reducing brokers' profits from trading; and a requirement establishing a firewall between underwriting and analyst research, which some say has made it costlier to provide research to support small IPOs.

Enacted on April 5, 2012, in the 112th Congress, the Jumpstart Our Businesses Startup Act (JOBS) Act (P.L. 112-106) is broadly aimed at stimulating capital formation for companies, especially for relatively new and smaller ones. Among other things, the JOBS Act lifts certain impediments to a small company external financing technique known as crowdfunding, establishes a category of firm known as an emerging growth company (EGC), and relaxes various disclosure and accounting requirements for such firms. Criteria for EGC status include having up to $1 billion in annual gross revenue and having less than five years elapse since its initial shares were first sold to the public. In late August 2012, some Members of Congress criticized the SEC's decision to issue a proposed rule, with a 30-day public comment period, rather than a quicker, final interim rule without the comment period. Others supported this approach. The SEC's proposed rule would relax traditional restrictions on the ability of a company to use general advertising to promote securities offering to certain defined-sophisticated investors under Rule 506, and under Rule 144a, which exempt certain securities from SEC registration. This report will be updated as events warrant.

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Introduction

Policymakers have expressed concern about the ability of small and young firms, in particular, to secure equity financing for growth and job creation. Indeed, over the past decade, many sources have reported a precipitous decline in the number of initial public offerings (IPOs) in the United States—particularly for small companies.[1] The recent decline in IPOs raises several questions: what has caused such a decline? What are the implications for the U.S. economy, and particularly for job creation? Are foreign exchanges outcompeting U.S. exchanges? At the same time, while IPOs appear to have fallen in the United States for a variety of reasons, the amount of private stock offerings has increased during this period. To what extent is this a viable replacement for IPOs?

This report analyzes the factors contributing to the decline in IPOs and discusses whether that decline is significant; the differences between an IPO involving the sale of shares to the public versus a private stock offering for sophisticated investors; and the potential economic implications of a rise in private versus public stock offerings.

On April 5, 2012, the Jumpstart Our Business Startup Act (JOBS Act; P.L. 112-106), which is broadly aimed at boosting capital formation, was enacted. This report describes key elements of the JOBS Act and provides a background discussion of key policy issues of relevance to the legislation.

Public vs. Private Markets

Companies can be categorized into two groups: privately held companies and publicly held companies. Most businesses are privately held companies that have either not distributed any ownership shares or have a small number of shareholders with limited ability to transact in shares. Although the preponderance of larger companies, such as Apple, General Electric, Google, and Facebook, are publicly held firms, a number of larger companies, like IKEA, Hallmark Cards, and Mars Candy, are privately held.

Among other things, the JOBS Act seeks to make it easier for firms to list publicly traded shares through IPOs. At the same time, while the number, and total dollar amount, of IPOs in the United States has fallen noticeably, the dollar amount of private, or restricted, stock offerings has risen. A study by the SEC's chief economist in 2011, which focused on the aggregate size of securities offerings, found that private offerings grew by nearly 50% from 2009 to 2010, from about $950 billion to about $1.4 trillion.[2] The study also found that between 2009 and 2010, aggregate public equity issuances fell by 11%, from $1.27 trillion to $1.133 trillion. In addition, the SEC study also found that aggregate amount of private stock issuances (at more than $905 billion) surpassed debt issuances (about $851 billion) in 2010, a trend that reportedly continued through the first quarter of 2011.[3]

[1] IPOs are the means by which firms access the stock market, raising equity finance from the public in exchange for shares in the company.

[2] Craig Lewis, "Unregistered Offerings and the Regulation D Exemption," *SEC Presentation*, November 2, 2011, available at http://www.sec.gov/info/smallbus/acsec/acsec103111presentation-regd.pdf.

[3] Most of these are offerings under Regulation D, which has exempts various types of securities offerings from the (continued...)

When a privately held firm conducts an IPO, its first widespread sale of company stock to the investing public, it becomes a publicly held firm whose shares are then subsequently traded on the secondary securities market through a securities exchange. IPOs enable such firms to raise equity capital, which may enable them to expand.[4] In exchange for the right to broadly distribute their shares, the publicly held companies are subject to an assortment of rules and regulations, such as a board of directors requirement, and having to comply with various Securities and Exchange Commission (SEC) enforced registration and financial disclosure filing requirements (such as filing quarterly and annual reports).

Although many privately held firms go public on their own, others become publicly held companies as part of the exit-payoff strategy of venture capital firms[5] who have been incubating them through funding and managerial support. According to IPO data published by a law firm, venture capital-backed IPOs accounted for 46 of the 142 IPOs in 2010. [6] Another kind of private to public strategy can involve an independent or venture capital-backed privately held company becoming part of an existing publicly held firm through an acquisition by such an entity.

There is also a corporate "middle ground" between the privately held companies with no shared equity ownership and the publicly held firms with widely dispersed equity ownership. These are generally small companies who pursue specific limited or restricted stock offerings, sometimes known as private stock offerings. Because of the limited nature of the offerings, they are not subject to the full array of SEC registration and disclosure requirements and the attendant compliance costs associated with unlimited public offerings. Such "private stock offerings" cannot be sold widely to the public, but only to certain "sophisticated" investors. The purpose of allowing such restricted stock offerings is to make it easier for small or growing companies to raise capital, while continuing to protect ordinary retail investors. As such, the SEC has established certain exemptions from the registration and disclosure requirements of the federal securities laws for companies that either seek to raise only a small amount of equity capital (less than $5 million) or to sell shares only to a limited number of sophisticated investors, rather than to the general public.

Among the SEC regulations that exempt certain small businesses from some of the registration and disclosure requirements of the federal securities laws, Regulation A[7] and Regulation D[8] are

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(...continued)

registration requirements of the Securities Act of 1933.

[4] One study examined the reasons that firms tap public equity markets by analyzing the ultimate uses of the funds raised through both initial public offerings (IPOs) and seasoned equity offerings (SEOs) in 38 countries between 1990 and 2003. It found that firms spend the money raised mostly on capital expenditures and R&D, suggesting that demand for capital to finance investments is indeed an important motivation behind public equity offers. On the other hand, it concluded that some firms seem to take advantage of mispricing in the market by hoarding more cash and offering more old shares—potentially held by insiders—when market valuation is high relative to accounting numbers. Overall, it determined that both market timing as well as investment financing seem to drive firms to engage in public offerings. See Woojin Kim and Michael S. Weisback, "Motivations for Public Equity Offers: An International Perspective," January 24, 2006, available at http://ssrn.com/abstract=843608 or http://dx.doi.org/10.2139/ssrn.843608.

[5] An investment company that invests its shareholders' money in startups and other risky but potentially very profitable ventures.

[6] Wilmer Cutler Pickering Hale and Dorr, "2011 IPO Report," available at http://www.wilmerhale.com/files/upload/2011_IPO_Report.pdf.

[7] 17 C.F.R. §§230.251 *et seq*.

[8] 17 C.F.R. §§230.501 *et seq*.

especially important. Regulation A allows the SEC, through the issuance of rules and regulations, to exempt any class of securities from registration under the Securities Act of 1933 if it finds that the exemption is in the public interest and the issue of securities does not exceed $5 million during any 12-month period. The JOBS Act increases this threshold to $50 million, a potential boost to the ability of small firms to raise equity capital. However, it also increases the number of potential firms who in conducting such offerings would do so in the context of reduced required disclosures and thus potentially reduced investor protections.

SEC's Regulation D[9]

Regulation D contains three rules that provide exemptions from registration. Rule 504[10] allows an exemption from registration for some companies when they offer and sell up to $1 million of their securities within a 12-month period.

To qualify for a Rule 505[11] exemption within Regulation D, a company can offer and sell only up to $5 million of its securities in any 12-month period, to an unlimited number of defined "accredited investors"[12] and up to 35 other investors who do not satisfy the sophistication or wealth standards. The company must inform purchasers that they have received restricted securities that cannot be sold for six months or longer without registration, and the company cannot use general solicitation or advertising to sell the securities.

Rule 506[13] of Regulation D allows a private offering under the Section 4(2)[14] registration exemption of the 1933 act if criteria such as the following are met: (1) general solicitation or advertising to market the securities is not used; (2) an unlimited number of defined accredited investors and up to 35 other investors may purchase the securities, but the other purchasers must have sufficient knowledge and experience to be able to evaluate the merits and risks of the investment; (3) accredited and non-accredited investors must receive similar disclosure documents; (4) the company must be available to answer questions from prospective investors; and (5) purchasers cannot sell the securities for at least a year without registration.

The rise in private stock offerings, alongside the decline in public listings, has been marked. From 1991 to 1997, nearly 80% of U.S. IPOs were of less than $50 million in market capitalization, but by 2000, their share had fallen to 20% or less of all IPOs. In 2010, IPOs of under $50 million

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[9] The authors thank CRS Legislative Attorney Michael V. Seitzinger, who authored much of this section.

[10] 17 C.F.R. §230.504.

[11] 17 C.F.R. §230.505.

[12] Under Regulation D, an accredited investor is defined as (1) a bank, insurance company, registered investment company, business development company, or small business investment company; (2) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million; (3) a charitable organization, corporation, or partnership with assets exceeding $5 million; (4) a director, executive officer, or general partner of the company selling the securities; (5) a business in which all the equity owners are accredited investors; (6) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person; (7) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or (8) a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

[13] 17 C.F.R. §230.506.

[14] 15 U.S.C. §77d(2).

comprised only around 18% of all IPOs.[15] At the same time, the amount of private offerings has risen sharply. SEC Commissioner Elise Walter estimated that in 2010, more than $900 billion in private securities were sold under Regulation D alone.[16] In addition, the SEC's chief economist estimated that since the beginning of 2009, there have been roughly 37,000 Regulation D offerings reported to the SEC, with a median size per offering of about $1 million.[17] Observers have noted that smaller issuers are displaying a preference for private offerings over IPOs—whether because they have no choice, due to market structure, or for other reasons.[18]

Financial experts argue that companies generally would probably prefer to issue publicly traded stock through an IPO, as such stock can be traded freely, has liquidity, and thus carries a "liquidity premium"—meaning investors are willing to pay more for the freedom to quickly sell their stock freely on the open market.[19] The vice president of the NASDAQ exchange, for instance, estimated that discounts on private corporate shares, due to lack of marketability or liquidity, range from 30% to 75%, on the principle that "the higher the number of bidders for an asset, the higher the sales price."[20] Yet, for a multiplicity of reasons discussed below, it has become more difficult for smaller companies to do IPOs. Although size estimates vary, some have argued that the level of liquidity desired by institutional investors probably begins with a public offering of market capitalization $500 million or more.[21]

Advantages and Disadvantages of Going Public or Remaining Private

Several advantages are often associated with remaining a privately held company vis-à-vis becoming a public company.[22] By the same token, other advantages are commonly ascribed to

[15] Testimony of Professor John Coffee, Jr. before the Securities and Exchange Commission Hearing on Government-Business Forum on Small Business Capital Formation, "Capital Formation, Job Creation and Congress: Private Versus Public Markets," November 17, 2011, Washington DC, p. 2, available at http://www.sec.gov/info/smallbus/sbforum111711-materials-coffee.pdf.

[16] Ibid, p. 2.

[17] Craig Lewis, "Unregistered Offerings and the Regulation D Exemption," *SEC Presentation*, November 2, 2011, available at http://www.sec.gov/info/smallbus/acsec/acsec103111presentation-regd.pdf.

[18] Testimony of Professor John Coffee, Jr. before the Securities and Exchange Commission Hearing on Government-Business Forum on Small Business Capital Formation, p. 2.

[19] Testimony by Eric Noll, executive vice president of NTS Management NASDAQ QMX Group, Inc, "How Roadblocks in Public Markets Prevent Job Creation on Main Street," November 15, 2011, hearing of the House Oversight and Government Reform Subcommittee on TARP, *Financial Services and Bailouts of Public and Private Programs*, available at http://oversight.house.gov/wp-content/uploads/2012/01/11-15-11_Noll_TARP_Testimony.pdf.

