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Where Are The Jobs In The Jobs Act? An Examination Of The Uneasy Connection Between Securities Disclosure And Job Creation

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WHERE ARE THE JOBS IN THE JOBS ACT? AN EXAMINATION OF THE UNEASY CONNECTION BETWEEN SECURITIES DISCLOSURE AND JOB CREATION

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The JOBS Act, passed in April 2012, is designed to produce American jobs through removing various regulatory barriers for small companies to access investor capital. As the regulations continue to be implemented, commentators have dissected the various ways in which the JOBS Act attempts to achieve this goal. One of the methods involves making the IPO process initially less burdensome, through scaling back financial and corporate governance disclosures. Crowdfunding, which will eventually permit companies to raise investor capital through an online "funding portal," has garnered both deep criticism from regulators and praise from small business owners. Yet little attention has been paid to the notion that the very reason for disclosure reform is job creation. This matters because job creation has not historically played a direct role in the reform of securities disclosure statutes and regulations. This Article analyzes what role, if any, job creation should occupy in the reform of securities disclosure laws. After establishing the normative baseline for disclosure theory and reform, this Article highlights various unintended consequences of using job creation as a justification for reform and proposes a framework for understanding job creation-based disclosure reforms going forward.

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INTRODUCTION

Of the many ailments caused by the 2008 financial crisis, the unemployment rate in the United States served as a direct indicator of the challenges the American economy and its workers faced. Unemployment rose to yearly averages of over nine percent in 2009 and 2010. Only since October of 2012 has the figure dipped below eight percent despite

relatively modest job gains.[1] Strengthening the American economy, with job creation at the helm, was a central issue during the 2012 presidential race that ultimately saw the incumbent Barack Obama victorious.

While various job-creation mechanisms have been employed, only one has utilized the federal securities laws as its catalyst: The Jumpstart Our Business Startups Act ("the JOBS Act" or "the Act"). The JOBS Act, signed into law on April 5, 2012, is somewhat unique among job-creation policies in that it works not through the tax code or the Federal Reserve but rather through federal securities laws. Indeed, the purpose of the Act is "[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies ["EGCs"]."[2] The Act, really a series of five unique bills rolled into one, generally strives to make it easier and more efficient for EGCs to gain access to investor capital. More American jobs will be created, so the rationale goes, when small companies tap needed capital to grow and hire workers. The JOBS Act received nearly unanimous support in Congress,[3] as it attained a certain popularity summed up by the following sentiments from a congresswoman:

> The JOBS Act is a legislative package designed to move our economy and restore opportunities for America's primary job creators, our small businesses, start-ups, and entrepreneurs. These measures create capital formation, will spur the growth of start-ups and small businesses, and pave the way for more small-scale businesses to go public and create more jobs. In his State of the Union, the President asked us to send him a bill that helps small businesses and entrepreneurs, and that's exactly what the JOBS Act does.[4]

To achieve its goal of efficiently connecting EGCs with willing investors, the JOBS Act primarily reforms the disclosure requirements of the Securities Act of 1933 ("'33 Act"). For example, for companies pursuing an initial public offering ("IPO") Title I of the Act (part of which includes the "IPO on ramp") eases the public disclosure requirements over the first five years of its publicly listed status. As this paper will discuss in greater detail in Section III, data suggest that for EGCs, IPOs add a greater

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1. UNEMPLOYMENT RATE – SEASONALLY ADJUSTED, *available at* http://www.google.com/publicdata/explore?ds=z1ebjpgk2654c1_&met_y=unemployment_rate&idim=country:US&fdim_y=seasonality:S&dl=en&hl=en&q=us%20unemplo y.ment%20rate (last updated June 9, 2015).

2. Jumpstart Our Business Startups Act, Pub. L. No. 126-106, 126 Stat. 306 (2012).

3. *See* FINAL VOTE RESULTS FOR ROLL CALL 110 (2012), *available at* http://clerk.house.gov/evs/2012/roll110.xml; *see also* Edward Wyatt, *Senate Passes Start-Ups Bill, With Amendments*, N.Y. TIMES (Mar. 22, 2012), at B1.

4. 158 CONG. REC. H1219 (Mar. 7, 2012) (statement of Rep. Capito).

number of jobs than mergers or acquisitions.[5] Title I of the JOBS Act can be seen as a way to revive lagging IPO activity, while the cause of such stagnation serves as a topic for debate.

Another example of disclosure reform is found in Title III ("crowdfunding"), where certain emerging companies will be permitted to solicit investments from a broad range of retail investors over the Internet without having to register their issued securities. Instead of incenting companies to pursue an IPO, the crowdfunding provision provides a method for undertaking a private offering while still gaining access to everyday retail investors. Through crowdfunding, Congress might have realized that not all small businesses are willing or able to undertake an IPO yet still have a need for investor capital.

On the surface, these changes to the '33 Act (and others that round out the JOBS Act) appear to create workable solutions to the challenging issue of high unemployment. However, amidst all of the momentum surrounding the JOBS Act, one versed in United States securities law may rightly step back and ponder whether those laws should serve as a springboard for job creation. This paper asks what role, if any, should job creation play as a justification for securities disclosure reform. While American securities law is at least indirectly connected to job creation and the growth of various types of enterprises, to what extent should we use securities disclosure law as the means to achieve job growth? I identify at least three possible concerns with such direct usage of disclosure law in the job creation realm. Two of the concerns may be deemed "unintended consequences" of the JOBS Act and the third might be considered a definitional issue, equating "capital formation" with "job creation."

First, if investor protection is subordinated to achieve gains in capital formation and job creation, then it is likely that such investments will be seen as riskier or at least less certain than an investment at pre JOBS Act levels. Uncertainty and risk tend to raise the cost of capital for issuers. It is possible, therefore, that the benefits of the JOBS Act would be outweighed by the costs imposed by investors demanding investment price protection. Second, especially given concerns over the potential for deceitful activity in crowdfunding and the IPO on ramp, if investor capital is allocated to weak or fraudulent issuers, the result could be job losses not job gains. Finally, there is a concern with equating capital formation with job creation. While the two do overlap, I argue that they are not precisely the same and that there is a danger in not recognizing the differences.

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5. *Rebuilding the IPO On-Ramp, Putting Emerging Companies and the Job Market Back on the Road to Growth*, IPO TASK FORCE, at 5 (2011), *available at* http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

The paper proceeds as follows. Section II outlines the various justifications for disclosure law reform over the history of federal U.S. securities regulation, setting the normative baseline for such reform. Section III then analyzes whether and to what extent the JOBS Act alters disclosure theory. Section IV answers my primary question of what role, if any, job creation should play in the calculus of disclosure reform. Section V concludes.

II. JUSTIFICATIONS FOR DISCLOSURE REFORM: THE NORMATIVE BASELINE

Since their inception in 1933, federal securities laws have been reformed as a response to various influences. The Securities and Exchange Commission's ("SEC") mission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation".[6] This mission statement neatly tracks two primary justifications for securities disclosure reform: investor protection and capital formation. To be sure, one instance of disclosure reform may reflect the other justification. However, at its core, each reform highlights one of the two principal justifications. To illuminate the two categories of justifications, I will provide examples of disclosure reforms driven by each. Instead of delving into the technical operation of each reform, my goal is to tease out what exactly the reform says about the motivations behind changes to disclosure laws.

A. Investor Protection Reforms

1. The Securities Act of 1933

Investor protection may appear to be the most obvious or intuitive rationale for introducing or reforming securities disclosure laws and regulations. Regulation by its very nature can be seen as a way to place limits on private enterprises so that all participants may be treated fairly. For the sake of consistency, I will define investor protection reforms as those reforms designed primarily to benefit investors by requiring securities issuers to take some affirmative action by providing investors with material information about the investment. In addition, investor protection reforms are often coupled with enforcement mechanisms that offer recourse to investors claiming that issuers shirked their disclosure responsibilities.

