White Paper

April 2012

The JOBS Act: Shifting into Gear and Accelerating Up the IPO On-Ramp

Executive Summary

On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups Act (JOBS Act), a comprehensive new law designed to make it easier for small businesses and emerging growth companies—the real growth engines of the U.S. economy—to raise capital and complete the initial public offering (IPO) process.

The stock market is, by its very nature, a risky place, and with or without Sarbanes-Oxley or the JOBS Act, it always has been and always will be. Those willing to take the risks have the opportunity to reap the rewards. Government regulation cannot guarantee equality of outcome, that everyone will profit and that no one will lose. We believe the JOBS Act will appropriately reduce and/or eliminate many of the impediments to public capital formation that were introduced over the past decade.

The purpose of this paper is to: (i) provide an overview and analysis of key provisions in the JOBS Act and explain why it is a positive development for the small company IPO market and emerging growth companies seeking to go public; and (ii) examine how the new law addresses the main ideas proposed in previous research about fixing the broken IPO market, where it falls short, and to highlight some of the key remaining market structure issues that still need to be resolved.

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Executive Summary

On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups Act (JOBS Act), a comprehensive new law designed to make it easier for small businesses and emerging growth companies—the real growth engines of the U.S. economy—to raise capital and complete the initial public offering (IPO) process. Members of Congress on both sides of the aisle, as well as the President, say the law is intended to help small businesses spur job creation, innovation and economic growth.

Among its key provisions, the JOBS Act creates a so-called IPO on-ramp that removes many of the roadblocks to going public that emerging growth companies have faced over the last decade because of a jumble of well-intentioned but ultimately misguided government regulations, including the almost universally loathed Sarbanes-Oxley Act (SOX) of 2002. This conglomeration of rules and regulations—along with the *perceived* cost of complying with them—has brought the market for small issuer IPOs almost to the brink of extinction. As emerging growth company IPO activity dried up in recent years, many researchers, analysts, market participants and academics stepped up their calls for action to fix the problem and offered a variety of recommendations on ways to help move emerging growth company IPOs off the endangered species list.

The JOBS Act accomplishes 80%-90% of what many participants in the IPO ecosystem (including Keating Investments) have been clamoring for. According to a report in *The New York Times*, the law firm of Davis & Polk, one of the largest in New York working with Wall Street investment banks, wrote in a note to its clients that the JOBS Act is "the most significant legislative loosening in memory of restrictions around the IPO process and public company reporting obligations."[1]

Supporters say the new law gives a much-needed shot in the arm to entrepreneurs and small companies by making it easier to reach potential investors, thus spurring capital formation and business startups, which will lead to more job creation and greater economic activity. Opponents argue the JOBS Act marks a return to the bad old days of anything goes, wild west capitalism, and strips away investor protections that were put in place specifically to prevent a repeat of the fraud and criminal excess that occurred at companies such as Enron, Tyco and WorldCom, destroyed confidence in the financial markets, and gave rise to the restrictive regulatory and oversight regime of the last decade.

At Keating Investments, we count ourselves among the JOBS Act's ardent supporters. We have long held the position, and advocated publicly, that blindly applying the same rules, regulations, and reporting standards to all public companies, whether they have $10 million or $10 billion in revenue, makes absolutely no sense.

Over the last 10 years, SOX became the poster child for over-regulation. Originally aimed specifically at the 1,000 largest U.S. public companies, the collapse of any one of which due to accounting or reporting fraud posed serious material risk to the entire U.S. financial system and economy, SOX ended up being applied to all U.S. public companies. A company with $150 million of market capitalization was subject to the same reporting and compliance standards as Exxon Mobil, General Electric and Apple. Many in the financial and business communities believe the evidence is overwhelming that the one size fits all SOX approach to regulation is counterproductive to creating jobs, wealth, and economic growth.

Critics of the JOBS Act point to events following Groupon Inc.'s recent IPO as an example of evidence that the new law weakens the very protections required to shield investors. In November 2011, discount coupon website Groupon raised $700 million in gross proceeds, issuing 35 million shares at $20 per share

[1] "Wall Street Examines Fine Print in Bill for Startups," *The New York Times*, DealBook, April 4, 2012.

in the biggest U.S. technology company IPO since Google Inc.'s $1.7 billion offering in 2004.[2] Groupon shares opened on the Nasdaq at $28 and briefly touched $30 on their first day of trading.[3] Fast forward to March 30, 2012, when Groupon restated its previously reported first quarter results to reflect $14.3 million of less revenue and an additional loss of $22.6 million, on top of the originally reported loss of $37 million.[4] Groupon and its auditor, Ernst & Young, cited a "material weakness" in the company's internal accounting controls that led to the company failing to set aside enough money to cover customer refunds. As of April 26, 2012, Groupon shares were trading around $12 and investors were forming up to file a class action lawsuit against the company, alleging that Groupon had violated federal securities law by issuing "false and misleading statements" prior to its IPO.[5]

We believe that trying to portray what happened with Groupon, as well as with many other so-called "flame out" IPOs, as proof that the JOBS Act weakens necessary government regulations is not only misguided, but it misses an obvious point. Putting aside the fact that everything that went wrong with Groupon occurred while SOX and the rest of the regulatory muddle were in place, the simple truth is that no amount of government regulation will ever make investing in stocks risk free. Many analysts, financial journalists and other stock market commentators believed Groupon was overpriced, that its business model did not support such a rich valuation and tried to warn investors. Prior to its IPO, one Morningstar analyst placed Groupon's fair value at closer to $8 per share.[6] Those who chose to ignore the warnings or believe other points of view have had to deal with the consequences.