[20] Ibid, p. 3.

[21] Testimony of Professor John Coffee, Jr. before the Securities and Exchange Commission Hearing on Government-Business Forum on Small Business Capital Formation, p. 3.

[22] A variation on this involves public companies who strategically decide to return to private company status. One recent study examined a host of such companies and concluded that firms with declining growth in analyst coverage, falling institutional ownership, and low stock turnover were more likely to go private and opted to do so sooner. They argue that a primary reason behind the decision of IPO firms to abandon their public listing was a failure to attract a critical mass of financial visibility and investor interest. Hamid Mehran Stavros Peristiani, "Financial Visibility and the Decision to Go Private," *Federal Reserve Bank of New York Staff Report no. 376*, June 2009, available at http://www.newyorkfed.org/research/staff_reports/sr376.pdf.

companies that have gone public via an IPO in contrast to remaining a privately held company. Key advantages associated with each of these are described below.

Advantages of Remaining Private

Frequently cited advantages of remaining private vis-à-vis going public through an IPO include the following:

- Public companies may face added market-based pressures to emphasize short-term results over long-term growth.
- Private company founders and insiders invariably lose a certain amount of control when their company goes public.
- Unlike private companies, public companies are at risk from unsolicited takeover attempts.
- Becoming a public company can be an expensive undertaking (with costs of IPOs that can range between $250,000 and more than $1 million). In addition, if the offering does not succeed, as is sometimes the case, the company will have nothing to show for those expenditures.
- Because they must comply with extensive financial disclosure requirements, public companies operate under closer scrutiny than do private companies. Some of the mandatory disclosures may be items that a public company would prefer not to reveal and that private companies are under no obligation to disclose.
- Compared with private companies, the decision-making process for public companies may be more formal and less flexible due to the presence of shareholders.
- Research on the impact on corporate innovation of transitioning from a private to a public company found that after going public, such companies tend to select less novel research projects; tend to rely on a narrower set of technologies; and tend to see an exodus of key inventors.[23]

Advantages of a Public Listing

Frequently cited advantages of being a public company include the following:

- Public companies can benefit from raising equity capital associated with IPOs, which can then be used to fund research and development, fund capital expenditure, or pay off existing debt.
- Some post-IPO company-held stock can later be used to make potentially advantageous corporate acquisitions.
- A company's debt-to-equity ratio often declines after an IPO, which means that the company may be able to obtain more favorable terms for loans.

[23] Shai Bernstein, *Does Going Public Affect Innovation?*, Harvard University Working Paper, January 18, 2012, available at http://www.gsb.stanford.edu/facseminars/events/finance/documents/fin_01_12_Bernstein.pdf.

- A commonly held view is that the stock of public companies benefit from a "liquidity premium,"[24] which can translate into better share pricing compared to stock from comparable privately held firms.[25]
- Research on the impact on corporate innovation of going from a private to a public company found that access to public equity markets allows firms to partially offset declines in the level of internally generated innovation by enabling them to attract new human capital and to acquire externally generated innovations through mergers and acquisitions.[26]

The JOBS Act of the 112th Congress

Members of the 112th Congress introduced an assortment of bills with a number of broadly connected goals. The bills address the perceived decline in IPOs by modifying various federal securities laws and attempt to stimulate markets for both public and private stock offerings by amending federal securities laws. Several such bills helped form the basis for the Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106),[27] which was signed into law on April 5, 2012. Among other things, the JOBS Act relaxes statutory restrictions on launching IPOs, eases the regulatory and disclosure obligations of firms it identifies as "emerging growth companies," reduces restrictions on promotional communications surrounding private offerings, and establishes a higher shareholder number requirement before a private company becomes subject to public company reporting requirements.

This section summaries key provisions of the JOBS Act and describes both their implementation timetable and developments to date.

Title I. Reopening American Capital Markets to Emerging Growth Companies

What is an Emerging Growth Company? Title I of the JOBS Act establishes a new category of companies, termed *emerging growth companies* (EGCs). A company can opt to be defined as an EGC, and then enjoy certain regulatory exemptions as a result of that status, until the earliest time it meets any one of the following conditions: (1) it reports $1 billion or more in annual gross revenues—an amount that will periodically be indexed for inflation; (2) it becomes a "large accelerated filer,"[28] which SEC regulations define, among other factors, as a company with a

[24] This means that investors are willing to pay more for the freedom to quickly sell their stock freely on the open market.

[25] Testimony by Eric Noll, executive vice president of NTS Management NASDAQ QMX Group, Inc, "How Roadblocks in Public Markets Prevent Job Creation on Main Street," November 15, 2011, Hearing of the House Oversight and Government Reform Subcommittee on TARP, *Financial Services and Bailouts of Public and Private Programs*.

[26] Shai Bernstein, *Does Going Public Affect Innovation?*, Harvard University Working Paper, January 18, 2012, available at http://www.gsb.stanford.edu/facseminars/events/finance/documents/fin_01_12_Bernstein.pdf.

[27] With some changes, the JOBS Act consolidated six earlier bills in the 112th that included H.R. 2930 (McHenry), H.R. 2940 (McCarthy), H.R. 1070 (Schweikert), H.R. 2167 (Schweikert), H.R. 3606 (Fincher), and H.R. 4088 (Quayle).

[28] The term *large accelerated filer* is defined in detail in §240.12b-2 of title 17, *Code of Federal Regulations*.

global market float[29] of $700 million or more; (3) the company reaches the fifth anniversary of its IPO's offering date; or (4) the date on which the company has, within the previous three years, issued more than $1 billion in non-convertible debt. The act amends provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 to provide regulatory exemptions, some of which are discussed below, from certain mandatory public company requirements for this new category of corporate issuers.

All of the provisions on EGCs described below became effective on April 5, 2012, the day the JOBS Act was enacted.

Accounting and Auditor Liberalizations. Except for public companies with a market capitalization of less than $75 million, Section 404(b) of the Sarbanes-Oxley Act of 2002 provides that an outside auditor must assess and audit a public company's internal control structures. Under the JOBS Act, EGCs are exempt from compliance with the section. The act also exempts EGCs from any future rules of the Public Company Accounting Oversight Board (PCAOB, a non-profit organization that regulates auditors of publicly traded companies established under the Sarbanes-Oxley Act) that may require mandatory audit firm rotation or periodic changes in a public firm's external auditor. Some believe that mandatory auditor rotation, which the PCAOB has been considering, would improve the independence of external corporate auditors. Others, however, perceive the measure to be unnecessary and potentially burdensome.

Also, under the JOBs Act, all PCAOB promulgated rules adopted after the act will only apply to an EGC in the event that the SEC determines that the application of such additional rules is necessary or in the public interest.

Under the act, EGCs are required to provide audited financial statements for the two years prior to registration rather than the previously required three years. With respect to any of an EGC's financial disclosure to and registration statements with the SEC, an EGC is not required to comply with any new or revised financial accounting standards (such as those issued by the Financial Accounting Standards Board, FASB) applicable to public companies until the time when private, non-public companies are also subject to the standards. If, however, an EGC opts to comply with such new or revised accounting standards, it cannot selectively comply with them; it must comply with all of them.

Exemptions from Dodd-Frank Act's "Say on Pay" Requirements, Executive-Worker Pay Ratio, and Executive Pay-for-Performance Compensation Disclosure Requirements. The JOBS Act exempts EGCs from compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank Act; P.L. 111-203) "say on pay" provision under which public companies must hold a non-binding stockholder advisory vote at least once every three years on executive compensation and a shareholder vote on executive severance payments called "golden parachutes." In addition, EGCs are exempt from provisions in the Dodd-Frank Act that require public companies to (1) calculate and publicly disclose the ratio of the median compensation for all their employees compared with that of their chief executive officer; and (2) disclose information on the relationship between paid executive compensation and the company's financial performance.

[29] A public float is the market value of a company's stock shares that are held by non-affiliate shareholders.

Provisions to Help Facilitate an EGC's IPO. The JOBS Act also makes other changes that are likely to affect the process of underwriting and offering an IPO to the public. Specifically, EGCs are able to file draft IPO registration statements and subsequent registration statements on a confidential basis to the SEC for agency review if the filing is done at least 21 days prior to the beginning of its IPO "road show."[30] This will enable EGCs to test the IPO waters without divulging potentially sensitive information about themselves. Under the JOBS Act, EGCs can meet with institutions who are accredited investors[31] and qualified institutional buyers[32] to preliminarily ascertain potential investor interest in an IPO prior to an offering while avoiding current restrictions on pre-offering communications.

Historically, federal securities regulation has limited the use of broker-dealer research reports as selling tools in a company's registered stock offerings. Under the JOBS Act, such restrictions on the use of such broker-dealer research, even when the broker-dealer is or will participate in the offering, do not apply when the issuer is an EGC.

During the early 2000s, in an effort to minimize the risk of potentially biased analysis, restrictions were imposed on the ability of broker-dealer securities analysts, who analyze the financial status of a company preparing for an IPO, to interact with firm colleagues involved in facilitating the company's IPO.

As described in more detail below, concerns have arisen that this corporate firewall between securities analysts and those involved in promoting an IPO has led to these analysts reducing their coverage of small and medium sized IPOs, thus diminishing their attractiveness. In response, the JOBS Act prohibits the SEC, or a national securities association (like the Financial Industry Regulatory Authority, FINRA, which regulates broker-dealers under the auspices of and in conjunction with the SEC) from adopting or maintaining any rule or regulation with respect to an IPO of an EGC that (1) restricts persons associated with a broker-dealer or a member of a national securities association; (2) may arrange for communications between a securities research analyst and a potential investor; or (3) restricts a securities research analyst from communicating with the management of an EGC during a meeting in which there are persons who are associated with a broker-dealer, or persons who are members of a national securities association, and who are not research analysts.

As discussed above, although JOBS Act provisions pertaining to EGCs became effective on April 5, 2012, as part of the implementation of the aforementioned provision on research analysts behavior, FINRA is required to rescind its rules restricting research analysts from attending

[30] This is a process in which investment banks who are underwriting a company's prospective IPO acquaint potential institutional investor customers with the company's products, people and finances in an effort to generate interest in the IPO.

[31] The federal securities laws in Rule 501 of Regulation D define an "accredited investor" as a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the share purchase, excluding the value of his or her primary residence, or a person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year. Accredited investors can also be trusts, corporations, charities or employee business plans with more than $5 million in assets, or registered investment companies, banks or insurance companies. See U.S. Securities and Exchange Commission definition of "Accredited Investors," available at http://www.sec.gov/answers/accred.htm.

[32] These include institutions that manage at least $100 million in securities, and may include banks, savings and loan institutions, insurance companies, investment companies, employee benefit plans, or an entity owned entirely by such qualified investors.

meetings with an EGC pertaining to its IPO at which investment banking personnel are also present. As of mid-September 2012, FINRA had not yet done so.

Decimalization. In 2000, the SEC mandated that domestic exchanges switch from larger fractional stock trading increments to smaller decimal stock trading increments (or ticks) of one penny. By various accounts, the change has led to smaller stock trade spreads and thus reduced profits for broker-dealers. As a result of the subsequent diminished spreads and per trade profits, as discussed later in this report, many argue that decimalization has resulted in reduced broker-dealer trading interest in small and medium capitalized companies. It has been argued that as a consequence, the trading liquidity for such firms has diminished, which has helped to discourage their interest in pursuing IPOs. The JOBS Act directed the SEC to conduct a study on the impact of decimalization on the liquidity of small- and medium-capitalized companies and to provide the analysis to Congress by July 4, 2012 (90 days after the act's enactment). It also says that if the study finds that EGCs' securities should be quoted in increments of greater than a penny, the SEC could adopt rules by October 2, 2012 (180 days after the enactment of the JOBS Act) requiring the use of minimum stock trading increments of up to 10 cents on domestic exchanges.

