Consumer Federation of America

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As Senate Begins Consideration of Jobs Package, CFA Urges Pro-Investor, Pro-Market Changes to the Legislation

The U.S. Senate is reportedly poised to begin consideration of companion legislation to the House-passed JOBS Act (H.R. 3606). The House bill's many provisions to weaken important investor protections, undermine market transparency, and erode market integrity have provoked opposition from a broad range of groups and individuals, including current and former securities regulators, consumer and investor groups, unions, legal experts, academics, and even some industry participants. (For a partial list of groups that have spoken out against the JOBS Act, including links to their letters and testimony, click here.) Opponents of the House bill are looking to the Senate to adopt a more thoughtful and balanced approach. Senators who care about investor protection should insist that the following changes are adopted in any final Senate capital formation legislation.

Regulation A Reform

Regulation A is intended to allow issuers to raise small amounts of money (currently up to $5 million) from the public under a simplified, streamlined process. Both the House JOBS Act and Senate companion legislation, S. 1544, would dramatically increase the ceiling for Regulation A offerings to $50 million. The Senate bill includes additional investor protections absent from the House bill, including requirements for up-front disclosure, periodic reporting, audited financial statements, Securities and Exchange Commission (SEC) oversight, and a negligence-based litigation remedy. These provisions, which seek to balance increased access to capital with appropriate investor protections, must be retained in any final bill. Even with these features, however, the Senate bill has several serious short-comings. To be minimally acceptable, the following changes must be adopted: [1]

- There appears to be a serious drafting error in S. 1455 which, if uncorrected, could allow companies to raise an unlimited amount of funds using the Regulation A exemption as long as they hadn't raised more than $50 million the previous year. This must be fixed.
- The bill would permit companies to go back year after year and raise money using the Regulation A exemption. At $50 million a time, this would allow companies to raise potentially very large sums of money from the public while evading appropriate

[1] These and other suggested amendments are based on the assumption that the Senate will use bills that have been introduced in the Senate as the base text, in this case S. 1544.

regulatory requirements and avoiding full disclosure. To fix this problem, the bill should limit companies to using Reg A no more than once every three years.

- The mechanism in the bill designed to increase the Reg A ceiling every two years should be eliminated. Instead, the SEC should be authorized to raise the ceiling based on a finding that doing so would be in the public interest and consistent with the protection of investors.

Crowd-funding

The crowd-funding provision in the House bill offers a broad and dangerous regulatory exemption for small offerings conducted over the Internet. Because of the potential for crowd-funding to be exploited by con artists, securities law expert Columbia University Law School Professor John Coffee has dubbed this the "Boiler Room Legalization Act." Fortunately, a far more investor-friendly bill, S. 1970, has been introduced in the Senate. In order to ensure that crowd-funding does not become a mecca for fraud, it should serve as the basis for the final package. For this legislation to be minimally acceptable, the legislation must:

- Include robust regulatory requirements for crowd-funding portals.
- Require appropriate disclosures to investors, including risk disclosures.
- Protect investors from having their rights and the value of their investments diluted by future capital raising initiatives.
- Preserve the authority of states to oversee and police the market, since the SEC is unlikely to have the time or resources to provide the necessary level of oversight for such small and risky offerings.

IPO On-Ramp

A centerpiece of the House JOBS Act is a measure designed to encourage companies to go public by giving them more time to come into compliance with a number of financial reporting and corporate governance requirements. Like its counterpart in the Senate (S. 1933), the JOBS Act would provide these exemptions to all but a handful of the very biggest IPOs, companies with over $1 billion in annual gross revenues or $700 million in market cap. As a result, it affects many companies that would have gone public without the legislation, leaving them subject to weaker investor protections without any benefit in jobs growth. At the same time, less seasoned companies would be encouraged to go public before they are prepared to meet the responsibilities of being a public company. Assuming investors behave rationally, these companies would likely face an increased cost of capital reflecting their higher risks that more than makes up for any reduction in compliance costs. To be even minimally acceptable, the legislation should be amended as follows:

- The definition of "emerging company" should be fixed so that the bill's regulatory exemptions would extend only to those companies that truly fit the small company profile the legislation purports to benefit. This would require significant reductions in both the revenue and market cap prongs of the definition – to $100 or $200 million at the most.

- There should be no exemption from say-on-pay and golden parachute shareholder vote requirements or from executive compensation disclosure requirements, since these clearly do not create a barrier to capital formation.

- The provisions exempting emerging companies from new accounting and auditing standards should also be removed. Having companies issue their financial reports based on different accounting standards, depending on whether the company is an emerging or established company, is particularly problematic since it would undermine market transparency and place an inappropriate burden on investors. Requiring auditors to conduct their audits under different standards would unnecessarily increase the complexity of the audit process.

- Remove provisions relaxing restrictions on analyst research. Lifting these restrictions threatens to reignite abuses that fueled the tech stock bubble and bust.

- Require disclosure to investors that the company is an "emerging growth" company subject to weaker investor protections, and provide companies with the ability to opt out of the designation and comply with higher level of investor protections.

Regulation D Revisions

Without any evidence of a problem that needs solving, the House JOBS Act would eliminate the ban on public solicitation in private offerings under Regulation D. An estimated $900 million was raised through Reg D offerings in 2010 alone, and more than 37,000 such offerings were reported to the SEC in 2009 and 2010 with a median value of $1 million. At the same time, state securities regulators have documented a troubling rise in fraud in this market since state oversight authority was preempted in the mid-1990s. Removing the ban on general solicitation would not only make a mockery of the concept of a private offering on which the Reg D exemption is based, it would also create an opportunity for fraud on a mass scale. It is for these reasons that the House bill's Reg D provisions, and its Senate companion (S. 1831), have been opposed by both the North American Securities Administrators Association and AARP, among many others. To be minimally acceptable:

- The final bill must retain the ban on public solicitations in private offerings.

Shareholder Threshold

The JOBS Act would dramatically expand the number of shareholders a company could have without having to register with the SEC and provide the periodic disclosures on which market transparency depends. It and Senate companion legislation (S. 1824) would thus undermine both the efficient functioning of the markets and the broader JOBS Act goal of encouraging companies to go public. To be minimally acceptable:

- The final bill should not raise the number of shareholders a company can have before being required to register with the SEC and begin periodic reporting.