The stock market is, by its very nature, a risky place, and with or without SOX or the JOBS Act, it always has been and always will be. Those willing to take the risks have the opportunity to reap the rewards. Government regulation cannot guarantee equality of outcome, that everyone will profit and that no one will lose. We believe the JOBS Act will appropriately reduce and/or eliminate many of the impediments to public capital formation that were introduced over the past decade.

The purpose of this paper is to:

- Provide an overview and analysis of key provisions in the JOBS Act and why it is a positive development for the small company IPO market and emerging growth companies seeking to go public;
- Examine how the new law addresses the main ideas proposed in previous research about fixing the broken IPO market and where it falls short; and
- Discuss ways to fix the market structure and economics of the IPO marketplace for small companies, covering topics such as availability of research and bid-ask spreads on trading in the aftermarket.

The JOBS Act is by no means a cure-all. While it does remove obstacles to capital formation for emerging growth companies, it is now up to market participants—including entrepreneurs, venture capitalists and investment banks—to immediately seize the opportunity, enter the newly built on-ramp, and accelerate down the road to a healthy, vibrant IPO market.

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[2] "Groupon's IPO Biggest by U.S. Web Company since Google," Reuters, November 4, 2011 (http://www.reuters.com/article/2011/11/04/us-groupon-idUSTRE7A352020111104).
[3] "Groupon IPO is Hot, but its Business Prospects? Not." CNN Money, November 4, 2011 (http://tech.fortune.cnn.com/2011/11/04/groupon-ipo-bubble/).
[4] "Groupon Forced to Revise Results," *The Wall Street Journal*, April 2, 2012.
[5] "Hagens Berman Files Securities Class-Action Lawsuit Against Groupon," news release from law firm of Hagens Berman Sobol Schapiro LLP, April 16, 2012.
[6] "Before Buying Groupon's Deal, Read Our Fine Print," *Morningstar*, October 22, 2011.

JOBS Act Overview

President Obama's signing of the JOBS Act on April 5, 2012, immediately qualified as one of the rarest occurrences in recent memory inside the nation's capital: a truly bipartisan effort that came to fruition—and at lightning speed by Washington standards. Growing out of the work and recommendations of the IPO Task Force,[7] the JOBS Act went from concept to signed legislation in about 180 days.

Equally surprising in the current political environment is that the JOBS Act successfully united six separate legislative proposals (on issues ranging from crowdfunding, increasing the number of shareholders a company must have before it is required to publicly file financial information, and changes to regulations regarding private placements) under one umbrella.

The specific provisions of the JOBS Act had their beginnings in the recommendations of the President's Council on Jobs and Competitiveness, a 27-member group that included U.S. corporate chairmen, CEOs and labor leaders. In its 2011 year-end report to the President, the Council called for "ensur[ing] that entrepreneurs can access financing to scale up their firms through traditional funding methods and new ones."[8]

The House of Representatives took up the challenge when Rep. Stephen Fincher (R-TN) introduced the unified bill on December 8, 2011. Three months later, on March 8, 2012, the House passed the JOBS Act by a vote of 390-23. The Senate then voted 73-26 to pass the bill on March 22, with amendments to provide additional consumer and investor protections on crowdfunding. The revised bill was returned to the House, where it was approved by a 380-41 margin before being sent to the President for his signature.[9] **Figure 1** below provides a detailed breakdown of votes in both the House and Senate.

Figure 1: Congress Votes for the JOBS Act

House

	Yes	No	Did not vote
Democrats	145	41	4
Republicans	235	0	6
Independent	0	0	0
Total	**380**	**41**	**10**

Senate

	Yes	No	Did not vote
Democrats	26	25	0
Republicans	46	0	1
Independent	1	1	0
Total	**73**	**26**	**1**

Source: *Washington Post*, March 27, 2012 and March 22, 2012

[7] The IPO Task Force comprised a cross-section of 18 participants in the emerging growth company IPO ecosystem, including venture capitalists, entrepreneurs, securities attorneys, academics, accountants, investors, and investment bankers, who formed independently after meeting at the U.S. Treasury Department's "Access to Capital" conference in March 2011.
[8] "Road Map to Renewal," p. 59, 2011 year-end report by The President's Council on Jobs and Competitiveness, January 2012.
[9] "House Passes JOBS Act, Sends Bill to Obama," Washington Post, March 27, 2012.