The first such reform, the '33 Act, is perhaps the best example of an investor protection measure. While the '33 Act may rightly be categorized as a response to economic crisis (the Great Depression), the Act focuses its

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6. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SECURITIES AND EXCHANGE COMMISSION (2013), *available at* http://www.sec.gov/about/whatwedo.shtml.

immediate attention on laying out a system whereby securities issuers are compelled to disclose certain types of information to potential investors. James M. Landis, one of the '33 Act's principal drafters wrote firsthand about the impetus for federal legislation concerning the offer and sale of securities.[7]

> The act naturally had its beginnings in the high financing of the Twenties that was followed by the market crash of 1929. [A Senate Banking and Currency Committee investigation] indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people's money. Investment bankers, brokers and dealers, corporate directors, accountants, all found themselves the object of criticism so severe that the American public lost much of its faith in professions that had theretofore been regarded with a respect that had approached awe.[8]

At the heart of the '33 Act regime is the concept of mandated disclosure. The drafters recognized that for too long securities issuers were able to select the information, if any, they disclosed to investors. As Landis wrote, "Our draft remained true to the conception voiced by the President . . . namely that its requirements should be limited to full and fair disclosure of the nature of the security being offered and that there should be no authority to pass upon the investment quality of the security."[9] Simply put, the '33 Act was instituted to ensure that companies issuing securities in public offerings would provide material *ex ante* disclosure to investors. While some state securities disclosure regimes passed on the merits of securities offerings (known as merit review), the '33 Act chose instead to favor disclosure and let investors decide on the merits.

While the decision was made to favor disclosure over merit review, the '33 Act contains various provisions that may subject issuers and related parties to civil liability for material misrepresentations or failure to disclose material information.[10] The disclosure and civil liability elements of the '33 Act reveal an important observation underpinning securities disclosure law: the push and pull between investor protection and capital formation.[11] On one hand, the '33 Act strives to leave behind the caveat emptor

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7. The federal securities laws came some ten to twenty years after the passage of state "blue sky" laws. *See generally* Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229 (2003).

8. James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

9. *Id.* at 34.

10. *See* 15 U.S.C. § 77k(a) (2013).

11. Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, FORDHAM J. CORP. & FIN. L. 367, 368 (2008).

approach of pre-federal securities law.[12] On the other hand, there is the concern that too much government intervention could stifle capital formation and economic growth.[13] This paradigm is the essential tension of United States securities disclosure law.

2. Securities Exchange Act of 1934, Section 12(g)

Issuers of securities whose stock is traded on an exchange are required to release on-going disclosures pursuant to the Securities Exchange Act of 1934 ("'34 Act"). This makes sense because while issuers must release a registration statement during an initial public offering, as time goes on, material changes occur that require continuous updates, yet the issuer's securities will continue to be bought and sold by investors on the secondary market. However, before 1964, issuers of securities whose stock traded in the over the counter markets ("OTC") were not required to register and provide on-going investor disclosure. This split resulted in high transparency (and presumably more accurate pricing) in listed securities but not those trading in the OTC markets.

The split was recognized as a problem because of the ever-increasing prominence of the OTC markets. As one SEC Commissioner at the time noted:

> It is abundantly clear that the over-the-counter markets are not now, if indeed they ever were, insignificant in their scope and economic impact. They involve thousands of corporations and hundreds of thousands of investors. The Securities Act Amendments of 1964 effectively remove the distinction which has existed as to a large number of the companies whose securities are traded over-the-counter.[14]

Section 12 of the '34 Act was reformed in order to "remove the distinction" between the disclosures the two types of investors received. Prior to the JOBS Act, Section 12(g)(1) subjected issuers, with total assets exceeding $10 million and equities held of record by 500 or more persons, to the same on-going disclosure regime that exchange-listed companies must comply with.[15] This reform demonstrates at least one important characteristic of investor protection: fluidity. As the nature of the

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12. Garland S. Ferguson, Jr., Commissioner, Federal Trade Commission, Address on the Securities Act of 1933 (Sept. 12, 1933).

13. David R. Burton *Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth,* THE HERITAGE FOUNDATION (June 20, 2014), http://www.heritage.org/research/reports/2014/06/reducing-the-burden-on-small-public-companies-would-promote-innovation-job-creation-and-economic-growth.

14. Hugh F. Owens, Commissioner, United States Securities and Exchange Commission, Address Before the Practicing Law Institute (Oct. 16, 1964).

15. 15 U.S.C. § 78l.

marketplace changes, so too does the character of investor protection. While 12(g)(1) made an arbitrary cutoff at 500 holders of record, the SEC recognized that at least for relatively large OTC-traded companies, there was "no logical basis for the distinction made by the Exchange Act between listed and unlisted securities."[16]

Yet another lesson from investor protection reforms, shown clearly by 12(g), is that they may have negative unintended consequences for capital formation.[17] If an unlisted company crosses the investor threshold, they do not automatically become a "listed" company subject to S-1 registration. However, this is the practical effect. If a company must regularly disclose sensitive information, they may as well attempt to take advantage of the deep capital of the public markets. The most recent high profile example of this phenomenon is Facebook, who surpassed the then-existing 500 holders of record limit.[18] Much has been written about the Facebook IPO, but for purposes of this paper, it is simply worth noting that perhaps Facebook would have waited longer to go public had it not been required to register under 12(g). This problem can be true particularly for smaller companies that may have to take a less aggressive financing approach in order to stay below the 12(g) threshold.[19]

Investor protection reforms to securities disclosure follow a general pattern. First, there is a perceived ill that must be remedied in order to ensure that investors receive the assurance they need to participate in United States securities markets. Second, the remedy usually comes in the form of enhanced or more widespread disclosure from the issuer to the investor. Disclosure, not merit review, is the cornerstone of investor protection in United States securities law, and it is natural that protection reforms build upon that principle.[20] Third and finally, we can look at the reform's effects on capital formation and ask whether the costs to capital formation are offset by the benefits of investor protection. In summary, regulators and lawmakers who pass investor protection measures come to

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16. *See supra* note 14, at 3.

17. Sometimes the consequences are known at the time of reform, it is just that the benefits outweigh the costs in the eyes of the reformer.

18. *The "Facebook Problem," Secondary Market Trading and the 500 Shareholder Rule: Part 2 of a 4-Part Series on the Jobs Act*, PE HUB (April 24, 2012), https://www.pehub.com/2012/04/the-%E2%80%9Cfacebook-problem%E2%80%9D-secondary-market-trading-and-the-500-shareholder-rule-part-2-of-a-4-part-series-on-the-jobs-act/.

19. William K. Sjostrom, *Questioning the 500 Equity Holders Trigger*, 1 HARV. BUS. L. REV. ONLINE 43, 45 (2011). Note, however, that this problem may be significantly alleviated by the JOBS Act.

20. However, sometimes investor protection reforms come by way of rules that explicitly require or prohibit certain behaviors. *See* 15 U.S.C. § 78g (setting margin requirements for securities purchased on credit).

the conclusion that, while certain constituencies must bear the burden of greater disclosure, a net gain throughout the capital markets justifies the reform.

B. Capital Formation Reforms

1. Regulation D, Rule 506

Regulation D, a series of SEC rules grounded in the '33 Act, was promulgated in 1982. The rules operate to exempt certain "private" securities offerings from Section 5 registration. The most commonly relied upon of the Regulation D rules, Rule 506, serves as a non-exclusive safe harbor to Section 4(2)'s exemption for issuer transactions not involving a public offering.[21] Prior to Rule 506, the SEC had released a series of rules attempting to provide guidance on the availability of the private offering exemption.[22] The policy rationale for Rule 506 is well documented:

> Regulation D was designed to facilitate capital formation, while protecting investors, by simplifying and clarifying the existing exemptions for private or limited offerings, expanding their availability, and providing more uniformity between federal and state exemptions. Although Regulation D originated as an effort to assist small business capital formation, companies of all sizes may use the Regulation D registration exemptions.[23]

Rule 506 now exists as the cornerstone exemptive authority for many private securities offerings, from hedge funds to EGCs.[24] Based on concerns that an inconsistent registration exemption scheme would discourage companies from raising capital, Regulation D and Rule 506 in particular are classic examples of the SEC's dual concern for investor protection and capital formation. What is interesting for the purpose of this paper is what the invocation and amendment of Rule 506 tells us about the justifications for disclosure reform. Two observations are particularly relevant.

