JOBS Act Would Ease Sarbox Standard, but Might Pave Way for Fraud

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March 26, 2012

Proponents of the Jumpstart Our Business Startups Act argue the law could be a game-changer for smaller companies by relaxing disclosure requirements and making it easier for them to go public and attract financing. But critics warn the act could grind investment activity to a halt.

The JOBS Act enjoys rare bipartisan support in the nation’s bitterly gridlocked capital, with the Senate passing it by an overwhelming margin last week before sending it back to the House for a vote. Experts say the law would provide a critical lift to newly public and fledgling companies in a number of ways if President Barack Obama signs it into law in its current form.

For starters, it would make it easier for new companies to attract seed capital by legalizing crowdfunding, a capital-raising strategy in which investors buy stakes in closely held companies over the Internet. This is where the law could potentially make its biggest impact, according to Chris Sloan, co-chair of the emerging companies team at law firm Baker, Donelson, Bearman, Caldwell & Berkowitz.

“It will allow more companies to essentially get launched that might not have ever been able to find that first $100,000 or $200,000 they need to build a prototype and launch it,” says Sloan. “The first money in is often the hardest money for a company to find, and sometimes really is the difference between a company getting off the ground or not.”

The law would also roll back one of the most contentious elements of Sarbanes-Oxley for companies that decide to make initial public offerings. For the first five years after an IPO, the JOBS Act exempts companies with up to $1 billion in revenues from Section 404(b) of Sarbanes-Oxley. (Sarbox 404(b) requires each registered public accounting firm that prepares an audit report for a company to attest to and report on the assessment of internal controls over a company’s financials made by the company’s CFO and chief executive officer.)

That would ease a big operational headache for CFOs at newly public companies, according to Harvard law professor John Coates. It could allow these emerging firms to save the hundreds of thousands of dollars they otherwise would have collectively been forced to spend on outside auditors to perform internal-controls attestations of management assessments.

“That’s a rollback of Sarbanes-Oxley for those companies for a limited amount of time, which is probably not a terrible idea, considering they ought to be focused on growing the business post-IPO,” says Coates. “The rest of the bill doesn’t have anything to do with Sarbanes-Oxley, but it is, however, a big change to existing securities law.”

And therein lies one the biggest problems for the JOBS Act’s detractors. Although one of the bill’s most publicized elements is the way in which it makes it easier for companies to go public, it also enables firms to wriggle past the Securities and Exchange Commission’s disclosure rules.
Under existing U.S. securities laws, companies with more than 500 shareholders and up to $10 million in assets are forced to register with the SEC. But under the JOBS Act, a company could have 2,000 shareholders before having to register. Coates suggests the extra wiggle room companies have in deciding whether or not to register with the SEC might keep would-be investors on the sidelines.

“There are a lot of companies who think having a cop to oversee their disclosures helps them because it means their investors can trust what they’re being told,” Coates explains. “Part of the reason capital costs are as low as they are in the U.S. is because most companies that want to raise a lot of money think it’s in general a pretty good way to do it. Unfortunately, if you make it easier to get around U.S. securities law, then it’s not just going to be honest companies that the law applies to.”

One of the bill’s most controversial elements is a rule that enables banks to circumvent the pre-IPO quiet period before a company goes public. Under the JOBS Act, a bank’s analyst could publish a research report about a company shortly before its IPO, which critics say opens the door to market manipulation.

“These rules are designed to protect investors from potential conflicts of interest,” SEC commissioner Luis Aguilar said in a statement. “The research scandals of the dot-com era and the collapse of the dot-com bubble buried the IPO market for years. Investors won’t return to the IPO market if they don’t believe they can trust it.”

Coates contends that while it makes sense to let companies go public more cost-effectively, the JOBS Act’s relaxed accounting standards will undoubtedly open the door to scandalous behavior.

“It’s not just a possibility; I guarantee that someone will in fact do worse than Enron as a result of this bill,” Coates predicts. “There will just be outright fraud.”