Certain provisions of the JOBS Act are the subjects of much public attention and discussion. For example, the above-mentioned crowdfunding rules allow young businesses and startups to raise up to $1 million annually from many individual, low-dollar investors through online platforms regulated by the Securities and Exchange Commission (SEC). Other provisions expand so-called “mini public offerings” to $50 million from $5 million and raise the SEC public registration threshold for companies with more than $10 million in assets to 2,000 shareholders from 500.

From our perspective, however, the crown jewel of the JOBS Act is the creation of the IPO On-Ramp. Specifically, the law amends the Securities Act of 1933 and the Securities Exchange Act of 1934 to add a new category of issuer, an “emerging growth company,” broadly defined as a company with less than $1 billion of annual gross revenue in the fiscal year prior to its IPO.[10]

A company fails to meet the definition of emerging growth company if it:

- First sold equity in a registered offering on or before December 8, 2011; or
- Has more than $1 billion in gross revenue. [11]

A company ceases being an emerging growth company on:

- The last day of the fiscal year during which it exceeds $1 billion in annual gross revenue;
- The last day of the fiscal year following the fifth anniversary of its IPO date;
- The date on which it has issued more than $1 billion in non-convertible debt during the prior three-year period; or
- The date on which it becomes a “large accelerated filer” (i.e., a public float of $700 million or more).[12]

We recognize the irony here. The same critics of the JOBS Act who say the Groupon IPO and its aftermath are reasons why the new law should not have been enacted fail to note that Groupon would *not* meet the definition of an emerging growth company under the JOBS Act. By virtue of the size of the company at the time of its IPO, Groupon had a public float in excess of $700 million and was therefore considered a large accelerated filer, one of the four tests to determine when a company ceases to be an emerging growth company.

For emerging growth companies that do qualify, the JOBS Act delivers much needed regulatory relief. This relief extends to both the easing of disclosure requirements and auditing and accounting rules that weighed like a millstone around the necks of small companies aspiring to go public.

For example, the JOBS Act amends Section 404 of SOX to exempt emerging growth companies for up to five years from the requirement to include an auditor’s statement attesting to management’s internal controls over financial reporting. Management is still required to provide its own assessment of internal financial controls, but the change is seen as a victory for simpler, less costly reporting.[13]

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[10] To put that number in context, many participants in the market for emerging growth company IPOs, including Keating Investments, were calling for a new issuer category and regulatory relief that would apply to companies with no more than $250 million in revenue.

[11] PricewaterhouseCoopers, “PWC In Brief: An Overview of Financial Reporting Developments,” March 26, 2012. See also, “PwC US IPO Watch Q1 2012: A Buoyant First Quarter Produces Strong IPO Returns, says PwC,” PwC News Release, April 2, 2012.

[12] Morrison Foerster LLP, News Bulletin, “The JOBS Act,” March 26, 2012.

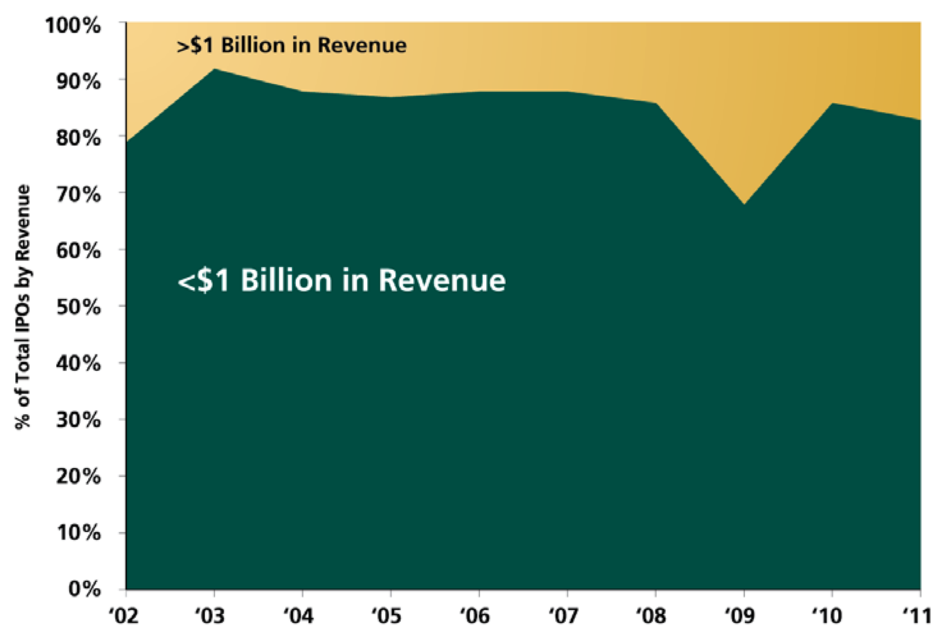
[13] Mintz Levin Newsletter, “JOBS Act to Ease Capital Formation for Public and Private Companies and Reduce Regulatory Burdens on Emerging Growth Companies,” April 5, 2012. See also, “PwC US IPO Watch Q1 2012: A Buoyant First Quarter Produces Strong IPO Returns, says PwC,” PwC News Release, April 2, 2012.