The first touches on the mindset of the SEC, if such a thing can be deciphered, when promulgating Regulation D. Nowhere in the thirty-three pages of its Regulation D release does the SEC mention job creation as either a direct or indirect rationale for the reform. Capital formation,

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21. *See* 17 C.F.R. § 230.506 (2011).

22. *See generally Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales*, Securities Act Release No. 33,6389 (Mar. 8, 1982).

23. *Id.* at 2.

24. *See* VLAD IVANOV & SCOTT BAUGUESS, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION 1 (2012).

however, is highlighted in the release's first paragraph.[25] This is important not because this means that the SEC, and others that influenced the Regulation D reform, did not ever consider the reform's effects on job creation. More important is the observation that for Regulation D purposes, capital formation may, but need not, touch on job creation; it is a broader concept.

The notion that capital formation is a broader concept than job creation is supported by data gathered on Regulation D filings for the years 2009 and 2010.[26] Two SEC economists were tasked with gathering and analyzing data on all Regulation D filings (done on Form D) during this two year period. The study was intended to "inform the Commission on the amount and nature of capital raised through unregistered offerings claiming a Regulation D exemption, and to provide some preliminary perspective on the state of competition and regulatory burden in capital markets."[27] Their findings detail two interesting sub-observations.

First, the data demonstrate that, of the various types of issuers using Regulation D, the majority (twenty-nine percent) are pooled investment vehicles as opposed to individual issuers.[28] Of that twenty-nine percent, the largest fund type using Regulation D is hedge funds fifty-five percent. This finding is highlighted not to suggest that hedge funds have some sort of unequal influence over the private formation of capital. Rather, the dominant use of Regulation D by pooled funds, especially hedge funds, strongly suggests that capital formation does not necessarily create jobs. Hedge funds are simply private funds that invest limited partner assets through the acquisition of securities in capital markets. Hedge funds do not aim to create jobs for their investors; they aim to create above-market returns through a variety of trading strategies. While this may sound nefarious, I would argue that capital formation through pooled investment funds is generally anything but that. Public mutual funds as well as private funds form capital to provide investors with professional money management for retirement or general capital appreciation.

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25. *See supra* note 22, at 1. The Commission announced the adoption of a new regulation governing certain offers and sales of securities without registration under the Securities Act of 1933 and a uniform notice of sales form to be used for all offerings under the regulation. The regulation replaced three exemptions and four forms, all of which were being rescinded. The new regulation was designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions in order to facilitate capital formation consistent with the protection of investors.

26. *See* IVANOV & BAUGUESS, *supra* note 24. These were the first two full years that the SEC changed to electronic filing of Form D.

27. *See id.* at 1.

28. *Id.*

The second sub-observation that the data highlight is the trend from public to private capital raising. The authors note that beginning in 2010, private offerings raised eight percent more capital than public offerings.[29] The trend continued in 2011, as of the date of the study. The distinction between public and private offerings signals a well-detailed trend away from initial public offerings ("IPO") and the embrace of strategic combinations.[30] It is generally understood that IPOs are a greater job creator than mergers or acquisitions.[31] The trend in private offerings shows that to a large extent, issuers may be using Regulation D to raise capital with aspirations of becoming an attractive acquisition target. While it is true that private capital offerings can grow a business and position it to create jobs, if such a company is vying to be acquired, that job growth might be temporary at best or at worst could lead to short term job losses through the elimination of redundant positions.[32]

A second feature of Regulation D, as a capital formation reform, is the notion of investor sophistication. Capital formation reforms necessarily require Congress, and more likely the rule makers at the SEC, to weigh the tradeoffs to investor protection. The SEC has historically felt comfortable with a decrease in investor protection to so-called sophisticated investors: those thought to be able to "fend for themselves" because of their financial sophistication or previous investment experience.[33] Not all of Regulation D restricts sales exclusively to accredited investors. Rule 504 contains no minimum investor net worth or income test.[34] Designed to assist small issuers in raising private capital,[35] Rule 504 may appear to violate the investor sophistication theme of Regulation D, and it does to the extent that no accreditation standards are present. However, it must be noted that Rule 504 offerings are capped at $1 million in a twelve-month period.[36] This mechanism still favors the notion that issuers should be limited in the extent to which they may access "unsophisticated" investor capital. In addition, in order for an issuer to avoid the prohibition on general

29. *Id.* at 3.

30. Xiaohui Gao, et al., *Where Have All the IPOs Gone?*, SECURITIES AND EXCHANGE COMMISSION, at 4-5 (2011), *available at* https://www.sec.gov/info/smallbus/acsec/acsec-090712-ritter-slides.pdf.

31. *See e.g.*, *supra* note 5, at 7.

32. *Id.*

33. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (supporting the proposition that those close to a transaction can bear the risk of an investment); *see also* 17 C.F.R. § 230.501 (2011).

34. 17 C.F.R. § 230.504.

35. *See supra* note 22, at 3. ("Rule 504 is an effort by the Commission to set aside a clear and workable exemption for small offerings by small issuers.").

36. *See supra* note 34.

solicitation in most cases, it must register the offering on the state level.[37] Thus, even when Regulation D eases the accreditation standards, it cabins in the extent to which non-accredited investors can participate in such offerings.

Regulation D, and other disclosure reforms that attempt to lower the regulatory burden on securities issuers, do naturally have some effect on job creation. It is not the goal of this paper to deny the impact that securities disclosure reform has on the macro economy in general and job creation specifically. To be sure, in the late 1970s there was a push to reexamine the impact of federal securities regulation on small businesses. The SEC was tasked with studying and making recommendations on how small businesses could access investor capital while still ensuring adequate investor protection. The SEC introduced the process as follows:

> The study of the problems confronting small businesses, while a topic of longstanding interest, has recently become the focus of considerable public attention. The wealth of concern for the well-being of that sector stems from the pivotal role it plays in the vitality of the general economy. The contribution of small businesses in supplying jobs, technical innovation, and generally in keeping our system competitive requires that unnecessary obstacles to their formation and growth be removed.
>
> Recent Congressional hearings and studies, studies by Government agencies and the professional literature have attempted to isolate and analyze the factors which impede the success of small businesses. These investigations have shown that the small business problem is exceedingly complex. In large part, it appears that the obstacles faced by small businesses are the product of factors deeply rooted in the economic environment as well as taxation and regulatory policies which are outside the scope of the federal securities laws. Nevertheless, there have been suggestions that the Commission's registration and periodic reporting requirements impose a relatively greater compliance burden on small companies than on large ones. Some have contended further that the net effect of these policies is to endanger the continued existence of smaller companies and to inhibit the formation of new enterprises.[38]

Regulation A is a series of SEC rules aimed at exempting from full registration, securities issued by small and emerging businesses. The offering limit in a twelve-month period has changed over time due to the nature of the marketplace. It currently stands at $5 million; however, the JOBS Act requires the SEC to expand the limit to $50 million.

37. *See* 17 C.F.R. § 230.504(b)(1)(i).

38. *See generally Examination of the Effects of Rules and Regulations on the Ability of Small Businesses to Raise Capital,* Securities Act Release No. 33,5914 (Mar. 6, 1978).

My reason for highlighting the potentially job-creating policy of Regulation A is to argue that while jobs may occupy some space in the disclosure reform conversation, it is an indirect one. I further argue that job creation is one concept embodied by the broader term capital formation but that the two are not mutually exclusive.