Released on July 20, 2012, the required SEC staff study, *Report to Congress on Decimalization*, observed that it was hard to quantify, or even confirm, the process by which decimalization may have impeded capital formation. The report advised against the agency pursuing rulemaking designed to increase tick sizes for EGCs. It nevertheless recommended that the agency consider other steps that could help it determine the merits of the rulemaking on the possible adoption of larger EGC tick sizes in the future by first soliciting the views of stakeholders, including investors, companies, market professionals, and academics.[33]

Communications to "Test the Waters." Under the JOBS Act, an EGC or a person acting on its behalf may engage in oral or written communications with potential investors that are qualified institutional buyers (QIBs) as defined in the SEC's Rule 144a,[34] to determine if such investors may have an interest in a securities offering being considered by the EGC. The communications may generally take place before or following the date in which the EGC's registration statement is filed.

By June 2012, about eight weeks after the EGC provisions had gone into effect, media sources reported that while most of the hundreds of companies that had opted for EGC status were small biotech, technology, retail, and energy companies. Of the companies, 17 described themselves as blank-check companies or special-purpose acquisition companies (SPACs). Blank-check companies and SPACs are described as essentially "empty shells" with virtually no employees. Such companies are sometimes used in mergers or as an easy way to gain a listing on a domestic exchange.[35]

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[33] "Report to Congress on Decimalization as Required by Section 106 of the Jumpstart Our Business Startups Act," July 20, 2012, available at http://www.sec.gov/news/studies/2012/decimalization-072012.pdf.

[34] Rule 144A provides a safe harbor for issuers and placement agents to conduct unregistered securities offerings called private placements and resales of those offerings of any amount involving an unlimited number of "qualified institutional buyers," or QIBs, subject to, among other things, prohibitions on general solicitations and advertising. QIBs are defined as institutions that manage at least $100 million in securities and includes banks, savings and loans institutions, insurance companies, investment companies, employee benefit plans, and entities owned entirely by qualified investors. They also consist of registered broker-dealers owning and investing, on a discretionary basis, at least $10 million in securities of non-affiliates.

[35] Emily Chasen, "Meet the JOBS Act's Jobs-Free Companies," *Wall Street Journal*, June 4, 2012. available at (continued...)

SEC Review of Regulation S-K. The SEC's Regulation S-K provides specific disclosure requirements for companies that go through the IPO process. The JOBS Act requires the SEC to analyze registration requirements under Regulation S-K and formulate how the registration protocol under it can be simplified and modernized. The act directs the agency to report the results of the review to Congress by October 2, 2012 (within 180 days of the law's enactment). As of mid-September, 2012, the study had not yet been released.

Title II. Access to Capital for Job Creators

Rule 506 and Rule 144a Relaxing General Solicitation Limits. Companies that seek to raise capital through the sale of securities must either register the securities offering with the SEC or rely on an exemption from registration. Generally, SEC rules that provide such exemptions also prohibit such exempt companies from engaging in general solicitation or general advertising in connection with securities offerings (through traditional media and Internet advertising). Rule 506 under the SEC's Regulation D is one such exemption, an exemption that is described as the broadest of the safe harbors under the regulation.[36] Rule 506 permits securities offerings to be made to an unlimited number of accredited investors without having to register them.[37] The significance of Rule 506 offerings as a vehicle for raising capital is reflected in SEC estimates that in 2011, total capital raised through such offerings was slightly more than $1 trillion, a figure that the agency indicated was comparable to the amount of capital raised through registered securities offerings during the year.[38]

Under the JOBS Act, the SEC is directed to amend Rule 506 to permit general solicitation or general advertising when all purchasers of the securities are accredited investors. Toward this end, it says that "[s]uch rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." Currently, corporate issuers subject to Rule 506 have not been subject to such a verification requirement.

In addition, the JOBS Act requires the SEC to revise the agency's Rule 144A. Rule 144A provides a safe harbor from SEC registration for issuers and placement agents who conduct securities offerings and resales of those offerings of any size that can involve an unlimited number of qualified institutional buyers. Traditionally, securities offerings or securities resales under Rule 144A have been prohibited from general solicitations and advertising. The JOBS Act changes that by directing the SEC to amend Rule 144A so that the prohibitions on solicitations and advertising are relaxed.

(...continued)

http://online.wsj.com/article/SB10001424052702303506404577443980893828956.

[36] For example, see "Increasing the Vulnerability of Investors," by Commissioner Luis A. Aguilar U.S. Securities and Exchange Commission, SEC Open Meeting," August 29, 2012. available at http://sec.gov/news/speech/2012/spch082912laa.htm.

[37] "Statement at SEC Open Meeting: Proposed Rules to Eliminate the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings by Commissioner Daniel M. Gallagher," August 29, 2012, available at http://www.sec.gov/news/speech/2012/spch082912dgm.htm.

[38] "Opening Statement at the SEC Open Meeting by SEC Chairman Mary L. Schapiro," August 29, 2012, available at http://www.sec.gov/news/speech/2012/spch082912mls.htm.

Under the JOBS Act, the SEC was required to promulgate the Rule 506 and Rule 144A amendments by July 4, 2012 (within 90 days after the act's enactment). On August 29, 2012, the SEC issued a proposed rule "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings." The proposed rule would allow companies to use general solicitation and general advertising to offer securities under Rule 506 of Regulation D of the Securities Act and under Rule 144A of the Securities Act. After a 30-day period of public comment, the SEC will vote on whether to adopt the rule as a final rule.[39]

The SEC's proposed amendments to Rule 506 do not provide for a specific verification protocol for determining that securities purchasers are accredited investors. Instead they would require companies to take objectively reasonable steps in determining if an investor is accredited based on the specific facts and circumstances surrounding a given transaction. Among the factors that the proposal indicated could be used as part of this calculation are information that a company has about an acquirer of its securities as well as the "nature of the offering."[40]

The SEC's proposed amendment of Rule 144A recommend that a securities offering subject to the rule could be solicited to any entities, but could only be sold to investors that the issuing company "reasonably believe[s]" are qualified institutional buyers.

In her opening speech before the SEC commissioners voted on the proposals, SEC Chair Schapiro observed that "[n]ew technologies have caused many to question the feasibility and continued desirability of communication restrictions in private offerings… [and that before] ... the JOBS Act, I had instructed the staff to take a fresh look at the prohibition in Rule 506 and develop ideas to reduce regulatory constraints on capital formation in a manner wholly consistent with investor protections…"

Chair Schapiro also noted that "the proposed rules fulfill Congress's clear directive that issuers be given the ability to communicate freely to attract the capital they need, while obligating them to take steps to ensure that this ability is not used to sell securities to those who are not qualified to participate in such offerings." However, she also indicated "that there are very real concerns about the potential impact of lifting the ban on general solicitation."[41]

According to media reports, SEC Chair Schapiro also observed that the agency had initially planned to vote on interim rules, but noted that when "serious commenters raised concerns about not having an opportunity to comment on a specific proposal, and would rather be left with an interim final rule, it was my view that it would be wrong not to give them that opportunity to be heard."[42] The decision to initially promulgate a proposal rather than formal rules found agreement

[39] See "SEC Proposes Rules to Implement JOBS Act Provision About General Solicitation and Advertising in Securities Offerings at http://www.sec.gov/news/press/2012/2012-170.htm.

[40] "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," August 29, 2012, available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

[41] Ibid.

[42] As reported in: Alexandra Alper, "SEC Proposes Dropping Ad Ban on Private Stock Offers," *Reuters*, August 29, 2012, available at http://newsandinsight.thomsonreuters.com/Securities/News/2012/08_-_August/SEC_proposes_dropping_ad_ban_on_private_stock_offers/. In a letter to Chair Schapiro dated August 15, 2012, Jack Herstein, president of the North American Securities Administrators Association, made a case for not rushing into rulemaking on the issue: "I write to express our deep concern that the Commission may choose to adopt an interim rule during its open meeting …. while simultaneously soliciting comment on a proposed final rule. Given the complexity of the issues involved in the changes to Rule 506, plus the enormous impact those changes will have on how these risky investments will be offered, we strongly urge the Commission to follow its normal course of (continued...)

from Senator Carl Levin, chairman of the Senate Permanent Subcommittee on Investigations. The chairman wrote, "Thankfully, the SEC decided to follow its normal procedures and open the rule up for comment before its implementation."[43]

By contrast, in a letter to SEC Chair Schapiro dated August 16, 2012, Representative Patrick McHenry, chairman of the TARP and Financial Services Subcommittee of the House Oversight Committee and a sponsor of legislation that was incorporated into the JOBS Act, criticized the agency's decision to promulgate proposals instead of rules:

> [T]hat "by issuing a proposed rule, rather than an interim final rule, the Commission is unlikely to finalize the rule until next year. By kicking the can down the road, you are abdicating your responsibility to follow the law…. We are now over four months since the JOBS Act was enacted and over one month past your statutory deadline to implement this section removing the ban on general solicitation….[44]

In the letter, Chairman McHenry also asked SEC Chair Schapiro to respond to several document requests, including communications between SEC commissioners or staff and outside entities related to the rulemaking, and documents prepared by the SEC's Office of the General Counsel related to the rulemaking.[45]

At the start of the meeting in which the SEC commissioners voted on the proposal, Chair Schapiro spoke of her views on the proposal and attendant public policy issues:

> I believe the proposed rules fulfill Congress's clear directive that issuers be given the ability to communicate freely to attract the capital they need, while obligating them to take steps to

(...continued)

publishing the proposed rule for public comment before it becomes effective…" at http://op.bna.com/srlr.nsf/id/pdid-8x8m3u/$File/nasaa.pdf. At least one other SEC commissioner criticized the decision to initially forego rulemaking. While he voted in support of the proposal, Commissioner Daniel Gallagher observed, "…. I am not happy to be sitting here today, almost two months after the JOBS Act deadline for a final rule, voting on a proposal. For months, the Commission had been told that the Staff was recommending that we vote on an interim final rule. That always made sense to me given the clear mandate we had to implement. Indeed, it still makes sense today. An interim final rule would have ensured that we had a final rule in place reasonably soon after the Congressional deadline. In situations like today's - where we are charged with quickly implementing a mandate that gives us an unambiguous bottom line and leaves us little room for discretion, the Commission can, 'for good cause' adopt an interim final release - a way to go ahead and make the required change, while at the same time soliciting market reactions to how the change actually works. Indeed, the draft interim final rule we were originally going to consider this month took into account the significant comments we had already gotten on this topic through the JOBS Act implementation comment portal on our website. We should be, and I wish we were, voting on an interim final rule today. We could also have pursued a much more timely proposal, perhaps two or three months ago, that would have put us in a position to promulgate a final rule today. But, as I stated, the staff had chosen the path of interim final, and that made good sense. Then, earlier this month, we were told that the Chairman had reconsidered the draft interim final rule and wanted to re-cast it. Though I disagreed with that decision, I worked hard to accommodate changes in order to get the job done without further delay…." "Statement at SEC Open Meeting: Proposed Rules to Eliminate the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings by Commissioner Daniel M. Gallagher," August 29, 2012, available at http://www.sec.gov/news/speech/2012/spch082912dgm.htm.

[43] "Levin Statement on SEC's Proposed General Solicitation Rule," August 29, 2012, available at http://www.levin.senate.gov/newsroom/press/release/levin-statement-on-secs-proposed-general-solicitation-rule/?section=alltypes.

[44] "Letter to the Honorable Mary L. Schapiro from Representative Patrick McHenry, chairman of the House Oversight TARP and Financial Services Subcommittee," August 16, 2012, available at http://oversight.house.gov/wp-content/uploads/2012/08/2012-08-16-PMC-to-Schapiro-SEC-general-solicitation-due-8-30.pdf.

[45] Ibid.