Beyond lowering the SOX and other regulatory hurdles, the JOBS Act does much to smooth the IPO On-Ramp further, including:

- Reducing the amount of financial information emerging growth companies will have to disclose to the SEC in IPO registrations to two years of audited financial statements from three;
- Allowing emerging growth companies to submit a draft IPO registration statement for confidential review by the SEC prior to making a public filing (the filing and any amendments would be filed publicly no later than 21 days before the issuer conducts its road show);
- Permitting emerging growth companies to "test the waters" by communicating with Qualified Institutional Buyers (QIBs), institutions and accredited investors before or after the filing of a registration statement to determine whether these prospective investors might be interested in the offering;
- Allowing investment banks to publish research reports on pending offerings, even if they serve as an underwriter; and
- Waiving conflict of interest and three-way communications rules involving research analysts, investment bankers, and an emerging growth company's management.[14]

What remains to be seen is whether the JOBS Act will have the desired effect of increasing emerging growth company IPOs. Very few companies have more than $1 billion in revenue at the time that they go public. In 2011, only 15 out of 117 companies[15] (or 13%) topped that threshold. The implication is clear: only a tiny fraction of companies that want to go public will not be able to avail themselves of the new IPO On-Ramp. And by the time a company has at least $1 billion in annual revenue, such a company quite clearly has emerged. **Figure 2** illustrates that an overwhelming number of companies that have completed IPOs since SOX passed have had less than $1 billion in revenue.

Figure 2: IPOs That Would Have Qualified as Emerging Growth Companies Since SOX



Source: Jay R. Ritter, Cordell Professor of Finance, University of Florida, "Initial Public Offerings: Sales Statistics Through 2011," April 20, 2012

[14] Orrick, Herrington & Sutcliffe LLP, "Jumpstart Our Business Startups Act—Implications for Issuers and Financial Institutions," April 3, 2012.
[15] Capital IQ and Renaissance Capital, as of December 31, 2011.

In our view, one of the most important differences the JOBS Act will make is changing perceptions about the cost and difficulty of taking an emerging growth company public, particularly among venture capitalists (VCs). For the last decade, the consensus opinion has been that SOX and other regulations have imposed unacceptably high compliance costs on emerging growth companies seeking to go the IPO route in terms of both dollars spent and time wasted.

Similar results were seen in a 2011 IPO Task Force survey of 35 CEOs of companies that had gone public in the previous five years. According to the survey, the CEOs placed the average cost of achieving initial regulatory compliance for an IPO at $2.5 million. That amount is compounded by ongoing compliance costs of $1.5 million per year once a company is public. More than nine out of 10 (92%) of the CEOs say the administrative burden of public reporting is the most significant IPO challenge, followed closely by reallocation of the CEO's time to reporting versus company building (91%), and the administrative burden of regulatory compliance (89%). [16]

While the sample size for both surveys is very small, what we find interesting about the results—based on our experience working with emerging growth companies that eventually go public—is that the perceived costs cited by the CEOs surveyed are much higher than the reality. Nonetheless, focusing on the actual costs (i.e., the reality) is to miss the point. What is important is the *perception* of the costs and burdens associated with going and being public.

On this score, there can be no debate. The consensus in Silicon Valley, which is home to many of the VCs that provide funding for emerging growth companies, was nearly unanimous that the costs of going public in the SOX era had become unacceptably high, except for only a few of the most promising companies that could command a market capitalization of $1 billion-plus right out of the box. It did not matter what the real numbers were because perception trumped reality.

That is why we believe one of the most important aspects of the JOBS Act is its potential to serve as a catalyst for changing opinions about the cost and difficulty of going public. Simply by reinforcing the idea that SOX is no longer an impediment to going public and that emerging growth companies and their backers will not be bogged down in regulatory quicksand, the JOBS Act will play a significant role in helping revitalize the IPO market.

The numbers point to the possibility of that happening. During the first quarter of 2012, 44 IPOs raised $5.8 billion in gross proceeds. That is the highest first quarter volume since 2007 and an increase of 33% from the year earlier period.[17] During the quarter, 48 companies began the IPO registration process, seeking an average of $274 million in gross proceeds per filing. Another 157 companies that filed registration documents in the preceding 12 months have not yet priced and represent $33 billion in prospective offerings—the equivalent of 94% of the total gross IPO proceeds raised in all of 2011.[18]

According to a report in *The Wall Street Journal,*[19] companies are moving quickly. Two companies—LegalZoom.com, Inc., an online provider of legal forms to individuals and businesses, and another unnamed entity—filed confidentially for IPOs within the first week following President Obama's signing of the JOBS Act. The story also quotes a VC executive as saying one of the companies his firm invested in submitted its confidential IPO plan at 8:00 a.m. the morning after the JOBS Act became law.

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[16] "Rebuilding the IPO On-Ramp – Putting Emerging Companies and the Job Market Back on the Road to Growth," Issued by The IPO Task Force, October 20, 2011.
[17] "PwC US IPO Watch Q1 2012: A Buoyant First Quarter Produces Strong IPO Returns, says PwC," PwC News Release, April 2, 2012.
[18] Ibid.
[19] "JOBS Act Jolts Firms to Action," *The Wall Street Journal*, April 12, 2012.