2. *The Evolution of the SEC's Gun Jumping Rules up to the JOBS Act*

Section 5 of the '33 Act regulates public securities offerings. As a result of the once-dominant role of the IPO, this section serves a gatekeeping function with respect to the requirements an issuer must follow before offering or selling securities to the public. Section 5(a) makes it unlawful to sell a security unless a registration statement has been filed with the SEC, except for when the issuer relies upon a valid exemption.[39] Section 5(b) deems it unlawful to transmit a prospectus relating to a registered security unless that prospectus both meets the statutory requirements of a prospectus, and the sale of a security is either accompanied or preceded by such a valid prospectus.[40] Finally, and the area of focus for this paper's gun jumping analysis, Section 5(c) prohibits parties (usually directed at issuers and underwriters) from offering to sell a security unless a registration statement has been filed with the SEC.[41] The term "offer" or "offer to sell" is defined broadly as "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[42]

This registration regime makes way for a fully temporal system regulating permissible communications prior to and during a public offering, known as "gun jumping" rules. The gun jumping rules are intended to confront an essential problem with Section 5(c)'s use of the word "offer" and its broad definition. What is a permissible communication before the registration statement has been filed and who may make it?[43] The SEC does not want interested parties to skirt the registration and disclosure rules prior to the time they take effect. Historically, oral and written "offers" by an issuer were not permitted prior to the filing of a registration statement. While serving a potential investor protection end, this policy was thought to hurt the capital formation process by cutting off valuable access to information in anticipation of an IPO.

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39. *See* 15 U.S.C. § 77e(a) (2010).

40. *Id.* § 77e(b).

41. *Id.* § 77e(c).

42. *See id.* § 77b(a)(3).

43. The gun jumping rules also deal with communications once the registration statement has been filed but before being accepted (known as the "waiting period").

One of the reforms designed to open up the stream of communication for issuers was SEC Rule 135. Rule 135 provides an issuer with a non-exclusive safe harbor to divulge certain pre-filing information about an up-coming public offering.[44] Under the rule, issuers may provide general notices including information such as the following: the issuer's name, title, amount, and basic terms of the security as well as the anticipated time of the offering. In addition, the issuer may briefly discuss the manner and purpose of the offering as long as the identity of the underwriter is not disclosed.[45] To ensure compliance, the SEC requires issuers to make a notice filing of any communications relied upon pursuant to the rule.[46] Along similar but slightly different lines, Rule 163A provides issuers with another non-exclusive safe harbor for communications made by or on behalf of an issuer during a period concluding thirty days prior to filing a registration statement.[47] The safe harbor is only available for communications that do not make reference to "a securities offering that is or will be the subject of a registration statement."[48] Both safe harbors are not meant to shield from securities' anti-fraud provisions.

Another area of gun jumping reform that receives fairly consistent attention focuses on research reports and fundamental analyses produced by financial analysts. Previous gun jumping rules could be construed such that analyst reports might violate Section 5(c)'s prohibition on premature securities offerings. SEC Rule 137 provides a safe harbor for certain research analysts to release reports about an issuer going through the IPO process. In a significant reform to Rule 137, the SEC noted, ". . . we believe it is appropriate to make measured revisions to the research rules that are consistent with investor protection but that will permit dissemination of research around the time of an offering under a broader range of circumstances."[49] Rule 137 requires analysis-producing broker-dealers to meet certain requirements in order to avoid potential gun jumping liability. For example, the broker-dealer must not be participating in the registered offering nor may they receive any compensation from the issuer or any of its affiliates for producing the analysis. Finally, the broker-dealer must publish or distribute the report in its regular course of

44. *See* 17 C.F.R. § 230.135 (2011).

45. *Id.*

46. *See generally Regulation of Takeovers and Security Holder Communications*, Securities Act Release No. 33,7760 (Oct. 22, 1999).

47. *See* 17 C.F.R. § 230.163A.

48. *Id.*

49. *See Securities Offering Reform*, Securities Act Release No. 33,8591, at 156 (Dec. 1, 2005).

business.[50] Analyst reforms were the result of an industry push to liberalize the scope of eligible communications prior to and during an issuer's IPO, reflecting new electronic communication methods.[51]

The gun jumping rules and their reforms reflect similar yet slightly different notes on the theme of capital formation compared with Regulation D. While Regulation D rules attempt to spur capital formation through private (exempt) securities offerings, the gun jumping reforms are in the context of public offerings. In one sense, capital formation reforms in the public arena can be seen as a more aggressive push toward encouraging capital formation. Instead of limiting the reform to the private, accredited investor population, the gun jumping reforms evince a willingness to cut into some of the investor protection so famously insisted upon in the public markets. Also relevant to the gun jumping reforms is the concept of the role of information in the public markets. At first blush, it might be easily understood that information in public markets can only serve positive ends. However, as demonstrated through the gun jumping rules, the SEC is sensitive to the timing of publicly released information. In other words, information to the public markets can be positive, but it must not be released too early, in violation of the gun jumping rules.

The history of securities law disclosure reform, as outlined above, serves as a useful baseline to understand the JOBS Act's disclosure reforms. This history reflects that disclosure reform has been driven by investor protection and capital formation concerns. Job creation has served, if at all, as a derivative of capital formation as seen in Regulation A.

II. THE JOBS ACT'S APPROACH TO SECURITIES DISCLOSURE THEORY

The JOBS Act's primary method in achieving its goal of job creation is to reform certain disclosure requirements of the '33 and '34 Acts. As mentioned above, disclosure is at the heart of the regulatory approach to securities transactions in both primary and secondary markets. As such, there is a well-documented body of scholarship on the issue of disclosure in federal and state securities regulation.[52] Background questions are debated (should we retain our mandatory federal disclosure regime?), as well as

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50. *Id.* at 162.

51. *Id.* at 1.

52. While the scholarship on disclosure theory includes dozens of articles, I have made the decision to highlight three perspectives that I believe articulates the debate on securities disclosure law and policy. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) (offering a public choice theory behind the mandatory disclosure principle); *see also* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995) (describing the price "accuracy enhancement" theory of disclosure and its practical effect on the nature of information disclosed).

secondary questions (if we do retain federal disclosure, which disclosures should we require and what metrics do we use to answer that question?). These two questions will form the basis for this paper's review of securities disclosure theory. In order to understand the disclosure approach that the JOBS Act takes, it is important to discuss this securities disclosure orthodoxy. With that foundation in place, my analysis of the JOBS Act's disclosure reforms will be set in the right context.

A. Securities Disclosure Orthodoxy: From Mandatory Disclosure to Issuer Choice

This section attempts to provide the reader with an overview of past disclosure orthodoxy so that the JOBS Act's disclosure choices can be understood in context. Three prominent securities disclosure academics are highlighted, each reflecting a different approach to disclosure's benefits and burdens. Simultaneously, there exists a shared narrative around the parties directly affected by disclosure regardless of the tenor of the disclosure regime. The subsequent section analyzes how the JOBS Act may alter this thinking and what it means for modern securities disclosure.

1. Merritt Fox

Columbia Law School's Merritt Fox takes a somewhat law and economics approach to the issue of securities disclosure. He discusses disclosure as an activity that entails social costs and social benefits, as well as private costs and private benefits.[53] Disclosed information about securities issuers, according to Fox, produces social benefits such as improved selection of new investment opportunities, improved managerial performance, and lower investor risk. Social costs include the time spent by lawyers and accountants in meticulously preparing mandatory disclosure documents, as well as the "diversions" of issuer management and staff in the time spent gathering and producing disclosure information.[54] Fox goes on to state that "[t]he issuer's socially optimal level of disclosure is reached when the marginal social benefits equal the marginal social costs."[55] In other words, there is some point that we could call an equilibrium at which the level and amount of mandatory disclosure optimally balances Fox's social benefits and costs. Considering society's finite resources (time, capital, human resources), this equilibrium is the ultimate goal that securities disclosure should attempt to reach.

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53. Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA L. REV. 1335, 1338-39 (1999).

54. *Id.*

55. *Id.* at 1339.

Against the backdrop of social optimality are an issuer's private disclosure benefits and costs. Issuers often gain private benefits from disclosure because it can reduce the cost of capital due to the reduced risks of the investment.[56] Importantly, Fox states that there are two variations of private costs of disclosure. First, operational costs are the "out-of-pocket expenses and the diversions of management and staff time that issuers incur to provide the required information."[57] While operational costs are also included in Fox's "social costs," there is little doubt that this cost is felt at the firm level. The second private cost, interfirm costs, "arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers, and major customers."[58] Fox notes that interfirm costs are just costs to the issuer because of the corresponding benefit that other firms attain from such disclosure.

