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The JOBS Act and the Return of the Microcaps

The Many Charms of the Emerging Growth Company. Part Two of a Two-Part Article

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Congress passed the Jumpstart Our Business Startups Act of 2012 (the JOBS Act) to encourage startup businesses and initial public offerings (IPOs) so as to spur job creation. In Part One of this article, I explored the JOBS Act's two new ways to raise capital — crowdfunding and the Small Issues Exemption. Here, I look at the JOBS Act provisions aimed at making it easier for small companies to go public.

Background

A company is "public" if it must file the periodic reports specified by the Securities Exchange Act of 1934 (the Exchange Act). That typically happens when a company first registers a sale of its securities — goes "public" or makes its IPO — under the Securities Act of 1933 (the Securities Act). The Securities Act requires all sales of securities to be registered (§ 5), unless the securities themselves are exempt (§ 3), or they are sold in a transaction that is exempt (§ 4). The JOBS Act, as we saw, created one new securities exemption (the Small Issues Exemption) and one new transactional exemption (crowdfunding).

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In addition, a private company historically became a "statutory public company" when it acquired 500 shareholders, triggering reporting obligations under the Exchange Act like those of other public companies. However, many companies have more than 500 beneficial shareholders, but they legally hold their interests through only a few venture funds. Other companies, like Facebook Inc., have more than 500 shareholders just among their own employees. The 500-shareholder threshold is an anachronism.

The JOBS Act and the Emerging Growth Company

The JOBS Act helps modernize the statutory public company concept. Now, an issuer must have at least $10 million in assets and 2,000 shareholders, or, unless it is a bank, 500 non-accredited shareholders. However, holders of exempted securities (like those issued under the Small Issues Exemption) don't count. JOBS Act § 501; Exchange Act § 12(g)(1)(a). Neither, generally, do holders of crowdfunded securities (although the SEC may impose conditions). JOBS Act

§ 303(a); Exchange Act § 12(g)(6). And neither do employees. JOBS Act

§ 502; Exchange Act § 12(g)(5). Therefore, so long as a company sticks to raising capital through crowdfunding and the Small Issues Exemption, it may be able to avoid Exchange Act reporting requirements however many shareholders it has.

Still, the fastest growing companies will inevitably need more capital than crowdfunding and the Small Issues Exemption will permit, and will need a true IPO. For them, the JOBS Act creates a new category of issuer: The Emerging Growth Company (EGC), taken wholesale directly from the IPO Task Force Report. Any issuer of securities with less than $1 billion in annual gross revenues is an EGC until: 1) five years after its IPO; or 2) it issues more than $1 billion in non-convertible debt in any three-year period; or 3) it becomes a "large accelerated filer" under SEC Rule 12b-2 by achieving a public float larger than $700 million. JOBS Act § 101(a); Securities Act § 2(a)(19).

To see how small an EGC actually is, consider the work six years ago by the SEC Advisory Committee on Small Public Companies. That Committee looked at the market values of the bottom 6% of all listed public companies and determined the cutoff to be $785 million. The relationship of market value to revenues is a common stock valuation metric — the price-to-sales ratio (P/S Ratio). P/S Ratios vary significantly depending on how leveraged a company is, and range from 0.5 to over 5, but the average across the economy is about 1.2. Using that average ratio, companies with $1 billion in revenue or less would on average have a market valuation of $1.2

billion or less. The upper size limit for an EGC, therefore, is more likely to be the $700 million public float of a large accelerated filer, which corresponds roughly to the Advisory Committee's $785 million market value threshold for small public companies. EGCs should be expected to populate the bottom 5% or 6% of listed public companies. But as the SEC Advisory Committee also found, those small companies at the bottom of the market-value pyramid account for 85% of all publicly trading companies. Virtually all small private companies will qualify to be EGCs, and most would remain so until five years after their IPOs. It is in the anticipation and aftermath of an IPO that being an EGC really matters.

Advantages of the JOBS Act

The JOBS Act gives EGCs a number of advantages over other reporting companies. Probably the most tangible benefit are waivers that the JOBS Act grants EGCs from some of the more onerous reporting requirements imposed on public companies by the Sarbanes-Oxley Act of 2002 (SOX) and the Investor Protection and Securities Reform Act of 2010 (Title IX of the Dodd-Frank Act) (Dodd-Frank).