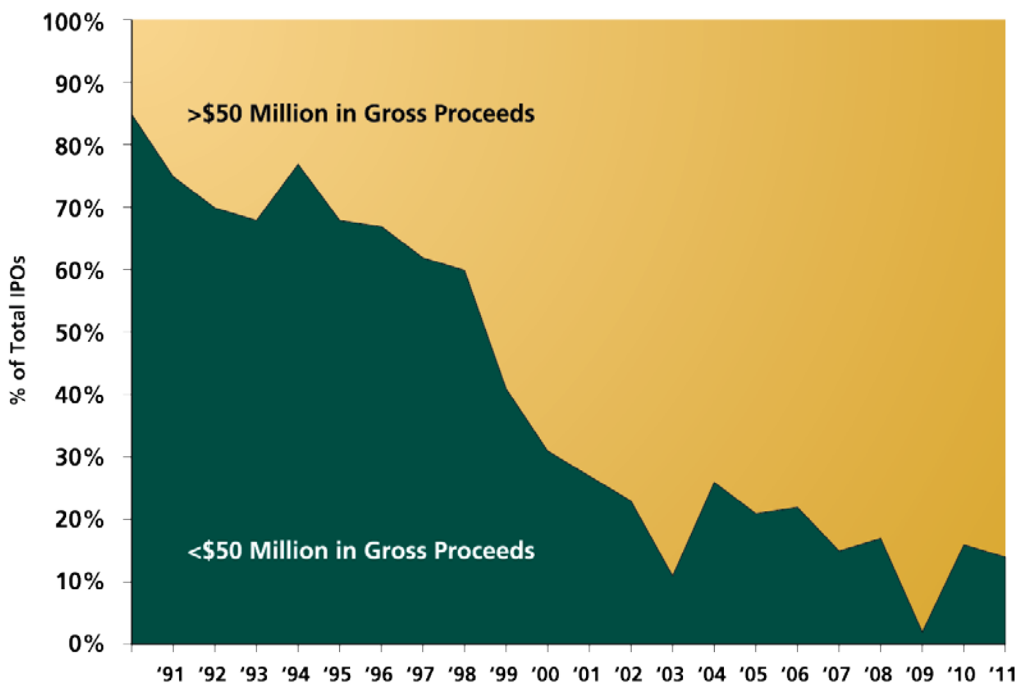
With the JOBS Act taking effect after the end of the first quarter, we believe that throughout the rest of 2012 and beyond an increasing number of emerging growth companies will avail themselves of the opportunities this new, less-cumbersome regulatory environment creates and look to raise capital through an IPO.

The JOBS Act vs. the Researchers: Finding Common Ground

To put the JOBS Act in the proper context, it is useful to look at how its provisions address what leading academics, researchers, and influential industry organizations have said is needed to rescue the market for emerging growth company IPOs. Some recent history is helpful in setting the stage.

Twenty years ago, the vast majority of IPOs were small ones, i.e, those that raised less than $50 million in gross proceeds. From a peak of more than 80% back in 1991, the percentage of IPOs raising less than $50 million has declined steadily and completely inverted to a level below 20% today. Even after adjusting for inflation, there is no way to describe the situation other than as a vanishing of the sub-$50 million IPO. **Figure 3** below displays the grim results.

Figure 3: Death of the Sub-$50 Million IPO



SOURCE: Securities Data Corporation, IPOHome, Capital IQ

Prior to the enactment of SOX in 2002, the median amount of time that it took for venture backed private companies to go from initial funding to IPO was three and a half years. By 2011, that time period doubled to over seven years. Furthermore, the money those companies raised in the additional years of being private came at a much higher aggregate cost of capital than would have been the case had they gone public sooner. Based on our experience in the marketplace, the cost of capital for a private company is typically at least two times higher than for a public company with similar financial attributes. All other factors being equal, a private company that executes a series of capital raisings over time incurs significantly higher aggregate costs of capital than one that raises the same amount of capital as a public issuer.

The decline in emerging growth company IPOs also was part of the larger trend of an overall diminution of the U.S. IPO market. From 2001 to 2010, the U.S. averaged 126 IPOs per year. That compares with an annual average of 530 IPOs between 1991 and 2000.[20] In 2011, 125 U.S. IPOs raised gross proceeds of $36.3 billion, a decline of 6% from 2010.[21]

Much has been written about the reasons why the emerging growth company IPO market had dried up over the past decade. Following is a summary of the main points contained in four of the most notable research reports on this topic. The reports represent a cross-section of the industry's mainstream thinking on the causes of the crisis in emerging growth company IPOs. Each offers a different perspective and comes to a different conclusion about what, if anything, might be done to remedy the situation.