> ensure that this ability is not used to sell securities to those who are not qualified to participate in such offerings. Nonetheless, I recognize that there are very real concerns about the potential impact of lifting the ban on general solicitation. Indeed, some of those concerns were noted in several of the letters submitted as part of our pre-rulemaking JOBS Act comment process. I appreciate the many thoughtful letters suggesting both specific and broad reforms to Rule 506 offerings and Regulation D more generally.[46]

Some observers have criticized the Rule 506 accredited investor verification proposal for being ambiguous. For example, two observers who are involved in the crowdfunding industry commented,

> Rather than stick with the current self-certification path or providing a mechanism for investors to prove accreditation, the SEC said that different investors may need to supply the government with different information based on the "type" of investor they are. This is concerning because according to the law, there is only one type of accredited investor (someone with a net worth of at least $1 million or an annual income of at least $200,000). What the new proposed regulation did was make the rules harder to interpret by saying the verification of an accredited investor's status will change depending on the amount, type of information, and the way in which the purchaser is solicited. Markets look for certainty before they act. The content of this proposed rule doesn't provide the markets with confidence but instead creates more questions. Currently, corporate issuers subject to Rule 506 have no such verification requirement. The proposed rule also would revise Form D, the required form for such private placements to include a check box for issuers seeking to market their offerings pursuant to the new exemption.[47]

In Congress, however, Senator Carl Levin raised concerns over what he saw as significant investor protection shortcomings in the SEC proposal:

> Today, the SEC began undermining significant investor protections and putting ordinary Americans' investments at risk. Just a few years after the financial crisis, it is disappointing that the SEC is proposing a rule that ignores years of experience and the law… For instance, the SEC rule should require those who advertise private deals to take specific steps to ensure that investors have the wherewithal and expertise to make these risky investments. And it should require that the content of the advertising meets some minimum standards, such as those that mutual funds are subject to today. The proposed rule does neither….[48]

Echoing Senator Levin's concerns, SEC Commissioner Luis Aguilar, the sole dissenting vote in the SEC's 4-1 adoption of the proposal, argued that the proposal "fails to address the acknowledged increased vulnerability of investors" after the advertising prohibitions are rescinded. He also asserted that the proposal did not capture earlier commenters' recommendations on the need to provide ways in which to insulate investors from potential securities fraud.[49]

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[46] "Opening Statement at the SEC Open Meeting by Chairman Mary L. Schapiro U.S. Securities and Exchange Commission," August 29, 2012, available at http://www.sec.gov/news/speech/2012/spch082912mls.htm.

[47] Jason Best and Sherwood Neiss, "SEC Uses JOBS Act to Set Up New Roadblocks to Crowdfunding," *Venture Beat*, August 31, 2012, available at http://venturebeat.com/2012/08/31/sec-uses-jobs-act-to-set-up-new-roadblocks-to-crowdfunding/.

[48] "Levin Statement on SEC's Proposed General Solicitation Rule."

[49] "Increasing the Vulnerability of Investors by Commissioner Luis A. Aguilar U.S. Securities and Exchange Commission, SEC Open Meeting."

Title III. Crowdfunding

Crowdfunding refers to the financing of an activity through the collective cooperation of people who pool their money or other resources, sometimes through a networking site on the Internet. Common goals of crowdfunding involve activities such as disaster relief, political campaigns, and investing. In the investment area, crowdfunding typically involves relatively small individual monetary contributions from a group of investors to meet a specific goal.[50] Current SEC regulations prohibit general solicitation and advertisements for non-registered offerings and cap the number of shareholders for nonregistered companies at 500, proscriptions that are alleged to impede crowdfunding. The JOBS Act limits the total amount that a company can raise through crowdfunding to $1 million annually. Under the act, the size of an individual's investment is limited by their income and wealth. In the event that both an investor's annual income and net wealth are under $100,000, he or she would be able to invest the greater of either $2,000 or 5% of their income or net wealth over a 12-month period. If an investor makes more than $100,000 annually, he or she would be able to invest up to 10% of their income or net wealth, with a maximum of $100,000 total over a 12-month period.

Under the JOBS Act, a crowdfunding investment must be made through an intermediary that will be required either be a registered broker-dealer or a newly created entity known as a funding portal (which is established by amending the Securities Exchange Act of 1934). All such intermediaries must be members of a national securities exchange, which are also known as a self-regulatory organization. They must also ensure that each investor reviews investor education information (to be later determined by the SEC) and confirm that each investor knows that he or she is risking the loss of his or her entire investment.

In addition, corporate issuers involved in crowdfunding will be required to file a "mini-prospectus" with the SEC, which among other things should identify their officers, business plan, and financial condition.

The JOBS Act requires the SEC to issue rules needed to implement the crowdfunding provisions by December 31, 2012 (270 days after its enactment).

Two broadly divergent perspectives on the impact of the crowdfunding provisions come from those who tend to focus on their potential for helping to expand small business access to capital and those who have concerns that the probable expansion of crowdfunding will result in more investor fraud.

Below is a typical example of the view that the crowdfunding provisions in the JOBS Act are likely to enhance access to capital:

> [T]he JOBS Act, which was signed into law earlier this month, set the stage for a major expansion in crowdfunding…. Until the passage of the JOBS Act crowdfunding was seriously limited by securities laws designed to protect 'unaccredited' investors – ordinary people – from securities scams. The JOBS Act reversed many of those laws and makes it much easier for individuals to invest in companies. Small and mid-size startups, which are the most likely to seek crowdfunded investment, will likely benefit the most from the growth

[50] CRS Report R42060, *Crowdfunding and the Exemption for Small Firms from Securities and Exchange Commission Registration Requirements*, by Michael V. Seitzinger.

> in crowdfunding, as they will now have a new pool of capital available to help expand their ventures….[51]

However, principally concerned with the implications of the crowdfunding provisions on investor protection, the North American Securities Administrators Association (NASAA), a group of state and provincial securities regulators, warns that,

> [T]he JOBS Act provisions related to crowdfunding, a much-publicized method for startups seeking capital, are not yet available – and will not be until sometime in 2013 – to legitimate businesses. Even when the relaxed rules and registration exemptions are effective, they will not make investments in small businesses less risky – just more prevalent. And the JOBS Act provisions do not eliminate fraud, an unfortunate common feature of Internet securities activity. Many states and provinces report a recent increase in active investigations or recent enforcement actions involving Internet fraud, and JOBS Act-triggered activity is likely to elongate this trend. Investors must remember that small startups are among the riskiest of investment categories under the best of situations. The crowdfunding and Internet investing marketplaces in North America will develop and undergo major changes in the next year, and investors should monitor this emerging capital formation community with a wary eye.[52]

Title IV. Small Company Capital Formation

Expanding the Regulation A Exemption. Among the SEC regulations providing exemptions for certain small businesses from some of the registration and disclosure requirements of the federal securities laws, Regulation A[53] is especially important. It allows the SEC to exempt any class of securities from registration under the Securities Act of 1933 if it finds that the exemption is in the public interest and the issue of securities does not exceed $5 million during any 12-month period. Securities offerings under the exemption are not limited to any kind of investors. The $5 million cap has been in effect for about two decades. Possibly due to this cap, the total amount of Regulation A offerings have historically been much smaller than have Regulation D offerings.[54] The JOBS Act increases the offering ceiling under Regulation A to $50 million in the course of a year. The act has no deadline for when the SEC must adopt rulemaking to implement the expansion of the Regulation A offering cap to $50 million annually.

According to a report released by the U.S. Government Accountability Office (GAO), Regulation A offerings cleared by the SEC have fallen significantly since the late 1990s. According to the study, after peaking at 116 in FY1997, the number of Regulation A offerings fell to 19 by 2011.[55]

Regarding the benefits of the Regulation A reform in the JOBS Act, House Financial Services Committee Chairman Spencer Bachus, observed,

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[51] Obama's JOBS Act Boosts Crowdfunding, *Kalia Law Group Release*, April 25, 2012, available at http://www.kalialawgroup.com/2012/04/25/obamas-jobs-act-boosts-crowdfunding/.

[52] "Laws Provide Con Artists with Personal Economic Growth Plan NASAA Identifies Emerging and Persistent Investor Threats," *NASAA News Release*, August 21, 2012. Available at http://www.nasaa.org/14679/laws-provide-con-artists-with-personal-economic-growth-plan/.

[53] 17 C.F.R. §§230.251 *et seq*.

[54] See Rutheford B. Campbell, Jr., "Regulation A: Small Business' Search for a Moderate Capital," University of Kentucky College of Law, Delaware Journal of Corporate Law, vol. 31, no. 1, p. 77-123, 2005.

[55] "Factors that May Affect Trends in Regulation A Offerings," GAO-12-839, *U.S. Government Accountability Office*, July 3, 2012, available at http://www.gao.gov/products/GAO-12-839.

> Amending Regulation A to make it viable for small companies to access capital will permit greater investment in these companies, resulting in economic growth and more jobs. By reducing the regulatory burden and expense of raising capital from the investing public….[56]

A similarly optimistic view on the likely benefits from the Regulation A reform comes from two lawyers who are involved in raising small business capital:

> [Due to the JOBS Act] Regulation A likely could become the dominant avenue for small and medium-size businesses to form capital. Moreover, as those businesses grow, funded by the capital from their Regulation A offerings, they will find appealing the IPO on-ramp [as EGCs]…. With what is expected to be an exponential increase in the use of Regulation A to form capital, there is every reason to believe the financial markets will develop a robust secondary market for these securities.[57]

The aforementioned GAO reported, however, was more qualified in its discussion about the potentially positive impact that the Regulation A reform's may have on capital markets:

> The number of small business that seek exemption through Regulation A may increase as a result of the JOBS Act's requirement for SEC to increase the maximum offering amount to $50 million, according to staff from some state securities administrators' offices, a small business advocate, and securities attorneys whom we interviewed. A small business advocate with whom we met stated the higher ceiling increase could attract those businesses for which the $5 million ceiling was too low. Moreover, this advocate noted that some small businesses may want to enter the securities market but are not yet prepared to register an offering with SEC; thus, Regulation A would be a good way for them to enter the market. The higher ceiling also could increase underwriters' interest in Regulation A, according to some stakeholders we interviewed. While investment banks are not interested in $5 million offerings, they are more likely to be interested in offerings that are closer to $50 million…. Under the JOBS Act, future Regulation A offerings generally remain subject to state blue sky laws, which may deter future use by small businesses… addressing and complying with securities registration requirements of states can be costly and time-consuming, according to several stakeholders with whom we met. Recent Regulation A issuers, a small businesses advocate, and securities attorneys we interviewed stated that researching individual state laws and registering with multiple states significantly increased the legal and accounting costs associated with Regulation A offerings. As a result, even with the increased attractiveness of the $50 million ceiling, blue sky requirements may still dampen small business' interest in Regulation A. However, some stakeholders also noted that with the increased ceiling, a Regulation A offering's transaction costs (attorney fees and accounting costs) will represent a smaller proportion of the overall offering costs….[58]

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[56] Chairman Richard Bachus, "Regulation A Reform in JOBS Act a 'Game Changer' for Small Business," June 27, 2012, available at http://financialservices.house.gov/blog/?postid=301209.

[57] Rob Kaplan, and Tom Voekler, "Beyond Crowdfunding: Why Regulation A reform is the Most Vital Piece of the JOBS Act," *Washington Post*, June 13, 2012, available at http://www.washingtonpost.com/business/on-small-business/beyond-crowdfunding-why-regulation-a-reform-is-the-most-vital-piece-of-the-jobs-act/2012/06/13/gJQAHnVQaV_story.html.

[58] "Factors that May Affect Trends in Regulation A Offerings," GAO-12-839.

Title V. Private Company Flexibility and Growth and Title VI. Capital Expansion

The Securities Registration Threshold Trigger for Companies in General. The Securities Exchange Act of 1934 requires a private company to register its securities with the SEC in the event that the holders of record (the registered owner of a security) exceed 500 and the company's total assets exceed $10 million, thresholds that have existed for decades. The JOBS Act amends the Securities Exchange Act by raising the number of shareholders of record who can invest in a private company from 500 to either 2,000 or 500 who are all non-accredited investors (individual investors with relatively low incomes and net worth),[59] excluding employee-held stock, before triggering the registration requirement. In addition, the JOBS Act mandates that the "held of record" be defined to include securities holders who received the securities as part of an employee compensation plan through transactions that are exempt from the registration requirements of Section 5 of the Securities Act, the part of the federal securities law that contains the basic registration requirements for securities offerings and rules.