This distinction between social and private cost and benefit is Fox's primary evidence for why we should retain mandatory federal securities disclosure laws ("mandatory disclosure") in the United States. "Issuer choice," discussed below in connection with Professor Romano, is the alternative to mandatory disclosure in that it would permit the issuer to choose which jurisdiction regulates it (the SEC, states, or possibly even foreign jurisdictions). Fox argues that if issuers were able to choose among a varying level of disclosure regimes, the issuer would rationally choose a lower disclosure level than would be socially optimal. This is because of the private costs of disclosure to issuers, particularly interfirm costs. Put a different way, Fox is saying that because of the private (firm-level) costs of disclosure, if they had the option, issuers would migrate to a jurisdiction that required a less socially optimal (but more privately optimal) level of disclosure. Fox notes that "[t]his divergence of private from social costs means that issuer choice will lead to market failure and thus presents a serious problem for the proponents of issuer choice."[59] Professor Fox's approach stands as a firm defense of the mandatory federal disclosure regime implemented by the SEC. Fox assumes that if they had the option, issuers would lead the "race to the bottom" to jurisdictions that reduced the private costs of disclosure.

2. *Michael Guttentag*

Professor Michael Guttentag of Loyola Law School takes a middle road position in the debate on mandatory disclosure versus issuer choice. He is

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56. *Id.* at 1358.
57. *Id.* at 1345.
58. *Id.*
59. *Id.* at 1346.

unsatisfied that Fox assumes, without truly balancing costs and benefits of a particular disclosure requirement or proposal, that issuers would always choose less disclosure. Guttentag notes that "a comprehensive microeconomic analysis of disclosure actually can be used to determine the efficacy of specific disclosure requirements . . . ."[60]

Guttentag lays out three categories under which it is most useful to analyze disclosure requirements:

> (1) Costs and benefits realized whether or not a company has publicly traded securities (2) costs and benefits realized only when a company has publicly traded securities and (3) costs and benefits from disclosure that are not realized by the company making the disclosure (externalities).[61]

Guttentag pays homage to the generally accepted benefits from disclosures by an issuer, which include reduced agency costs, lower capital costs, improved liquidity for an issuer's shares, as well as many benefits that an issuer making a disclosure may not itself fully capture (analogous to Fox's "interfirm" costs). He does not, as Fox did, organize the costs and benefits of disclosure by social and private standards, although such standards do play into each of his three categories.

Category one, the costs and benefits realized whether or not a company has publicly traded shares, takes a broad approach because of the sheer number of firms that fall into it. Benefits of disclosure in such circumstances include reduced agency costs, as well as the reduction in the amount of information to which managers have exclusive access.[62] This latter benefit reduces the likelihood that firm managers can hold firms hostage by threat of departing to and sharing information with the competition. Costs of disclosure mostly include "production costs" being the direct cost to the firm of producing information.

The second category focuses on the costs and benefits of disclosure solely for public firms. The primary benefit is that of improved share price accuracy, which can also reduce agency costs and also provide investors with "a more reliable indicator of manager performance, and a more efficient means to reward value creation within the firm."[63] The cost centers around the "publication cost," which is the "competitive disadvantage that may result when a firm discloses proprietary information."[64]

The third category focuses on the costs and benefits of disclosure that are

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60. Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 132 (2004).

61. *Id.*

62. *Id.* at 133-34.

63. *Id.* at 135.

64. *Id.* at 140.

not fully realized by the issuer making the disclosure. Three potential benefits outside the firm may result from disclosure. First, Guttentag discusses Professor Fox's "interfirm" theory that competitors can benefit from disclosed information at a direct cost to the issuer. However, Guttentag is skeptical that these effects are "always positive or that this externality can or should be rectified through regulatory intervention."[65] The second benefit of disclosure by parties outside the issuer is the economy as a whole. The idea here is that disclosures improve the allocation of assets through the greater economy and that more accurate share prices mean more efficient allocation of capital throughout the economy.[66] Guttentag admits, however, that "[a]rguments that relate asset allocation in the economy with public company disclosure requirements are, at best, anecdotal."[67] The final benefit of disclosure outside the issuer could go to investors that do not hold shares in the disclosing issuer. Such investors may get a "free look" at issuer fundamentals meaning that they bear no production costs. Finally, as for potential costs linked with parties in the third category, Guttentag lays out an example to demonstrate the idea. He imagines two firms that both have information that they use for a competitive advantage. If one of those firms is suddenly required to publicly disclose that informational advantage, the profits of both firms would reasonably be harmed due to the dependence on such information staying private.[68]

Guttentag notes that "[a] hybrid regulatory scheme, including some mandatory provisions and some provisions applicable only in certain regimes, could provide an attractive degree of flexibility."[69] Through his methodical balancing system, Guttentag attempts to demonstrate that some disclosure requirements may be justified but that others are not. While he attempts to answer this question through balancing, the test is extremely subjective and could vary widely in its application.

3. *Roberta Romano*

Yale Law School's Roberta Romano advocates for what she calls the "market approach" to securities regulation.[70] Also known as "issuer choice," this approach fundamentally disagrees with the existence of a mandatory federal securities regulation regime:

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65. *Id.* at 136-37.
66. *Id.* at 137.
67. *Id.*
68. *Id.* at 141.
69. *Id.* at 193.
70. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. 2359, 2361 (1998).

> The market approach to securities regulation . . . takes as its paradigm the successful experience of the U.S. states in corporate law, in which the fifty states and the District of Columbia compete for the business of corporate charters. The proposed market approach can be implemented by modifying the federal securities laws in favor of a menu approach to securities regulation under which firms elect whether to be covered by federal law or by the securities law of a specified state, such as their state of incorporation.[71]

Romano's approach values regulatory competition because, as the argument goes, investors will be empowered through electing whether or not to allocate their capital to a firm based on the securities regime of the firm's elected regulator. Romano states that "when the choice of investments includes variation in legal regimes, promoters of firms will find that they can obtain a lower cost of capital by choosing the regime that investors prefer."[72] Taking a page out of the state competition for corporate charters, the market approach to disclosure posits that states will reform disclosure requirements away from current SEC standards and toward those thought to be attractive for firms and investors.

Whether both firms and investors would benefit in a market approach is beyond the scope of this discussion. It is important, however, to highlight whom Romano sees as the ultimate beneficiaries of the market approach: investors and firms. By attaining the flexibility to choose their securities disclosure regime, investors and issuers will ostensibly advance their interests in lower disclosure costs and higher returns, respectively. Despite the larger economic issues created by disclosure regime competition, such as the possibility that more firms would operate in the desired state, no mention is made of disclosure's effects on jobs.

4. *Disclosure Theory – Not About Jobs*

The overarching securities disclosure theory paradigm is designed to analyze the costs and benefits of disclosure. Whether a particular disclosure requirement is a desirable one depends on an analysis of whom the reform will benefit and whom it will harm and by how much. The common thread running through classic securities disclosure theory is that the cost/benefit analysis is largely done on a micro economic scale. That is, the costs and benefits of disclosure are considered as impacting parties in their individual or group-specific capacities as shareholders, issuers, and competitor firms. Classic securities disclosure theory does not factor in macro economic elements such as job creation into its mix of considerations.

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71. *Id.* at 2361-62.
72. *Id.* at 2366.

Professor Guttentag's three cost benefit categories focus on issues of agency costs (investors monitoring firm officers), time spent preparing and disseminating disclosure information (firm lawyers and auditors), and publishing proprietary information (competing firms). Only once, in the context of the impact of disclosure on parties other than issuers, does he mention an impact on the "greater economy." He argues that improved share price accuracy leads to more efficient asset allocation throughout the economy. However, not much else is stated as to how policy makers take efficient asset allocation under consideration when determining whether to require further disclosure or to scale it back. In addition, asset allocation decisions do not necessarily implicate job creation; efficient asset allocation may just mean that investors are more willing to invest in firms or projects that have no plans for any meaningful job expansion. Indeed, if assets are efficiently allocated to firms intending to seek a strategic buyer in a merger or acquisition event, such allocation may very well operate against job creation.[73] It is arguably the case that, before the JOBS Act and discussed in further detail below, disclosure burdens were not viewed as producing a negative externality to the macro economy.