1. "Market Structure is Causing the IPO Crisis–and More," by David Weild & Edward Kim, Grant Thornton (June 2010)

Weild and Kim make the case that the crisis in U.S. IPOs is primarily the result of structural changes in the market that go back to at least 1997, and *not* because of SOX or other regulatory reforms. They argue that the erosion in the U.S. IPO market can be seen as the perfect storm of unintended consequences resulting from the cumulative effects of uncoordinated regulatory changes and technology advances—all of which eroded the economic model that once supported investors and small cap companies with capital commitment, sales support and high quality research. Specifically, declines in bid/ask spreads reduced the financial incentives for traders to make markets in the shares of emerging growth companies and for investment banks and brokers to provide the research investors require before investing in those companies.

It must be noted, however, that the issue of bid/ask spreads is a double-edged sword that cuts emerging growth companies both ways. Wider bid/ask spreads do support the economic infrastructure necessary for emerging growth company IPOs and their shares to thrive in the marketplace by creating the financial incentives for broker-dealers to buy and sell those stocks and produce the equity research needed to attract investors. On the other hand, narrower bid/ask spreads make it easier to trade emerging growth company stocks, leading to higher trading volumes and valuations. This creates something of a dilemma as to which is preferable for emerging growth companies. (We will address this topic in greater detail in a future white paper.)

The result of the structural changes posited by Weild and Kim was that U.S. companies could no longer rely on the domestic equity markets for an infusion of capital or turn to credit-strapped banks. The inevitable consequences were that small, young, emerging companies were unable to expand, grow, innovate or compete and were left to wither and die, contributing to a struggling economy and high unemployment.

Compounding the situation, according to Weild and Kim, the deterioration of the IPO market caused VC firms to avoid financing forward-looking, albeit risky, new ideas, technologies, and industries for which there is no obvious Fortune 500 acquirer. The retreat of VCs meant that most small companies never made it to an IPO. Instead, VCs sold portfolio companies to large corporate acquirers, who seek to achieve "synergies" by virtue of cost reduction through job elimination. A number of pundits likened this process to "eating our own young."

[20] "Market structure is causing the IPO crisis—and more," David Weild, Edward Kim, June 2010, Grant Thornton Capital Markets Series.
[21] "IPOs Have Had a Dismal Year," *USA Today*, January 4, 2012.

The fallout from these structural changes and the resulting weakness in the IPO market had far-reaching implications, including lower U.S. economic growth; the loss of the country's prestige and historical competitive advantage in developing, incubating, and applying new technologies; and fewer entrepreneurs who were willing to take a risk and create an innovative new business or product.

2. *"Where Have All the IPOs Gone?"* by Xiaohui Gao, Jay Ritter, Zhongyan Zhu (April 3, 2011)

Gao, Ritter and Zhu, like Weild and Kim, do not blame regulatory changes for the declines in emerging growth company IPOs and the number of underwriters willing to back them. They, too, cite structural changes, but in the economics of being a small company rather than a large company, of being private rather than public. Gao, Ritter and Zhu argue that getting big fast is more important than it used to be in many industries.

The authors say these economic changes have reduced the profitability of small companies and made it more profitable for an emerging growth company to sell itself to a larger company in the same or a related industry rather than remaining independent. According to Gao, Ritter and Zhu, earnings will be higher for a small company if it is part of a larger organization that can realize economies of scale and bring new technologies/products to market faster. In short, small companies are worth more as part of a larger organization than on their own.

Gao, Ritter and Zhu come to the conclusion that, given the declines in overall profitability of small-companies (whether private or public) coupled with the low returns for investors in the IPOs of small companies over the last three decades, IPO volumes will not return to the levels of the 1980s and 1990s and regulatory changes will not have much of a positive effect on emerging growth company IPOs.

3. *"Rebuilding the IPO On-Ramp, Putting Emerging Companies and the Job Market Back on the Road to Growth,"* IPO Task Force (October 20, 2011)

The IPO Task Force's October 2011 report to the U.S. Treasury places the blame for the emerging growth company IPO crisis on the cumulative effect of a sequence of government regulatory actions, rather than one single event. According to the report, these regulations have driven up costs for emerging growth companies looking to go public and reduced the supply of such companies. In addition, regulatory burdens limited the amount of information available to investors about emerging growth companies, making them more difficult to understand and invest in. As a consequence, the economics of stock trading were shifted away from long-term investing in emerging growth companies and toward high-frequency trading of large cap stocks.

The report included several detailed recommendations, including that policymakers create an "on-ramp" for emerging growth companies seeking to go the IPO route by scaling back regulations. It also called for allowing companies with total annual gross revenue of less than $1 billion at IPO registration that are not recognized by the SEC as "well-known seasoned issuers" to be given up to five years from the date of their IPOs to come into full compliance.

Additional recommendations deal with such wide ranging issues as improving the availability and flow of information for investors before and after an IPO, lowering the capital gains tax rate for investors who purchase shares in an IPO and hold them for a minimum of two years, and educating issuers about how to succeed in the new capital markets environment.