This "shareholder trigger" under Section 12(g)(1) of the Securities Exchange Act of 1934 has been subject to debate and scrutiny in recent years. One academic complained that "the practical effect of this rule is to force certain types of firms into the public markets earlier than is desirable."[60] Indeed, Google noted in its registration statement for its public share offering that "the deadline imposed by this requirement accelerated our decision [to go public]."[61] Some have argued that raising the Section 12(g) threshold would better enable firms to find other sources of financing beyond venture capital, and avoid conducting an IPO before they may be ready to do so.[62]

Officials at a venture capital trade group, the National Venture Capital Association, however, have said that there are probably only a very limited number of firms that are close to triggering the 12(g) shareholder threshold and would thus potentially benefit from a more liberalized trigger.[63] In response to such concerns, SEC staff has been examining whether current 12(g) thresholds and standards are effective for implementing the securities laws' registration and reporting requirements.[64]

The Securities Registration Threshold Trigger for Banks. The JOBS Act also raises the threshold for triggering mandatory registration under the Exchange Act for banks and bank holding companies to 2,000 holders of record (subject to no limit on the number of non-

[59] Under the Securities Act of 1933, an accredited investor is an entity who is allowed to take part in certain non-public and limited securities offerings. Accredited investors are defined as natural persons (individually or jointly with their spouses) if their net worth exceeds $1 million, excluding the equity value of their primary residence.

[60] William K. Sjostrom, Jr., "Questioning the 500 Equity Holders Trigger," *Harvard Business Law Review Online*, vol. 1 (2011), p. 43.

[61] Google Inc. Registration Statement (Form S-1), at 36 (April 29, 2004), available at http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds.l.htm.

[62] For example, see the comments of Representative David Schweikert as reported in: Deborah Gage, "Bill Aims To Loosen Private-Company Stock Rules, *Wall Street Journal*, June 14, 2011.

[63] Telis Demos, "Fewer than 12 Companies to Benefit from Rule Change," *Financial Times*, June 24, 2011.

[64] See "Testimony of Meredith B. Cross, Director SEC Division of Corporation Finance Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the U.S. House of Representatives, Committee on Oversight and Government Reform," September 15, 2011.

accredited investors). The act also raises the threshold that permits an entity to terminate its securities registration and to suspend its SEC reporting requirements for banks and bank holding companies that have as few as 1,200 holders of record. These reforms were of particular interest to community banks.

The JOBS Act requires the SEC to implement the aforementioned changes to the Exchange Act threshold triggers no later than April 4, 2013, a year after enactment. In addition, the agency is required to revise the definition of held of record, a directive that has no deadline.

Examining the Decline in IPOs Since 2000

Broad consensus among academics is that since about 2000, there has been a marked decline in IPOs in the United States, particularly by domestic companies, as compared with the period from about 1980 to 2000. In many respects, this observed decline has been a significant impetus behind much of the aforementioned legislation—both in its own terms and as a symbol of the perceived erosion of domestic capital markets, particularly for small- and medium-sized firms. The following sections examine various perspectives on both the nature of the IPO decline, its possible causes, its implications, and questions over its ultimate significance.

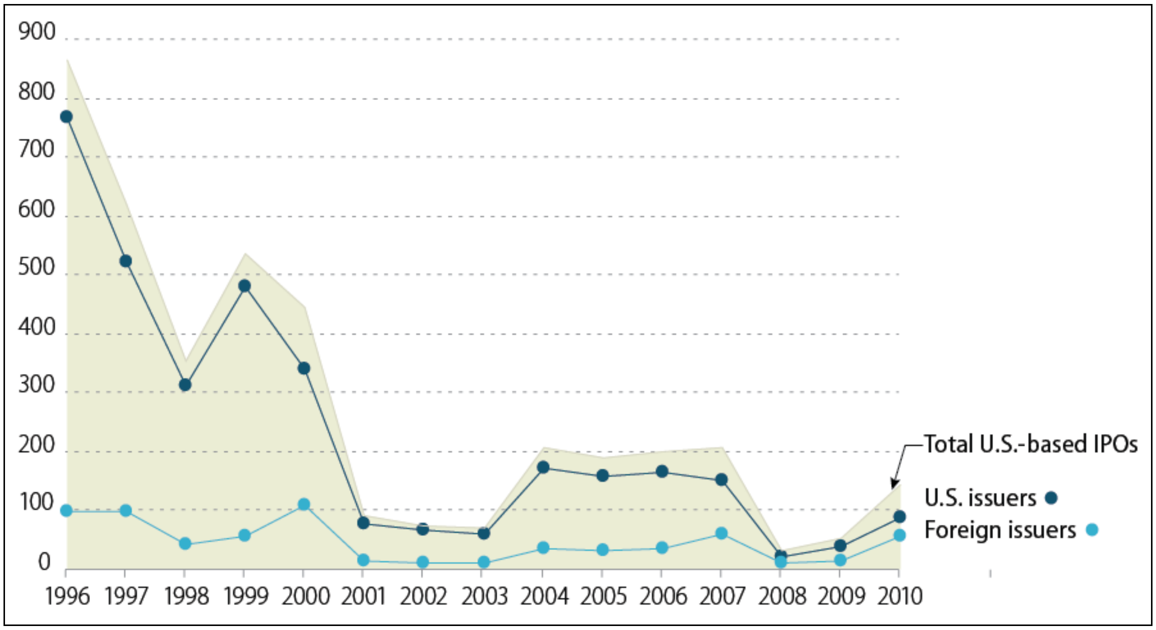
On the issue of the IPO decline, a 2011 study, for instance, found that in the period from 1980 to 2000, there were, on average, 311 IPOs per year; but in the decade since 2000, an average of only 102 firms per year have gone public.[65] The study also noted that of the 7,443 IPOs identified from 1980 to 2009, only 12% of them, or 921 IPOs, occurred between 2001 and 2009.[66] The drop in IPOs is even more marked if economic growth is taken into account. All else equal, a larger economy would be expected to have more IPOs, rather than fewer.

The recent decline in IPOs is also confirmed by the data presented in **Figure 1** and **Figure 2** below, collected by the law firm Wilmer Cutler Pickering Hale & Dorr LLP, using SEC data.

[65] Jay R. Ritter, Xiaohui Gao and Zhongyan Zhu, "Where Have All the IPOs Gone?," November 4, 2011, p 2, available at http://ssrn.com/abstract=1954788 or http://dx.doi.org/10.2139/ssrn.1954788.

[66] Ibid., see Table 1, p. 34.

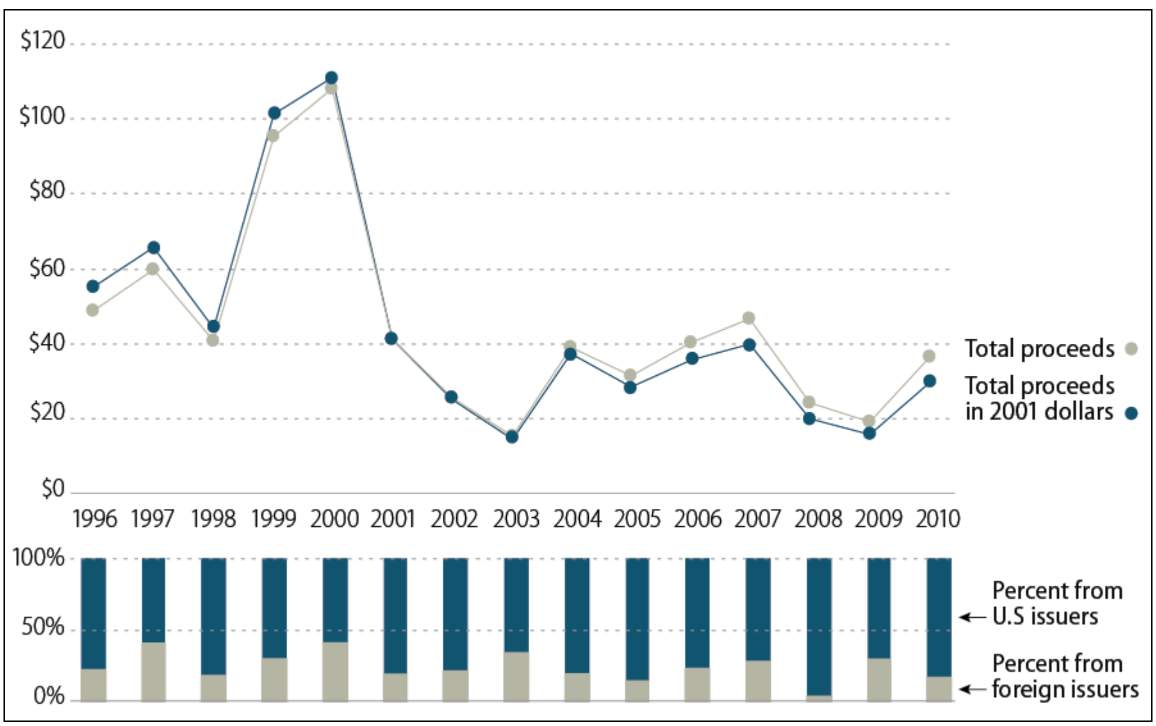
Figure 1. Number of U.S.-Based IPOs



Source: Wilmer Cutler Pickering Hale & Dorr LLP based on SEC data.

Note: The total represents the sum of the U.S. issuers and foreign issuers.

Figure 2. Aggregate Proceeds for U.S.-Based IPOs
(in $ billions)



Source: Wilmer Cutler Pickering Hale & Dorr LLP based on SEC data.

Note: The data in 2001 dollars was calculated by CRS based on the Bureau of Labor Statistics' Consumer Price Index for Urban Families.

Other studies have found a similar, pronounced drop in IPOs. For instance, the financial advisory firm Grant Thornton, using another dataset, found an annual average of roughly 500 IPOs during the years before the dotcom bubble burst around 2000; but that figure fell to just 61 IPOs in 2009, and 153 IPOs in 2010.[67] Reports also indicate that companies are waiting longer to do IPOs. Between 1997 and 2001, the average age of a domestic company that did an IPO was about five and a half years, compared with an average of nine years for companies that went public between 2006 and 2011.[68]

Although most research has found a decline in U.S. IPOs, there are differences in how observers define the notion of "decline." Some studies challenge the view that there is a broad "decline" in U.S. public stock markets more generally, focusing instead on various aspects of the U.S. stock markets beyond the number of, and proceeds from, U.S. IPOs. This includes some research published by the Federal Reserve Bank of New York, commentary by Securities and Exchange Commission (SEC) officials based on their review of studies of public equities markets, and reports that a significant number of China-based firms have listed on the NASDAQ and the New York Stock Exchange in recent years (which is discussed further below).[69]

Nevertheless, research suggests a particularly pronounced drop in the numbers of IPOs and market share of IPOs for small companies—an issue addressed in a number of the capital markets bills in Congress.[70] Small companies have seen the average volume of their IPOs decline from 165 IPOs per year from 1980 to 2000 to 72 IPOs per year from 2001 to 2009.[71] Before 1998,

[67] "Grant Thornton LLP announces update to U.S. IPO Market Study," June 21, 2010, available at http://www.grantthornton.com/portal/site/gtcom/menuitem.550794734a67d883a5f2ba40633841ca/?vgnextoid=e8eb2be99ea59210VgnVCM1000003a8314acRCRD.

[68] "Rebuilding the IPO on Ramp," *The IPO Task Force*, October 20, 2011, available at http://www.slideshare.net/TENOR/rebuilding-the-ipo-on-rampfinal-slideshare.