EGCs need only file two years of audited financials in registration and periodic filings, rather than the usual three years. EGCs do not need to file any of the selected financial information required by existing SEC rules for any prior period, and they need not comply with any new or revised financial accounting standards under SOX until those standards are made applicable, if they ever are, to private companies. JOBS Act § 102(b); Securities Act § 7(a)(2); Exchange Act

§ 13(a)(2). Likewise, EGCs are exempt from SOX's internal auditing control certification requirements, as well as its requirement to rotate auditors periodically. JOBS Act §§ 103-104; SOX §§ 404, 103. And EGCs need not comply with the enhanced executive compensation disclosure requirements recently imposed on public companies, like the shareholder vote on executive pay (or "say on pay") rules, and the comparisons of executive compensation to performance and to average rank-and-file pay. JOBS Act § 102(a)(1)-(3); Exchange Act §§ 14A(e)(2), 14(i); Dodd-Frank § 953(b)(1).

EGCs are also protected against the risks of premature public disclosures in the IPO process. In general, a company looking to go public must file its registration statement and prospectus with the Commission on a preliminary basis as a "red herring." Those disclosure documents are not effective until the SEC staff reviews them and any deficiencies are met, but they are still publicly available. If for any reason the IPO does not go forward or is unexpectedly delayed (not a rare occurrence in recent years), the prospective issuer has commercially disadvantaged itself by exposing its internal operations and finances to its still private competitors. The JOBS Act alleviates this risk by permitting EGCs to file preliminary registration statements and prospectuses with the Commission on a confidential basis, and by shielding the Commission from disclosing confidentially filed statements under, for example, the Freedom of Information Act. JOBS Act § 106(a); Securities Act § 6(e). As congressional witnesses noted, this puts EGCs on a par with foreign issuers, who already get confidential review of proposed registration statements.

Other Companies

By definition, EGCs are both small and young, but even large and old companies may find the new entity useful. One quite obvious way a large public corporation might use the EGC is in spinning off subsidiaries or divisions. So long as the spin-off is not required to report on a consolidated basis with its parent, nothing in the JOBS Act prevents it from taking full advantage of being an EGC. Large corporations may also benefit indirectly by partnering with or investing in EGCs. Many large technology and pharmaceutical companies today support start-ups. Indeed, research and development have practically been outsourced to start-ups in many high technology industries. Deal lawyers and investment bankers will no doubt envision the possibilities, but one can well imagine a large enterprise having economic interests in a constellation of EGCs, benefiting indirectly from the advantaged status of its EGC dependants.

Thus, the JOBS Act seeks to alleviate the oft-heard complaint that it is just too expensive for a small company to go public. However, the creation of vibrant public markets for EGC shares is an even more essential goal of the JOBS Act, for the "IPO on-ramp" may lead nowhere without them. It is obvious that if there were strong markets for small and microcap shares, there would be more small companies going public. The absence of vibrant markets for EGC shares limits the liquidity opportunities for pre-IPO investors, and thereby inevitably limits the number of such investors. Resurrecting the small and microcap stock markets should be a key component of any strategy to nurture small growth companies.

Analysis and Investment

While the IPO Task Force identified programmed, high-velocity algorithmic trading as an important reason why microcap markets dried up, it and congressional witnesses also pointed to recent rule changes that reduced the availability of research and the size of the "tick" for small IPOs.

Analysis and investment banking are symbiotic: Investment bankers need analysts to help sell the deal and to maintain investor interest in aftermarkets, and analysts need investment banking profits to be compensated for their work. However, just as obviously, this presents a conflict of interests: Research that purports to be impartial is all too likely to be biased in favor of the companies that the investment bankers are trying to sell. New rules sought to minimize those conflicts, but those rules have hit those firms that catered to small

IPOs disproportionate, because in those firms investment banking and analysis were so interdependent that the one could not survive without the other.