4. ***"National Venture Capital Association 4-Pillar Plan to Restore Liquidity in the U.S. Venture Capital Industry,"* by the National Venture Capital Association (NVCA) (April 2009)**

The NVCA developed a 4-point plan that called for:

- An IPO ecosystem partnership including entrepreneurs, VC firms, investment banks, buy-side firms/analysts, stock exchanges, law firms, and accounting firms;
- Enhanced liquidity paths, including the use of private market platforms and global financing/fundraising through international stock exchanges to increase VC ecosystem liquidity;
- Tax incentives to stimulate IPOs, including a one-time 10% capital gains tax rate for investors in emerging growth company IPOs and tax incentives for VC investments in certain sizes and types of companies (e.g., clean technology, life sciences, etc.); and
- Regulatory changes to streamline the SEC review process for small company IPOs and relaxing SOX compliance restrictions.

Evaluating the Results

Clearly the JOBS Act's provisions match perfectly with many of the recommendations by the IPO Task Force, the NVCA, and other like-minded organizations by (i) easing the onerous regulatory burdens placed on emerging growth companies trying to go public, (ii) redefining a small issuer as a company with less than $1 billion of annual gross revenue in the fiscal year prior to its IPO, and (iii) streamlining certain SEC registration review processes. From their perspectives, we believe the JOBS Act should fill in many of the biggest potholes that made the road to an IPO such a rough ride for emerging growth companies.

1. Decimalization

The JOBS Act also attempts to address some of the underlying structural economic changes in the market for emerging growth company IPOs raised by Weild and Kim, and separately by Gao, Ritter and Zhu. For example, the new law directs the SEC to study the effects of "decimalization"—the trading and quoting of securities in one-cent increments—on the IPOs of emerging growth companies and the market for their stock.

This may mark the beginning of the reversal of a policy begun in 2001 when, in an effort to make financial markets more user-friendly for individual investors, the SEC required that all exchange-traded share prices be quoted to the penny, instead of in increments of one-eighth or one-sixteenth of a dollar, as had been done previously.

Weild and Kim describe it as "the death star of decimalization," which led to a "loss of 96 percent of the economics from the trading spread of most small cap stocks—from $0.25 per share to $0.01 per share."[22] They go on to say that, "As spreads disappeared, so did economic incentives for firms to provide research and liquidity support for stocks….Traders stop supporting small cap stocks once trading spreads decline by 96 percent. The last bit of economics left for retail stockbrokers to market stocks is stripped away."[23]

The SEC is required to submit its findings to Congress within 90 days of the JOBS Act's enactment.

[22] "Market structure is causing the IPO crisis – and more," David Weild, Edward Kim, June 2010, Grant Thornton Capital Markets Series.
[23] Ibid.

2. Research Coverage

Decimalization is but one example of the structural changes in the economics of small-company IPOs. Another has been the elimination of the financial incentives for investment banks and underwriters to work with emerging growth companies that wish to go public. This can be traced back to what became known as the Global Settlement of 2003. Here again, almost 10 years after the fact, a short historical summary may be useful.

In 2001, then New York State Attorney General Eliot Spitzer obtained internal Merrill Lynch emails that confirmed a published report that the firm's top Internet analyst was privately disparaging companies the firm had taken public, but which he had praised in his research reports. The SEC, various federal and state securities regulators, law enforcement authorities and the New York Stock Exchange eventually joined the investigation and found that the practice of hyping IPO companies to generate investment banking revenues was widespread on Wall Street and not just limited to Merrill Lynch.

Investigators found that 10 of the largest investment banking firms in the U.S. (later expanded to 12) had, to one degree or another, improperly influenced their research analysts. The firms were accused of pressuring analysts to issue favorable reports on companies they had taken public to create demand for the shares and induce investors to buy into the IPOs.

Under the terms of the Global Settlement, the 10 firms agreed to pay $1.4 billion in combined fines and penalties. The settlement also required firms to, among other mandates, keep their investment banking operations separate from their research departments, in effect, cutting off communications between the two sides of the house.

The result has reduced the quantity and quality of research by removing the profit incentive, with small-cap issuers being hurt most. Many promising, highly innovative, and potentially greatly profitable emerging growth companies have been unable to get the analyst coverage needed to confer the credibility and legitimacy that indicates to investors a stock is of institutional quality.

As of December 31, 2011, nearly 20% of *all* the companies listed on Nasdaq, historically considered the home of innovative growth companies, had no analyst coverage at all—not a single one. As **Figure 4** below illustrates, 55% of Nasdaq listed companies with a market cap of $41 million or less had no coverage, and companies with market caps between $41 million and $119 million had, on average, only a single analyst covering their stocks.

Figure 4: Analyst Coverage of Nasdaq Stocks by Market Cap Quintiles

Quintile	Market Cap Range (MM)	Median Market Cap (MM)	Median # of Analysts	Max. # of Analysts	Stocks with No Analysts
1	$0 – 41	$21	0	12	55%
2	$41 – 119	$72	1	21	25%
3	$119 – 301	$189	4	21	7%
4	$301 – 926	$526	6	29	4%
5	$926+	$2,150	14	52	1%

Though intended to increase transparency and eliminate conflicts of interest, the Global Settlement has erected barriers that make it difficult for emerging growth companies to tell their stories to investors and create a market for their stock. Those barriers have contributed to preventing many small companies from going public.