[69] For example, see "Evaluating the Relative Strength of the U.S. Capital Markets," *Current Issues in Economics and Finance of the Federal Reserve Bank of New York*, July 2007, available at http://www.newyorkfed.org/research/current_issues/ci13-6/ci13-6.html. After examining the health of the U.S. public equities markets, the study concluded "… that evidence on the competitiveness of the U.S. equity market is mixed, and that the same trends seen in the U.S. market are also shaping equity markets abroad. Overall, the NYSE and the NASDAQ continue to be the world's most actively traded markets." See also "Letter from SEC chairman Mary Schapiro to the Honorable Darrell E. Issa, chairman House Committee on Oversight and Government Reform," April 6, 2011, available at http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf. In the letter, a response to questions on the state of domestic capital markets raised by Chairman Issa, the SEC chairman observed, "Several reports have raised the possibility that the U.S. market is losing its competitive edge to foreign markets with respect to being a market for global initial public offerings, pointing out the decrease in the number of global initial public offerings listing on U.S. exchanges. Other studies, by contrast, note that the perceived disadvantage of the United States might not hold when the size of the global issues that list in the U.S. is taken into consideration." An article published in early 2011 observed, "[O]ne group had a banner year on the NASDAQ and the NYSE: Chinese companies. Last year, 38 China-based companies went public on U.S. exchanges, raising more than $4 billion and accounting for a quarter of all IPOs last year." Lin Hurst, "Why Chinese Companies are Listing Stateside," *Venture Capital Journal*, February 2011. In addition, an academic study examined the determinants and consequences of cross-listings (companies who list on several exchanges) on the New York Stock Exchange (NYSE) and the London Stock Exchange (LSE) between 1990 and 2005. Among other things, it found that there was a significant premium for NYSE listings, which did not fall over the period, while there was no premium for listings on the LSE. It concluded that "our evidence is consistent with the theory that an exchange listing in New York has unique governance benefits for foreign firms." Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, *Has New York Become Less Competitive in Global Markets?* NBER Working Paper 13079, July 2007, available at http://www.nber.org/papers/w13079.

[70] In the study we cite here, "small companies" are firms with pre-IPO sales of less than $50 million, using inflation-adjusted, 2009 purchasing power.

[71] Jay R. Ritter, Xiaohui Gao, and Zhongyan Zhu, "Where Have All the IPOs Gone?," November 4, 2011, p. 8.

according to observers, smaller IPOs constituted about 80% of the total number of yearly IPOs, but since 1998, that percentage has been in the 20% range.[72]

How does this compare with trends for other markets overseas? Some have argued that the ability of some foreign stock exchanges, such as the United Kingdom's Alternative Investment Market (AIM), to successfully market and brand themselves as lower-cost, attractive venues for smaller firms has helped to lure IPOs away from U.S. exchanges.[73] Another study in 2011 found that firms in countries with weaker governance, investor protections, and other legal institutions are less likely to go public with an IPO in their home country, and are more likely to go public globally, in a country with stronger institutions.[74] If true, this trend should tend to boost U.S. listings by companies from some foreign countries. Indeed, it could be argued that an example of this is evidence that suggests that former state-owned Chinese firms that have gone public have become a growing portion of global and U.S. IPOs in recent years.[75]

Another study found that the market share of U.S. IPOs by foreign companies as a percentage of the total has increased in this decade, partly due to the low number of U.S. companies going public.[76] For instance, in 1988, 8.3% of the total of 109 IPOs in the United States were by foreign companies, and none of the total IPOs were by Chinese companies in particular.[77] By 2010, 34.4% of the total of 128 domestic IPOs were by foreign companies, and 25.8% of the IPOs[78] were by Chinese companies.[79]

While there is little evidence that supports concerns that foreign companies are fleeing the United States, the domestic IPO market does not appear to have kept pace with the United States' share of economic growth worldwide. A 2011 study by Doidge et. al. found that in the 1990s, the yearly average number of U.S. IPOs comprised 27% of all IPOs in the world, while the United States accounted for 27% of world Gross Domestic Product (GDP). Since 2000, however, they found that the U.S. share of all IPOs has fallen to 12% whereas the U.S. share of worldwide GDP has averaged 30%.[80]

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[72] For example, see Helen Avery, "U.S. IPO market: Normality? What Normality?," *Euromoney,* December 2010.

[73] Sergey G Litvintsev, "At What Do Venture Capitalists AIM?" April 15, 2009, available at http://ssrn.com/abstract=1677633.

[74] Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, "The U.S. Left Behind: The Rise of IPO Activity Around the World," *National Bureau of Economic Research Working Paper 16916*, March 2011, available at http://www.nber.org/papers/w16916.pdf.

[75] Interview of Edward Nusbaum of Grant Thornton at "Nusbaum on Sarbanes-Oxley, Risk, and Foreign Markets," *The Practical Accountant*, September 2007, available at http://www.accountingtoday.com/prc_issues/2007_9/25115-1.html.

[76] Jay R. Ritter, Xiaohui Gao and Zhongyan Zhu, "Where Have All the IPOs Gone?" Table 7, p. 40, available at http://ssrn.com/abstract=1954788 or http://dx.doi.org/10.2139/ssrn.1954788.

[77] Ibid., Table 7, p. 40.

[78] Ibid., Table 7, p. 40.

[79] Indeed, observers have reported that many smaller, earlier stage, unprofitable Chinese technology companies have been electing to list on U.S. exchanges instead of on Chinese stock exchanges. Despite the fact that U.S.-listed Chinese stocks were reportedly trading at a 50% to 70% discount to their Chinese peers on the Hong Kong and the Shanghai/Shenzhen stock exchanges, U.S. exchanges saw a record number of Chinese IPOs in 2010. Representing almost one-third of all U.S.-listed IPOs, some predict that the number of such U.S.-listed Chinese IPOs will continue to grow. See, e.g., "The Current IPO Landscape and the Vital Role of the Secondary Marketplace: Size Does Matter – Except If You Are Chinese," *NowStreet Journal*, March 29, 2011, available at http://nowstreetjournal.com/2011/03.

[80] Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, *The U.S. Left Behind: The Rise of IPO Activity Around the World*, National Bureau of Economic Research, Working Paper 16916, March 2011, p. 1, available at http://www.nber.org/papers/w16916.pdf.

Analysis such as the Doidge study generally suggests that there has been an overall numerical decline in the number of yearly domestic IPOs and the nation's share of overall IPOs as well.[81]

The Doidge study and others have tended to attribute the drop in U.S. IPO activity vis-à-vis the rest of the world to a combination of lower U.S. IPO activity by U.S. firms, and the growth of IPOs in other countries during this period, particularly in emerging markets.[82]

Some evidence suggests that other developed countries may face a similar situation. For example, both Germany and France saw their respective IPO volumes drop by more than 50% from 2002 to 2007 relative to the 1994- 2001 period, even as average IPO proceeds in those countries more than doubled, according to one study.[83] This may indicate that, as in the United States, some other developed countries may also be losing smaller IPO deals. At the same time, however, others have noted an increase in the number of IPOs in Hong Kong,[84] Tokyo, and Australia, and some have observed slight increases in the United Kingdom and Italy.[85]

An apparent decline in the U.S. share of IPOs worldwide leads to several corollary questions: what are the implications, if any, for the U.S. economy, and particularly for job creation? What are the causes of this decline? Are legislative measures such as the JOBS Act helpful for addressing it?

Implications: Decline in IPOs and the Question of Job Creation

Those proposing to streamline the process of raising equity finance, including some supporters of various capital market bills currently being considered by Congress, argue that improving the ability of companies to do both public and restricted stock offerings will benefit the nation through expanded job creation. For example, a widely cited report, *Rebuilding the IPO On-Ramp*,[86] presented to the Department of the Treasury by the IPO Task Force in October 2011, stated that the apparent slowdown in IPOs may have been responsible for 22 million jobs not being created. The IPO Task Force includes CEOs, public investors, venture capitalists, securities lawyers, academicians, and investment bankers who were tasked with identifying key factors holding back the growth of emerging public companies and making recommendations to alleviate those constraints.

In this context, some observers argue that it has become more difficult, and expensive, to conduct an IPO in recent years, leading many privately held emerging growth companies to opt to be acquired instead of going public. Some contend this lacks the beneficial job-creating impact of an IPO.[87]

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[81] Ibid.

[82] Ibid.

[83] Cecilia Caglio, Kathleen Weiss Hanley, and Jennifer Marietta-Westberg, *Going Public Abroad*, 2011, unpublished U.S. Securities and Exchange Commission working paper.

[84] "The Current IPO Landscape and the Vital Role of the Secondary Marketplace: Size Does Matter – Except If You Are Chinese," *NowStreet Journal*, March 29, 2011, available at http://nowstreetjournal.com/2011/03.

[85] Helen Avery, "U.S. IPO Market: Normality? What Normality?" *Euromoney*, December 2010.

[86] The report is available at http://www.wsgr.com/PDFs/rebuilding-IPO.pdf.

[87] For example, see the comments of William Hambrecht, chairman and CEO of WR Hambrecht & Co. Mergers, in: Bill McConnell, "Congress eyes raising cap on streamlined IPOs," *The Deal*, December 8, 2010.

Others, such as veteran IPO researcher and University of Florida finance professor Richard Ritter, reportedly criticized the Task Force's estimate of 22 million jobs not created as a groundless "mechanical calculation." Professor Ritter also reportedly asserted that while IPOs do create jobs, larger companies who absorb smaller, growing firms do so as well.[88]

Similarly, a 2009 study of job creation by the Kauffman Foundation found that "nearly all net job creation since 1980 has occurred in firms less than five years old" and that if the jobs from new firms were excluded, the U.S. net employment growth rate would be negative, on average.[89] Young firms have been the most dynamic in terms of adding jobs to the U.S. economy, the study found.

However, the study did not directly address the question of whether the way in which a young company raised capital was a factor in employment growth. It did not conclude that the choice of a young company to grow via a public stock listing, as opposed to being acquired by a larger firm, led to more job creation. Instead, the authors concluded that, "we suspect that the net addition of jobs in larger companies comes from their symbiosis with younger firms," and that such job creation may be a result of mergers and acquisitions of young companies.[90]

Similarly, a study by Professor Haltiwanger also concluded that startups contribute substantially to both gross and net job creation.[91] The study stressed the important role of business startups and of young businesses in U.S. job creation. But it did not address the question of whether the form of financing or growth for young firms and startups was a factor in job creation.

What Has Caused the Decline in IPOs?

When examining legislation like the JOBs Act, which is aimed at stimulating IPOs, it is useful to analyze some of the major arguments as to why IPOs have fallen. Broadly speaking, arguments as to the root causes of the decline in U.S. IPOs tend to fall into two camps. The first camp argues that regulatory factors are to blame and that the United States has a burdensome, costly regulatory scheme affecting public companies. The second camp focuses on developments in market infrastructure—some of which derive from regulatory changes affecting stock trading, but some of which do not, and might be more difficult to address through legislation alone.

[88] Rick Romell, "IPOs rebound, but still far off historic highs" *Journal Sentinel*, December 10, 2011, available at http://www.jsonline.com/business/ipos-rebound-but-still-far-off-historic-highs-973c6v8-135376213.html.

[89] Dane Stangler and Robert E. Litan, *Where Will the Jobs Come From?*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, November 2009, p. 4.

[90] "Namely, one of the only ways for big companies to add net jobs is to acquire the younger companies that are not only generating jobs, but also are responsible for a good number of innovations that will keep the bigger company's revenue growth from diminishing." Dane Stangler and Robert E. Litan, *Where Will the Jobs Come From?*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, November 2009, p. 10.

[91] John Haltiwanger, Ron S Jarmin, and Javier Miranda, *Who Creates Jobs? Small Vs. Large Vs. Young*, National Bureau of Economic Research, Working Paper 16300, August 2011, available at http://www.nber.org/papers/w16300.pdf.

Regulatory Factors Cited

A common premise behind several capital market bills in Congress is that the corporate offering "ecosystem" would better nurture offerings if a number of regulatory impediments were rolled back or liberalized. Several of these de-regulatory perspectives are examined below.