Professor Fox's categories of social costs and benefits of disclosure may appear to understand disclosure's impact on the national economy. However, like Guttentag, Fox's sole macro factor centers on the improved selection of new investments, a social benefit. I believe this factor stands for the principle that disclosure aids investors. Such investors use society's finite resources to allocate capital in the most efficient manner, avoiding (to the extent possible) wasteful investments to unpromising firms. Nothing further is said about the actual benefits of this efficient allocation resulting from disclosure. Instead, Fox focuses on disclosure's costs and benefits at the individual and firm levels. Paying special attention to the private costs of disclosure, Fox says little in the way of social costs of disclosure except for the time and talent of disclosure professionals and the diversion that disclosure causes firms. Finally, Professor Romano's market approach to securities disclosure centers on two parties: the disclosing firms and their investors. Shareholders win, so goes her argument, when the firms they invest in are given the flexibility to choose their own disclosure regime.

B. How the JOBS Act Alters the Focus of Disclosure

Curiously, none of the three disclosure theorists make the connection between disclosure requirements and a burden on job creation. The notion that securities disclosure has a material impact on the macro employment picture is simply inconsistent with how we have historically understood

73. *See supra* note 5.

securities regulation – as a tool to protect investors and to foster capital formation. Certainly, there have been instances in the past where disclosure can be understood as having consequences beyond the firm and investor levels; Regulation A is such an example.[74] Regulation simply cannot be implemented in isolation. However, for the first time in the history of securities regulation, the sole and direct rationale driving the JOBS Act is that one of the costs of securities disclosure is fewer jobs across the economy. This is a departure from classical disclosure theory. While we are still examining the costs and benefits of disclosure, we are now stating unequivocally that a new brand of social cost exists in the form of burdened job growth. Furthermore, disclosure can apparently have an impact on those who are not direct participants in the public markets. Imagine a person who does not invest any of their own savings in the capital markets and struggles, like many, to find stable employment. The rationale behind the JOBS Act is that, despite not being a direct stakeholder in a public company, this person's unemployment is tied, to some extent, to the problem of a burdensome securities disclosure regime.

1. The Deregulatory Reaction to Sarbanes-Oxley and Dodd-Frank

The scholarly and public debate about the cost of disclosure reform has changed dramatically in the past decade. Specifically, there has been an aggressive pushback against regulatory reforms such as Sarbanes-Oxley and Dodd-Frank. Sarbanes-Oxley in particular has received attention from groups such as the American Heritage Foundation and the American Enterprise Institute.

Commentators view Section 404 of Sarbanes-Oxley as a prime example of securities disclosure's job-killing effects. Section 404 requires public company managers, in its annual reports to the SEC, to "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting."[75] In addition, the report must "contain an assessment . . . of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."[76] Perhaps, most controversially, Section 404(b) requires "[w]ith respect to the internal control assessment . . . each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer."[77]

74. *See supra* note 38.
75. 15 U.S.C. § 7262(a)(1) (2012).
76. *Id.* § 7262(a)(2).
77. *Id.* § 7262(b).

For the American Enterprise Institute and others, Section 404(b) has become a critical example of how disclosure requirements for public companies impede job creation. In order to understand the concern, an example may be useful. Suppose Private Co. is a four-year-old non-public company headquartered in Menlo Park, California, that produces and develops an intriguing and potentially valuable mobile application. It has a total staff of fifteen, including its two co-founders. To date, it has received venture financing to shoulder the considerable research and development expenses it faces. However, due to its founders' recognition in the Silicon Valley technology industry, there is some excitement about its growth prospects as well as some rumblings about a future IPO. In addition, there are rumors that two large technology companies are seriously considering making offers to acquire Private Co. Private Co.'s founders, as well as its venture capital partners, are trying to determine the company's next steps. What should the company consider as the costs and benefits of going public?

Alex J. Pollock, a Resident Fellow at the American Enterprise Institute argues that for Private Co., the decision to go public is significantly less attractive because of Sarbanes-Oxley Section 404:

> We now know, after the fact, with five years experience, that Sarbanes-Oxley did indeed unleash a host of expense, paperwork and bureaucracy, and this disproportionately affects small firms. It makes me think of a line from the Declaration of Independence which says, in the bill of particulars against King George III, "He has sent hither swarms of officers to harass the people and eat out their substance." You might say analogously about Sarbanes-Oxley that it has sent hither swarms of accountants to harass the people and eat out their substance.[78]

At this point, it should rightfully be asked what the connection is among Private Co., Sarbanes-Oxley, and job creation. A startup company's decision to go public, so the thinking goes, is deeply impacted by which regulatory requirements await them in its new life as a publicly traded entity. Sarbanes-Oxley Section 404, without an available exemption, is thought to create a far larger burden on companies less able to absorb the cost of compliance. If Section 404 and other recent regulatory reforms are a strong enough deterrent for private firms, they may delay a public offering or decide to forego one altogether, opting instead to stay private or seek a strategic buyer. If private firms remain private longer, the next step of the story is that fewer jobs are created. Why is that so?

There is a considerable body of evidence that the single largest job

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78. Alex J. Pollock, *Has Sarbanes-Oxley Harmed Entrepreneurs?*, AMERICAN ENTERPRISE INSTITUTE (May 24, 2007), http://www.aei.org/article/economics/fiscal-policy/has-sarbanes-oxley-harmed-entrepreneurs/.

creators in the U.S. economy are small companies that have gone public. In 2011, the IPO Task Force, a group of economists, industry experts, and legal academics and practitioners, released a report to the United States Department of the Treasury with its findings on the dwindling IPO market, its effects on job creation, and what can be done about it.[79] The report notes the following:

> The role of EGCs in creating American jobs cannot be understated. From 1980 to 2005, firms less than five years old accounted for all net job growth in the U.S. In fact, 92 percent of job growth occurs after a company's initial public offering.[80]

The report goes on to say –

> Over the last decade, the number of EGCs entering the capital markets through IPOs has plummeted. After achieving a one-year high of 791 IPOs in 1996, the U.S. averaged fewer than 157 per year from 2001 to 2008. Acquisitions by a shrinking number of larger companies (due to the lack of IPOs) have become the primary liquidity vehicle for venture capital-backed companies as compared to IPOs. This is significant because M&A events don't produce the same job growth as IPOs.[81]

The IPO Task Force's paper was almost completely adopted by Congress as Title I of the JOBS Act. Labeled "Reopening American Capital Markets to [EGCs]," Title I is a direct response to the declining IPO market.[82] The '33 Act is reformed to create a new category of securities issuer, an EGC.[83] Such companies must have less than $1 billion in annual gross revenues in the most recent fiscal year.[84] That status is retained for a period of five years post-IPO assuming that the EGC does not first exceed $1 billion in revenue in a given fiscal year or sell more than $1 billion in non-convertible debt over a three year period.[85] With this new status in mind, which would presumably sweep in a significant portion of private companies considering an IPO, Title I then scales back existing IPO regulations or institutes new rules in favor of a public offering.

Section 105 of the JOBS Act permits EGCs to "test the waters" for their public securities without avoiding securities laws as long as such testing is communicated to qualified institutional buyers.[86] The same section also

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79. *See supra* note 5.

80. *Id.* at 5.

81. *Id.*

82. *See* Jumpstart Our Business Startups Act, Pub. L. No. 126-106, § 101, 126 Stat. 306, 307 (2012).

83. *Id.*

84. *See* 15 U.S.C. § 77b(a)(19) (2012).