One of the many virtues of the JOBS Act is that it relaxes some of the Global Settlement restrictions and again permits research analysts to be involved with investment banker presentations to emerging growth companies considering an IPO. Under the old regulations, managing underwriters of an IPO were generally prohibited from publishing or distributing research until 40 days after the IPO. Under the new law, investment banks, brokers and dealers are allowed *at any time* to publish and distribute analyst research reports about an emerging growth company even if the firms are participating in the company's IPO.

Some securities law specialists say that despite the JOBS Act, the terms of the Global Settlement still apply to the investment banks that have been subject to its restrictions. These observers say that many large banks and IPO underwriters are likely to move slowly on providing research until the dust settles and the SEC and other regulatory bodies issue clear guidance on what is permissible.[24]

Nevertheless, we believe this is a hugely positive development with the long term benefit of having more analysts provide research on a greater number of emerging growth companies and fewer companies going without coverage. The fact that investors place a high value on research about lesser-known companies cannot be stressed strongly enough. Investors currently have access to research by dozens of analysts who cover a mega cap stock such as Apple, and the addition of one more new analyst covering the stock adds minimal incremental value for investors. However, the marginal utility of the first analyst to cover a stock, and even the second or third, is enormously beneficial for issuer and investors alike.

We recognize that some conflicts may exist, and where they do, they must be clearly identified and addressed, but our conclusion is that the value of providing analyst research coverage for emerging growth companies dramatically outweighs the cost of resolving potential conflicts.

Where the JOBS Act Misses the Mark

From our perspective, one of the major disappointments in the new legislation is that emerging growth company status is not being applied retroactively to companies that went public *prior* to December 8, 2011. Unfortunately, there is no grandfathering of the regulatory relief for smaller public companies that would otherwise qualify for emerging growth company status. We point specifically to the requirement for the audit of internal controls under Section 404(b) of Sarbanes-Oxley.

We also have reservations about the rule changes that apply to confidential filings, long a privilege reserved solely for non-U.S. filers. The SEC revoked the confidential filing rule for non-U.S. filers, with certain limited exceptions, in December 2011, in response to criticism about unequal treatment of domestic and overseas filers. It has been resuscitated in the JOBS Act in a form that allows any qualified emerging growth company to submit a confidential filing for SEC review prior to the company's IPO date. In our opinion, this has the potential to be a controversial provision that may open the JOBS Act to additional and—in our opinion, avoidable—criticism in the future.

[24] "Investment Banks Welcome JOBS Act's Lifting of Research Restrictions, Plan to Go Slow," *The DealFlow Report,* April 19, 2012.

Conclusion

We see the JOBS Act as an important and bold step forward in what is an absolutely necessary effort to reenergize one of the country's most important financial sectors, the market for emerging growth company IPOs—our relatively minor disagreements with certain provisions of the law notwithstanding.

Aside from the direct positive impact the JOBS Act will have on the IPO market, we believe its benefits will ripple through the American economy in the forms of more new business startups, the expansion of existing businesses, greater innovation, job creation, wealth formation, and all the resulting economic activity and growth that flows from these developments.

The JOBS Act seeks to create a new reality in the marketplace by easing regulatory, registration and reporting restrictions, lowering costs, and reducing many of the barriers to going public for emerging growth companies. In our view, it will also lead to a new psychology among entrepreneurs and small business owners that could trigger a wave of IPO activity.

One of the most important topics in the discussion of what was needed to remedy the market for emerging growth company IPOs is the cannibalization of the aftermarket. The JOBS Act does not address issues such as the near elimination of sales commissions, the lowering of trading spreads or the need for middle-market, boutique style investment banks that specialize in working with smaller capitalization companies. Nor should it. These issues are best resolved by industry participants, with government assistance where needed, to ensure that emerging growth companies seeking to go the IPO route can count on a vibrant aftermarket for their shares that will help them grow, increase their valuation, and benefit investors.

With the JOBS Act in place and, most importantly, delivering much of the relief that most participants in the market for emerging growth company IPOs were seeking, the responsibility to make it work successfully now falls on those same market participants. Quite simply, it's time to seize the moment. The reforms spelled out in the JOBS Act have been a long time coming and it is unlikely that the emerging growth company IPO ecosystem will see additional legislation any time soon.

Collectively, we are now in the driver's seat behind a powerful engine of wealth creation and economic growth. The speed restrictions have, for the most part, been lifted. It is now time to fire up that engine, make sure it is hitting on all cylinders, and accelerate up the on-ramp to new, more successful destinations for emerging growth companies that wish to travel down the road to an IPO.

About Keating Investments

Keating Investments, LLC is a Denver-based SEC registered investment adviser founded in 1997, and is the investment adviser to Keating Capital, Inc. (www.KeatingCapital.com). Keating Capital is a business development company that specializes in making pre-IPO investments in innovative, emerging growth companies that are committed to and capable of becoming public. We provide investors with the ability to participate in a unique fund that allows our stockholders to share in the potential value accretion that we believe typically occurs once a company transforms from private to public status. Keating Capital's shares are listed on Nasdaq under the ticker symbol "KIPO."

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