Sarbanes-Oxley

Section 404(a) of the Sarbanes-Oxley Act of 2002[92] (SOX) requires publicly registered companies to include in their annual reports a statement from management on the effectiveness of a company's internal controls over its financial reporting.[93] Section 404(b) requires such company's outside auditor to attest to and report on such assessments. Initially, after SOX went into effect, the SEC granted small cap firms known as non-accelerated filers (basically, firms with less than $75 million in market capitalization) an exemption from implementing Section 404(a) until the fiscal year ending on or after December 2007. The agency allowed small-cap firms with less than $75 million in market capitalization to delay implementation of Section 404(b), the auditor attestation requirement, until 2010. By that time in 2010, however, Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank),[94] and its provision exempting public companies with less than $75 million in market capitalization from implementation of Section 404(b), had already taken effect.

Many advocates of expanding the Section 404(b) exemption have said that there are medium-sized companies with $75 million or more in market capitalization who are discouraged from going public because they would face the costly and burdensome prospect of having to comply with Section 404(b).[95]

Arguments against broadening the Section 404(b) exemption can be found in a 2011 SEC staff study mandated by the Dodd-Frank Act.[96] The analysis addressed the question of whether the Section 404(b) exemption should be expanded to firms with up to $250 million in market capitalization and argued against doing so. [97] Among other things, it based its conclusion on it findings that the costs of SOX 404(b) have declined since the SEC first implemented the requirements of the section; investors generally view the auditor's attestation as beneficial; financial reporting is more reliable when the auditor is involved with ICFR assessments; and there is no conclusive evidence that links the requirements of the section to listing decisions of the range of corporate issuers that were studied.[98]

[92] P.L. 107-204.

[93] For more on Sarbanes-Oxley, please see CRS Report RS22482, *Section 404 of the Sarbanes-Oxley Act of 2002 (Management Assessment of Internal Controls): Current Regulation and Congressional Concerns*, by Michael V. Seitzinger.

[94] P.L. 111-203.

[95] For example, see Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission, 2006, available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

[96] SEC officials say that the 404(b) exemption already applies to more than half of public companies.

[97] "SEC Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million," April 2011, available at http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.

[98] Ibid.

The JOBS Act exempts EGCs from compliance with the auditor attestation requirement of Section 404(b).

Disclosure and Registration Requirements[99]

The key federal and registration and disclosure laws for public companies are the Securities Act of 1933[100] and the Securities Exchange Act of 1934.[101] Various people who have advocated for greater access to capital for small and medium-sized businesses often cite the existence of comparatively costly and burdensome domestic registration and disclosure requirements as one reason why some companies may resist going public, which would enable them to tap shareholder capital from those markets.

As described earlier, among other things, the JOBS Act broadens the total amount that an issuer can raise in securities offers that are exempt from registration under Regulation A to up to $50 million a year; permits EGCs to provide audited financial statements for the two years prior to their SEC registration, rather than the previously required three years; and with respect to their financial disclosure and registration statements to the SEC, EGCs can opt out of compliance with new or revised financial accounting standards promulgated by standard setters such as FINRA.

The **Appendix** in this report describes key aspects of the registration and disclosure provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Shorter "Holding Period" For Restricted Shares

As described earlier in this report, Rule 144A, provides an exemption from registration for the sale and resale of certain securities. In the late 1990s, the SEC amended Rule 144, enabling those who purchased private offering securities under the rule to resell them into the public market after holding them for one year, which superseded the previous holding period of two years. It has been argued that if smaller companies are concerned with avoiding the higher liability and greater amount of SEC oversight associated with an IPO, the lessening of this restriction on selling privately offered shares makes a private offering even more attractive relative to an IPO. Some observers, such as John Coffee, Jr., a law professor at Columbia University School of Law, say that a marked recent increase in private placements under Regulation D, lend support to the argument. [102]

The JOBS Act does not change the Rule 144A holding period.

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[99] The authors wish to thank CRS Legislative Attorney Michael V. Seitzinger who wrote this section. For additional details, see CRS Report RS22482, *Section 404 of the Sarbanes-Oxley Act of 2002 (Management Assessment of Internal Controls): Current Regulation and Congressional Concerns*, by Michael V. Seitzinger.

[100] 15 U.S.C. §§77a *et seq*.

[101] 15 U.S.C. §§78a *et seq*.

[102] Statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law Columbia University Law School At Hearings Before the Senate Committee on Banking, Housing and Urban Affairs "Spurring Job Growth Through Capital Formation While Protecting Investors," December 1, 2011.

Cost of Registering Public Shares With Multiple States

At a November 2011 SEC Government-Business Forum on Small Business Capital Formation, a number of private-sector participants noted that the cost of registering securities offerings with multiple state regulators could be expensive, particularly for small companies, and potentially overlapping or duplicative with federal regulation. They called for federal preemption of some requirements to register securities offerings at the state level, particularly for small offerings below the Regulation A exemption threshold.[103] For small securities offerings under the Regulation A exemption, participants urged federal preemption of state securities filings in some of the prior year's written recommendations as well.[104] As discussed above in the section on "Title III. Crowdfunding," the JOBS Act preempts state securities registration laws for small securities offerings subject to the "crowdfunding" restrictions, but does not restrict state regulators' right to discover, halt, and prosecute fraudulent offerings.

Market Infrastructure Changes Cited

The second set of arguments aimed at explaining the decline in U.S. IPOs focuses on changes in market infrastructure that have made it costlier to bring small IPOs to market. Except for a liberalization of some of the restrictions on securities analyst research at investment banks surrounding IPOs and mandating certain studies, the JOBS Act generally does not address these factors, which are discussed below.

Underwriting Costs

When a company seeks to list an initial public offering on a U.S. stock exchange, or issue bonds, it will generally use an underwriter to conduct due diligence, sell the securities to investors, and make a market in the securities. There are several ways that a firm doing an IPO incurs costs through underwriting. First, there are the direct costs, in terms of fees to underwriters, advisers, lawyers, and accountants. Some studies have estimated that a small company undertaking an IPO in the United States will, on average, pay a typical rate of roughly 7% of the size of the offering to an underwriter as a fee.[105] In addition, a small company may pay 3% or more of the offering size to lawyers, accountants, and advisers.

On top of this expense, there are indirect costs to underwriting, particularly the practice of underpricing shares listed in IPOs so that they will rise immediately following the onset of trading. One study found that, on average, IPO share offerings on the New York Stock Exchange

[103] See, e.g., panelist comments of John D. Hogoboom, Partner, Lowenstein Sandler, PC, of Roseland, New Jersey, on November 17, 2011, panel discussion "IPOs and Securities Regulation Involving Smaller Public Companies" at 2011 SEC Government-Business Forum on Small Business Capital Formation.

[104] See, e.g., "Recommendations of the 2010 SEC Government-Business Forum on Small Business Capital Formation," p. 3, Recommendation 7B: "Preempt state laws that require state registration or qualification of Regulation A offerings by defining purchasers of securities in Regulation A offerings as 'qualified purchasers' under §18 of the Securities Act." Note that the recommendations of this group, which met November 18, 2010, do not represent the views of the SEC itself, but of forum participants, mostly private-sector practitioners, lawyers, and securities experts. Available at http://www.sec.gov/info/smallbus/2011gbforumprogram.pdf.

[105] See Sean J. Griffith, "Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings," *Brooklyn Law Review*, 69, 2004.

(NYSE) rose 5.1%, and on the NASDAQ exchange 6.6%, within the first day of trading.[106] Money gained from this "underpricing" of shares ends up in the pocket of initial shareholders, rather than going to the company listing the shares. By comparison, the study found that first day IPO price gains on the UK's Alternate Investment Market rose 11.2% and on the UK's main market rose 4.4%.[107]

The concern that underwriting costs are significantly higher in the United States and are depressing U.S. IPOs is bolstered by a study that found median underwriting fees on the Hong Kong Stock Exchange to be 2.5% of the offering proceeds, 3.3% on the London Stock Exchange, 3.6% on the Euronext Exchange, and 4.8% on the Deutsche Borse, compared with 6.5% on the New York Stock Exchange and 7.0% on the NASDAQ.[108]

Although the U.S. securities laws do not mandate that a company seeking to list shares use an underwriter, it has become standard practice for firms to do so. Indeed, investors may rely on the reputation of an underwriter and may feel more secure when a well-known investment bank acts as underwriter, particularly as the underwriter performs due diligence on the financials of the company, which is going public.[109] Some studies have shown, for instance, that underpricing is less as the prestige of the underwriter increases, suggesting that investors demand a higher initial return when the underwriter is less well-known.[110] However, with the rise of the Internet, some firms have turned to "direct public offerings" (DPOs) as an alternative to using more established underwriters to sell and distribute their securities.[111] In a DPO, a company raises capital by marketing its shares directly to its own customers, employees, suppliers, distributors, and friends in the community. They generally are less expensive than are traditional underwritten offerings. Some observers have called for regulatory changes that would make DPOs a more attractive alternative to traditional underwriting for small firms.[112]

Some Conceptual Basics: IPOs and DPOs

An IPO is an underwritten public offering of corporate stock from the issuing company. This means that an underwriter, commonly an investment bank, prepays the company for the stock, then goes out to the public market and attempts to sell it to the broad investing public. A DPO is a process in which companies raise capital through issuing stock directly to investors, thus

[106] "The Cost of Capital: An International Comparison," *Oxera Consulting Ltd*, June 2006, available at http://www.oxera.com/main.aspx?id=5112. Oxera made these calculations based on data from the Bloomberg financial database.

[107] Ibid.

[108] Prof. Christoph Kaserer and Prof. Dirk Schiereck, "Going Public and Being Public – A Global Comparison of the Impact of the Listing Decision on the Cost of Capital," (2007) at pp. 7-8, available at http://deutsche-boerse.com/dbag/dispatch/de/binary/gdb_content_pool/imported_files/public_files/10_downloads/33_going_being_public/30_studies/dbag-studie_coc.pdf.

[109] For more on this, see Cox, Hillman and Langevoort, Securities: Cases and Materials, Fifth Edition, *Aspen Publishers*, 2006, p. 118.

[110] Richard Carter, Rick Dark, and Ajai Singh, "Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks, *Journal of Finance*, vol. 53, issue 1., 1998, available at SSRN: http://ssrn.com/abstract=1505904; and Randolph Beatty, "Auditor Reputation and the Pricing of Initial Public Offerings," *Accounting Review*, October 1989, at http://www.jstor.org/stable/10.2307/247856.

[111] Updated data on the number of DPOs does not appear to be readily available.

[112] See, e.g., Dale A. Oesterle, "The High Cost of IPOs Depresses Venture Capital in the U.S.," *Entrepreneurial Business Law Journal*, vol. 1:2, (2006), p. 369.

bypassing an underwriter and its attendant costs, as is the case for an IPO. Rather than using underwriters—typically, large investment banks—a company may try, through a DPO, to use firms often known as "cyber middlemen," which can prepare registration documents if needed, offer hyperlink marketing programs, and website consultations or creation.[113] Although this type of offering may reduce costs associated with traditional underwriting, researchers have found that many such offerings ultimately do not succeed.[114] Such DPO offerings are generally considered to be within SEC rules, as long as the company either registers the securities with the SEC, or qualifies for an exemption from such registration, such as under Regulation A or Regulation D.[115]

Changes Affecting Profitability of Brokerage and Underwriting

Some observers argue that the securities market infrastructure has become less hospitable for small cap private companies interested in a public offering. These IPO infrastructure-related impediments include (1) lower trading fees for mainline securities firms that stemmed from the rise of online discount brokerage firms; (2) the SEC's order-handling rules;[116] and (3) the decimalization of traded securities (wherein stocks that were historically incrementally priced in fractions were subsequently priced in cents, thereby reducing broker's bid-ask spreads, and thus brokers' profits from market-making for IPO shares). Cumulatively, these developments are said to have helped to reduce securities firms' profits. As a consequence, the viability of a business model that enabled them to provide research on, and do underwriting for, small business was reportedly undermined, resulting in a marked decline in securities firms' interest in both underwriting small businesses interested in going public and providing research coverage to those that have gone public.[117]

The SEC's order-handling rules have been blamed for making the securities markets less hospitable for small IPOs. The rules were adopted by the SEC in 1997. When market markers do not immediately execute a customer limit order (an order to buy or sell a stock price within certain price parameters), they are required to display the order to the entire marketplace when the

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[113] For more on the DPO process, please see Dale A. Oesterle, "The High Cost of IPOs Depresses Venture Capital in the U.S.," *Entrepreneurial Business Law Journal*, vol. 1:2, (2006), p. 375.