85. *Id.*

86. *See id.* § 77b(a)(3).

loosens the constraints on publically available information about the company. It will not be considered an "offer" under the '33 Act for a broker-dealer to publish and distribute a research report about the EGC even if the broker-dealer participates in the offering.[87] In addition, an analyst may communicate with the management of an EGC as long as an investment banker from the same firm is present.[88] More liberal analyst coverage leads to greater information in the market, which in turn can lead to accurate pricing, greater investor interest, and deeper liquidity for the security. At the same time, EGCs are given an opportunity (should it serve their interests) to file a confidential registration statement with the SEC.[89] The registration statement becomes public no later than twenty-one days before the company's road show.[90]

Perhaps, the centerpiece of Title I is its "on-ramp" provisions. In order to ease the all or nothing requirements of becoming a public company, the on-ramp eases the transition over a period of five years.[91] To carry the on-ramp analogy further, an EGC may now ease its way onto the public highway by scaling up to full disclosure once it has spent time getting used to its existence as a public company. The on-ramp uses the architecture of scaled back disclosure to achieve this goal. EGCs are exempt from Sarbanes-Oxley Section 404.[92] They need not comply with Dodd-Frank's "say on pay" provisions,[93] and they need only provide two (as opposed to three to five) years of financial audited statements.[94]

Title I has in mind a company much like Private Co.,[95] which has the potential to become a successful public company but which might consider full public disclosure in year one a less attractive option than a high

87. *See* Jumpstart Our Business Startups Act, Pub. L. No. 126-106, § 105.

88. *Id.*

89. *See* 15 U.S.C. § 77f(e).

90. *Id.*

91. *See* Jumpstart Our Business Startups Act, Pub. L. No. 126-106, § 101.

92. *See* 15 U.S.C. § 7262(b).

93. *See id.* § 78n-1(e).

94. *See id.* § 77g(a)(2). Professor Robert Bartlett has gathered some interesting findings on the early usage trends of the on-ramp. Of his own examination of fifty-seven registration statements declared effective between August 2012 and February 2013, nine provided a compensation disclosure and analysis, only six used confidential registration statement treatment, seventeen provided a full three years of audited financial statements, and thirty-six opted out of relief on new accounting standards. *See* Robert Bartlett, The JOBS Act—Where Do We Stand Today?, at 11 (2013) (hereinafter Bartlett Presentation).

95. The IPO Task Force report poses the following hypothetical: "Imagine how different Seattle, Cupertino or Austin would look today if—instead of going public—Microsoft, Apple or Dell had undergone an acquisition by an old-line conglomerate." *See supra* note 5, at 7.

acquisition valuation. While eventually rescinding such favorable treatment, Title I assumes that, generally, the five years of the on-ramp will make a difference in a company's decision to enter the public markets or not. Although there is some evidence to suggest that some eligible firms will not take advantage of the full on-ramp,[96] it is unclear whether the on-ramp (in conjunction with all of Title I) will be the catalyst for the re-emergence of the IPO market.[97]

Yet, not everyone aligns with the notion that IPOs create jobs as vigorously as the ninety-two percent rate suggests. In their 2012 Kauffman Foundation report (the "Ritter Report"), Kenney, Patton, and Ritter analyze employment and revenue growth of domestic operating companies having undergone an IPO from June 1996 to 2012 in the United States.[98] The Ritter Report finds that, for IPOs occurring between June 1996 and December 2000,[99] total post-IPO employment increased in these firms by sixty percent.[100] For EGC IPOs, post-IPO employment increased by sixty-two percent, which is "in contrast to a widely quoted number that 90 percent of job creation occurs after the IPO."[101] The Ritter Report links the ninety percent figure back to an IHS Global Insight study, paid for by the National Venture Capital Association.[102] In an article, after the release of the Ritter Report, Professor Ritter questioned the IPO sample on which the IHS study was based, claiming that there was a tendency to cherry-pick mega IPOs such as eBay and Google.[103] The point in highlighting the Ritter Report's critique is to evidence the broad range of factors supporting the JOBS Act reform, especially Title I.

Aside from the IPO employment numbers, the Ritter Report teases out IPO trends by industry sector. Using the same base sample of operating

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96. *See* Bartlett Presentation, *supra* note 94; *see also* Skadden, Arps, Slate, Meagher & Flom, LLP, *The Jobs Act: What We Learned in the First Nine Months* (2013), http://www.skadden.com/sites/default/files/publications/The_JOBS_Act_What_We_Learned_in_the_First_Nine_Months.pdf (finding that Title I's reduced financial statement reform garnered "weak acceptance," testing the waters received "mixed acceptance" and that reforms on research reports" received "mixed acceptance," among other provisions).

97. *See supra* note 30, at 28.

98. Martin Kenney et al., *Post-IPO Employment and Revenue Growth for the U.S. IPOs*, KAUFMANN FOUNDATION, 1996-2010, at 3.

99. The author notes that this range was chosen because ten years of post-IPO data is available.

100. Kenney, *supra* note 98, at 7.

101. *Id.*

102. *Id.*

103. Jay R. Ritter, *The Facebook Effect: How Many Jobs Do IPOs Really Create?*, FORBES (May 21, 2012, 8:15 AM), http://www.forbes.com/sites/kauffman/2012/05/21/the-facebook-effect-how-many-jobs-do-ipos-really-create/.

company IPOs in the United States between 1996 and 2010, the report finds that the vast majority of IPOs occurred in the Internet, information and communication technology, and biomedical spheres.[104] Retail, manufacturing, and service industries lagged far behind in their IPO volume.[105] In addition, the report found that a few states and regions in particular had a monopoly in IPO events. The leaders are California, Massachusetts, New York, Texas, and Florida.[106] The report also found that among all EGC IPOs, venture capital firms funded more than fifty percent of all such companies and that venture capital involvement was most pronounced in Internet (77.6 percent), biomedical (80.2 percent), and information and communications technology firms (68.3 percent).[107]

2. *Beyond the IPO Market: Equity Meets the Crowd*

The JOBS Act starts rather than stops with IPO reform. Also reformed are Regulation D and Regulation A provisions as well as the '34 Act threshold, whereby private companies become required to produce Exchange Act reports. An additional provision, however, has received at least as much (if not more) attention than Title I. Title III, simply called "Crowdfunding" creates a new registration exemption from Section 5 of the '33 Act.[108] Taking the lead from previous non-equity crowdsourcing models such as Kiva, Kickstarter, and Indiegogo, Title III envisions connecting small businesses with potential investors using the power of the online "crowd." Title III is a momentous reform to United States securities law, one which is seen to "disrupt" traditional financing and is often heralded as "democratizing" it as well.

To achieve this goal, Title III permits crowdfunded issuers to sell securities directly to unaccredited retail investors without first having to register those securities under Section 5 of the '33 Act.[109] Crowdfunded offerings are exempt from state blue sky registration.[110] Investor protection advocates, including the SEC and state securities regulators, have expressed serious concerns about the mixture of information opacity and a presumed financially unsophisticated investor base.[111] They point to the

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104. *Supra* note 98, at 14.

105. *Id.* at 13-14.

106. *Id.* at 15.

107. *Id.* at 16.

108. *See* Jumpstart Our Business Startups Act, Pub. L. No. 126-106, § 201(c)(2)(C), 126 Stat. 306, 315 (2012).

109. *See* 15 U.S.C. § 77d(a)(6) (2012).

110. *See id.* § 77r(b)(4).

111. *Inside Focus: The Jobs Act,* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, http://www.nasaa.org/issues-and-advocacy/issue-focus/.

enormous potential for fraud. In attempt to assuage concerns, the crowdfunding provisions sets limits on the three primary parties involved in a crowdfunded transaction.

First, investors are capped at the annual amount they can invest in a company relying on the crowdfunding exemption. For those earning less than $100,000 per year, their investment cannot exceed the greater of $2000 or five percent of annual income or net worth.[112] For investors earning more than $100,000 per year, investments cannot exceed ten percent of annual income or net worth, and in no case may the investment amount to more than $100,000.[113] Second, crowdfunded issuers are limited to raising no more than $1,000,000 in reliance on the exemption during the twelve month period prior to the date of the transaction.[114] Finally, while the House bill did not envision a middleman, the final version of Title III requires that sales of crowdfunded securities occur through registered "funding portals" that will be scrutinized akin to a broker-dealer.[115]

Title III as well as the other non-IPO reforms point to an interesting query; if the JOBS Act is motivated by job creation and if IPOs are the most significant job-creating events, why include the other provisions? In fact, these provisions (crowdfunding, Regulation D, Regulation A, and the reform to Section 12(g)) all allow companies to more easily remain private. This may appear to be an internal contradiction in the structure of the JOBS Act. However, perhaps it is more indicative of Congress' broad attempt to achieve the task of putting more Americans back to work. This congressional goal has changed the way in which we think about the costs and benefits of securities disclosure theory, and it sets a new precedent for future reforms.