The JOBS Act loosens some of the restrictions on analysts covering EGCs. It allows those analysts to participate freely with other brokers or investment bankers in communicating with issuers and investors. JOBS Act § 105(b)(2); Exchange Act

§ 15D(c). In addition, research reports on EGCs will not be deemed an offer to sell their securities, even if published in advance of an IPO and even if the publishing broker-dealer will be participating in the IPO. JOBS Act § 105(a); Securities Act § 2(a)(3). Similarly, EGCs themselves will be able to communicate directly with qualified institutional buyers and accredited institutions to gauge their interest in a prospective securities offering. JOBS Act § 105(c)(2); Securities Act § 5(d). In the same vein of liberalizing the ability of small companies to communicate with sophisticated investors, even private placements under Rule 506 can now be marketed by general advertising and solicitation without being deemed public offerings. JOBS Act § 201(b)(2); Securities Act § 4(a)(b).

Still, this begs the question whether it is even possible for broker-dealers to make a profit dealing in small and microcap stocks. The IPO Task Force suggested not, and identified "decimalization" as a culprit. Until 2001, the minimum increment between quoted share prices — the "tick" — was 1/8 of a dollar (12.5 cents), or 1/16 or 1/32 for very low price shares (i.e., no less than 3.125 cents). In 2001, the SEC reduced the minimum tick size for all trades to one cent, known as decimalization. The reduced tick size meant that market-makers who could once count on a profit of at least 3.125 cents per share on trades now risked being bid down to as low as a penny. As a result, market-making in small and microcap stocks has virtually disappeared as largely unprofitable. If most new jobs are created in the wake of an IPO, and if IPOs depend on the existence of stable markets, it seems axiomatic that the JOBS Act's jobs-creation project fails if broker-dealers cannot be profitable in making those markets.

Reacting to this, Congress required the SEC to study and report back the impact of decimalization on the number of IPOs, the liquidity for small and microcap stocks, and "whether there is sufficient economic incentive to support trading operations in these securities in penny increments." The JOBS Act gave the SEC authority to increase minimum tick sizes for EGCs up to 10 cents revive the small and microcap stock markets. JOBS Act § 106(b); Exchange Act § 11A(c)(6). But the SEC did not take the hint. In its July 2012 report to Congress, the SEC concluded that smaller tick sizes do not hurt markets, and declined to increase minimum tick sizes for EGCs.

Now it is quite obvious that higher minimum tick sizes will increase market-maker profits — but it will do so at the expense of investors who will inevitably pay higher prices, and that is the SEC's real problem. The SEC is apparently unwilling to compromise investor price optimality for the sake of broker profits, even if, as two commenters quite reasonably told the SEC, "Increases in tick sizes ... would do more for ... job growth than the all other provisions of The JOBS Act, combined." James Fehrenbach, Managing Director and Bradford Pleimann, Managing Director, Piper Jaffray & Co., Letter to Co-Chairs of the SEC Advisory Committee on Small and Emerging Companies (June 8, 2012), available at www.sec.gov/comments/265-27/26527-29.pdf. The resurrection of the small and microcap stock markets is such a key element to the JOBS Act's success that the SEC must inevitably reconsider its position on minimum tick sizes for EGCs.

Conclusion

This entire discussion should give those of us who remember the microcap markets of the 1990s cause to reminisce. Do you remember boiler rooms, pump-and-dump schemes, and projected earnings based on "eyeballs" and other exotic metrics? Don't those now seem quaint next to such industrial-scale scams as the national mortgage debacle, Madoff-sized ponzi schemes, and fixing the LIBOR rate? Alas, one can't help feeling a bit nostalgic. Perhaps things weren't as bad then as we thought.

I return, then, to what I said six years ago: Small companies should be largely left alone even while large companies are more stringently regulated. Unlike large companies, which as repositories of national wealth should be managed conservatively to avoid systemic risks, small companies and those brave enough to invest in them should be free to risk all they dare. See Aegis J. Frumento, The Rich Are Different, The Corporate Compliance and Regulatory Newsletter (May 2006), available at www.lawjournalnewsletters.com/issues/ljn_corporate/3_9/news/146512-1.html. Risk-taking leads to growth which leads to jobs — that is the underlying premise of the JOBS Act. Yet we should not delude ourselves: Risk-taking and growth always create opportunities for fraud. But we shouldn't overreact either. We should punish fraud severely when we uncover it, deterring it by making it the riskiest of behaviors. However, we should not attempt to prevent fraud by over-regulating the internal affairs of small companies, because that will stifle the underlying risk-taking behaviors that ultimately drives our economic engine and creates our jobs. Seen in that light, the JOBS Act is a positive step toward treating small companies the way they should be.

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