[114] William K. Sjostrom, Jr., Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?, 53 FLA. L. REV. 529, 581 (2001). Sjostrom found that of the 2,000 DPOs of companies from 1990 to 2001, only 156 still publicly trade.

[115] Dale A. Oesterle, "The High Cost of IPOs Depresses Venture Capital in the U.S.," *Entrepreneurial Business Law Journal*, vol. 1:2, (2006), p. 375.

[116] These rules were adopted by the SEC in 1997 and require a market maker who receives a customer limit order (an order to buy or sell a stock price within certain price parameters) for better than the best buy or sell price that is currently being offered, and who does not immediately execute the order, to display the order to the entire marketplace. Alternatively, the market maker can choose to send the order to another market maker or an electronic communication network (ECN, an alternative all-electronic stock exchange).

[117] David Weild and Edward Kim, "Market Structure is Causing the IPO Crisis—and More," *Grant Thornton*, June 2010, available at http://www.gt.com/staticfiles//GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf. According to officials at the National Venture Capital Association, a venture capital trade group, $100 million in annual revenue has become a de facto minimum revenue threshold for an IPO. As a consequence, the official said that "VCs have to invest longer and spend more time on companies that are later stage, so they have less time and money to put in companies that are earlier stage." Alix Stuart, "Is Going Public Going Out of Style?" Still, SEC chairman Schapiro has observed that during 2010, almost half of SEC-registered offerings undertaken by first-time corporate registrants were for less than $10 million in value. "Letter from SEC Chairman Mary Schapiro to the Honorable Darrell E. Issa, Chairman House Committee on Oversight and Government Reform," available at http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

order is for better than the best buy or sell price that is currently being offered. Alternatively, the market maker can choose to send the order to another market maker or an electronic communication network (ECN), an alternative all-electronic stock exchange. Taken together, these developments are said to have helped to reduce securities firms' profits.[118]

Another regulatory change that has been blamed for raising underwriting costs—but has at the same time been praised for reducing conflicts of interest detrimental to investors—is what is known as "The Global Research Settlement." This was an enforcement agreement reached in April 2003 between various states; various financial regulators, including the SEC and the New York Stock Exchange; and 10 of the nation's largest investment firms, including Bear Stearns, Credit Suisse, Deutsche Bank, Goldman Sachs, and J.P. Morgan Chase, to address issues of conflict of interest involving improper influence on their research analysts by their investment bankers involved in underwriting IPOs.

A major part of the 2003 Global Research Settlement was an agreement by the firms to ensure that there were proper firewalls between the firm's analysts and investment bankers. Key aspects of the settlement have been incorporated into the business models of other securities firms who were not part of the settlement. Many observers say that the aforementioned withdrawal of analyst coverage for small public companies was exacerbated by the Global settlement's analyst-investment banker firewall reform.[119] As a consequence, the viability of a business model that enabled underwriters to provide research on, and do underwriting for, small businesses was reportedly undermined, resulting in a marked decline in securities firms' interest in both underwriting small businesses interested in going public and providing research coverage to those that have gone public.[120]

Some observers, such as Professor Jay Ritter of the University of Florida, however, have questioned whether the Global Settlement has actually played a significant role in inhibiting the growth of small IPOs.[121] Ritter et al concluded they found little change in analyst coverage of companies post-IPOs around the April 2003 Global Settlement.[122]

Decline in Small-Firm Profitability

Some have suggested that there are shortcomings to using annual IPO number counts as a proxy for the overall health of the nation's emerging growth companies. In a study, Professor Jay Ritter and his co-authors argue that the nation's IPO market has gone through a structural change

118 David Weild and Edward Kim, "Market Structure is Causing the IPO Crisis—and More," *Grant Thornton*, June 2010.

119 For example, see "Prepared Statement of Kate Mitchell, Former President of the National Venture Capital Association before the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises Hearing on Reopening American Capital Markets to Emerging Growth Companies Act of 2011," December 15, 2011.

120 David Weild and Edward Kim, "Market Structure is Causing the IPO Crisis—and More," *Grant Thornton*, June 2010, available at http://www.gt.com/staticfiles//GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf.

121 Jay R. Ritter, Xiaohui Gao and Zhongyan Zhu, "Where Have All the IPOs Gone?," November 4, 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954788&download=yes.

122 Ibid., p. 18.

significantly driven by shifts in the economy that have eroded the profitability of small companies, both public and private.[123]

In response to this structural change, which the authors observed between 1980 and 2000, Ritter and his co-authors emphasized that small firms have increasingly been acquired by larger firms rather than going public because in many industries a small firm has greater value and higher earnings as part of a larger enterprise than as a free standing public or private firm.[124]

The authors concluded that these corporate strategies, which are said to derive from larger structural shifts, are significantly responsible for a large part of the decline in the nation's IPOs. As such, they say that "regulatory reforms aimed at restoring the IPO ecosystem"—arguably the focus of several capital market bills before Congress—"will have only a modest ability to affect IPO volume … [and] IPO volume is unlikely to achieve the number of deals routinely reached in much of the 1980s and 1990s."[125]

Conclusion

Evidence indicates a marked decline in U.S. IPOs over the past decade, particularly for smaller firms. This has raised concerns among policymakers over the economic implications of such a decline, particularly for job creation in the United States. Although studies show that younger firms (i.e., startups) are particularly important for job creation, most have not addressed the question of whether the form of growth financing for young firms—for example, through acquisition, or through IPOs—is a factor in creating jobs. In addition, although statistics show a decline in IPOs, the number and proceeds from private stock offerings, particularly under Regulation D, have risen.

The implications for the economy and for job creation of a rise in private offerings concurrently with a fall in IPOs are less clear. On one hand, the stock of public companies is believed to benefit from a "liquidity premium," implying better share pricing and greater ease of capital-raising. A company's debt-to-equity ratio often declines after an IPO, meaning it may be able to obtain more favorable terms for loans. Also, some research indicates that going public can help a company attract new human capital and make potentially advantageous corporate acquisitions. However, others note the added pressure on public companies to produce short-term earnings results potentially at the expense of long-term growth. Some research has also suggested that public companies tend to select less novel research projects.

As discussed earlier, one aim of the JOBS Act was to make it easier for companies to conduct both public and private share offerings, by relaxing certain requirements for IPOs and for private offerings sold only to accredited investors. A concern of some when easing such requirements is maintaining adequate investor protections. The executive branch agency charged with overseeing and ensuring investor protections is the SEC, and the chair of the SEC, as well as an SEC

[123] Jay R. Ritter, Xiaohui Gao and Zhongyan Zhu, "Where Have All the IPOs Gone?" November 4, 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954788&download=yes.

[124] Ibid.

[125] Ibid.

commissioner separately, have voiced such concerns regarding the level of investor protections from such changes required by the JOBS Act.[126]

[126] For example, see "U.S. Securities and Exchange Commission Letter from Chair Mary Schapiro to Senate Banking Committee Chairman Tim Johnson and Ranking Member Richard Shelby," March 13, 2012, available at http://www.cq.com/file/govdoc-4046512/Letter%20to%20Sen.%20Johnson%20From%20the%20SEC%20Regarding%20Concerns%20About%20the%20Jumpstart%20Our%20Business%20Startups%20Act.pdf.

Appendix. Disclosure Under the 1933 and 1934 Federal Securities Laws

This section describes key aspects of the federal securities registration and disclosure requirements in the Securities Act of 1933[127] and the Securities Exchange Act of 1934.[128]

The Securities Act of 1933 makes it illegal to offer or sell securities[129] to the public unless they have been registered with the SEC.[130] Registration covers only the securities actually being offered and only for the purposes of the offering in the registration statement. The registration consists of two basic parts: (1) the prospectus, which must be provided to every purchaser of the securities, and (2) supplemental information, which contains information and exhibits that do not have to be provided to purchasers but are available for inspection by the public at the SEC. Section 7 of the 1933 act,[131] referring to Schedule A,[132] sets forth the information that must be contained in the registration statement. The schedule requires a great deal of information, such as the underwriters, the specific type of business, significant shareholders, debt and assets of the company, and opinions as to the legality of the issue. Section 10(a) of the 1933 act specifies the information that the prospectus must contain.[133] There are also numerous regulations issued by the SEC that provide further details about the registration process under the 1933 act.[134]

Certain transactions and securities are exempted from the registration process. The exempted transactions include private placements, intrastate offerings, and small offerings.[135] The Commission may, by rules and regulations, exempt any class of securities if it finds that such an exemption is in the public interest and the issue of securities does not exceed $5 million.[136] Among other exempted securities are government securities and short-term commercial paper, securities for which it is believed that other, adequate means of government regulation exist.[137]

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[127] 15 U.S.C. §§77a *et seq*.

[128] 15 U.S.C. §§78a *et seq*.

[129] The term *security* is defined very broadly in 15 U.S.C. §77b(1) as,

> any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

[130] 15 U.S.C. §77e.

[131] 15 U.S.C. §77g.

[132] 15 U.S.C. §77aa.

[133] 15 U.S.C. §77j(a).

[134] See, e.g., 17 C.F.R. Parts 230, 231, and 239.

[135] 15 U.S.C. §77d.

[136] 15 U.S.C. §77c(b). See also SEC Regulation A at 17 C.F.R. §§230.251 *et seq*.

[137] 15 U.S.C. §77c.

The Securities Exchange Act of 1934 is concerned with many different areas, one of which is the ongoing process of disclosure to the investing public through the filing of periodic and updated reports with the SEC.[138] Any issuer that has a class of securities traded on a national securities exchange or has total assets exceeding $1 million and a class of equity securities with at least 500 or 750 shareholders, depending upon certain factors, must register under the 1934 act with the Commission.[139] Every issuer required to register under the 1934 act must file periodic and other reports with the SEC.[140] Section 12[141] requires the filing of a detailed statement about the company when the company first registers under the 1934 act. Section 13[142] requires a registered company to file annual and quarterly reports with the SEC. These reports must contain essentially all material information, financial and otherwise, about the company that the investing public might need in making a decision about whether to invest in the company. The SEC has issued extensive regulations to specify information that these required reports must provide.[143]

Some exemptions from these reporting requirements are provided.[144] Exemptions include securities of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for profit; securities issued by a mutual or cooperative organization supplying a commodity or service primarily for the benefit of its members and operating as a nonprofit; and securities issued by a registered investment company.

Failure to disclose material information is actionable. For example, Section 18(a) of the Securities Exchange Act[145] grants an express private right of action to investors who have been injured by reliance upon material misstatements or omissions of facts in reports that have been filed with the SEC. Section 10(b) of the 1934 act,[146] the general antifraud provision, and Rule 10b-5,[147] issued by the SEC to carry out the statutory fraud prohibition, provide for a cause of action for injuries that have been caused by omissions, misrepresentations, or manipulations of material facts in statements other than those filed in documents with the SEC.

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[138] 15 U.S.C. §78m.

[139] 15 U.S.C. §78*l*. As stated earlier, the 1933 Act requires the registration of a particular *offering* of securities. The 1934 Act requires the registration of a *class* of securities.

[140] 15 U.S.C. §§78*l*, 78m, and 78n.

[141] 15 U.S.C. §78*l*.

[142] 15 U.S.C. §78m.

[143] See, e.g., 17 C.F.R. Parts 240, 241, and 249.

[144] 15 U.S.C. §78*l*.

[145] 15 U.S.C. §78r(a).

[146] 15 U.S.C. §78j(b).

[147] 17 C.F.R. §240.10b-5.