3. *Recent Trends in Securities Disclosure*

After a thorough review of legal and financial papers on securities disclosure, it still cannot be said that much attention has been paid to the relationship between disclosure and job creation. However, as a result of the JOBS Act, there has been some commentary that appears to show a move toward making such a connection even if it is in critical response to the idea.

In his most recent paper on securities disclosure, Professor Michael Guttentag plays on a familiar theme by discussing when firms should be

112. 15 U.S.C. § 77d(a)(6)(B)(i).

113. *Id.* § 77d(a)(6)(B)(ii).

114. *Id.* § 77d(a)(6)(A).

115. *See id.* § 77d-1(a).

required to comply with federal disclosure requirements.[116] However, his paper was written in the context of the JOBS Act making it easier for firms to skirt federally mandated disclosure provisions which "were enacted based upon a virtually nonexistent legislative record and upended rules established only after careful consideration almost fifty years earlier."[117] Professor Guttentag's paper calls for the creation of a three-tiered system with respect to what he calls "federal periodic disclosure requirements" ("FPDRs").[118] First, firms with a market capitalization of less than $35 million would receive an automatic exemption from the federal securities disclosure regime.[119] Second, for firms that are not eligible for the automatic exemption, they may steer clear of disclosure if they take "specified ameliorative measures to minimize the societal costs from persistent underdisclosure."[120] Third, for firms that do not fit into category one or two, such firms must comply with the full range of FPDRs.[121]

While Professor Guttentag presents a new framework for securities disclosure, the most relevant comments with regard to the JOBS Act come in the form of discussing who benefits from its passage, specifically the rules allowing firms to more easily remain private. While he does not drill down on the job creation theme, he might be seen as dismissing the jobs rationale through his remarks on who the JOBS Act deems as winners. The first winners are firms that operate private exchanges, such as SecondMarket, Inc. Given Title V of the JOBS Act, which now permits companies with fewer than 2,000 holders of record, Professor Guttentag notes that "[m]any more firms will probably allow their securities to be traded on these secondary private markets."[122] The second beneficiary is technology firms and financial institutions. For venture-backed technology firms, this means that employees receiving options (or even fully vested shares) will not count toward the 2000 threshold. This provides such firms with added flexibility to recruit needed talent yet avoid federal disclosure obligations. Financial institutions, especially banks, will now also be able to more easily avoid disclosure. Professor Guttentag describes this deregulatory effort as one that was pushed through Congress with little

116. *See* Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules That Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151 (2013) (forming an alternative framework for when firms should be required to comply with federal disclosure requirements).

117. *Id.* at 151.

118. *Id.* at 155.

119. *Id.* at 200-01.

120. *Id.* at 199.

121. *Id.*

122. *Id.* at 175-76.

resistance from those that had fought so long to build a thoughtful disclosure regime.[123] It is almost as if he goes out of his way to discuss the utter lack of debate around such drastic changes to the disclosure status quo.

Professors Donald Langevoort and Robert Thompson, in a recent article on the dividing line between public and private company status, also highlight the JOBS Act's Section 12(g) reform.[124] Early in their paper, they discuss Facebook's pre-JOBS Act dilemma as it was creeping up on the then 500 shareholders of record threshold.[125] The authors find that Congress sympathized with Facebook's dilemma (i.e. the dilemma between raising capital and triggering the public reporting requirements of Section 12(g)) and that other technology firms had similar issues. Between the Section 12(g) reform, crowdfunding, and other JOBS Act reforms, the authors state that they were "all stylized as job creation mechanisms—a particularly potent political label heading into an election year—and bipartisan momentum grew."[126] And while the paper generally discusses the fault line between public and private company status as evidenced by Section 12(g), the authors take an opportunity to call crowdfunding "a pure trade-off of investor protection in the hope of job creation."[127]

Outside the legal academy, there has been at least one influential voice making the connection between securities disclosure and job creation. Speaking at the Council of Institutional Investors Spring Meeting just one year before passage of the JOBS Act, SEC Commissioner Luis Aguilar highlighted the connection between "the real economy" and "capital formation."[128] While suggesting that part of the SEC's mission, capital formation, was never specifically defined, he attempted to give some life to that phrase by noting that it "is about all the ways of creating productive capital in our economy, including but not limited to improving infrastructure, building plants, and hiring workers."[129] Commissioner Aguilar contrasts that with "raising capital."[130] He goes on to state that if capital formation were just about raising capital, then certain illiquid

123. *Id.* at 177.

124. Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After The JOBS Act*, 101 GEO. L.J. 337 (2013).

125. *Id.* at 338.

126. *Id.* at 339.

127. *Id.* at 339 n. 122.

128. Luis A. Aguilar, Commissioner, Securities and Exchange Commission, Address at the Council of Institutional Investors Spring Meeting: Facilitating Real Capital Formation (Apr. 4, 2011).

129. *Id.* at 2.

130. *Id.* at 3.

mortgage-backed securities as well as Ponzi schemes would fit the definition.[131] True capital formation, as a result, would have effects on the "real economy," which, in the wake of the financial crisis, Aguilar is particularly concerned with. What is striking is the confluence of events surrounding the passage of the JOBS Act. Commissioner Aguilar's statements, symbolic because of his position of authority at the SEC, accept the position that statutory and regulatory disclosure choices affect the real economy, including job creation. The "productive capital" understanding of capital formation provided an intellectual foundation on which the JOBS Act could solidly stand.

III. WHAT ROLE, IF ANY, SHOULD JOB CREATION PLAY IN THE REFORM OF SECURITIES LAW DISCLOSURE?

The issue of job creation has played a minor and indirect role in the history of American securities regulation. When it comes to securities disclosure requirements, the primary method of analyzing them has been through a cost/benefit analysis focused on the effects on those parties most directly involved – issuers and investors. Within the last ten to fifteen years, however, a new angle on securities disclosure has become prominent. This new inquiry expands on the historic analysis by examining disclosure's effects on the macro economy, particularly employment figures. In this final major section, I will first examine, through two distinct narratives, whether or not the JOBS Act really is about jobs. Second, I will highlight certain concerns about reforming disclosure law through the guise of job creation. Finally, I will propose a framework for what role job creation can safely play in the reform of securities disclosure law.

A. Is the JOBS Act Really About Jobs? Two Distinct Narratives

The JOBS Act, despite its extreme brevity (twenty-two pages) allows the imagination to wander. Why attempt to create jobs through securities disclosure? Why was there such a rush to push the bill through Congress, and why did it receive such unprecedented bi-partisan support? Is there another story, beyond job creation, that is a driving force behind this reform? I see at least two stories that can be told.

1. Story One: The JOBS Act as Job Creation Agent

There is ample evidence to support the narrative that the JOBS Act was passed to help small businesses access investor capital, expand, and in the process, create jobs. In its report, the IPO Task Force found that between

131. *Id.*

1997 and 2001 "the prevalence of IPOs versus acquisitions of EGCs has undergone a stunning reversal."[132] This matters, according to the report, because mergers and acquisitions ("M&A") do not result in the same high level job growth as IPOs do.[133] The report also noted that, according to United States Labor Department statistics, "up to 22 million jobs may have been lost because of our broken IPO market."[134] The link between IPOs and job creation is then made in clear terms: "[t]he losers of the IPO crisis are the [United States] workers who would have been hired by EGCs had they been able to go public and generate new jobs through their subsequent growth."[135]

Further examples of a compelling connection between securities disclosure, the IPO market, and job creation abound. Silicon Valley Bank conducted a survey of 270 executives of startup companies in late 2012.[136] The survey notes that thirty-five percent of respondents stated that their biggest challenge is the regulatory/political environment.[137] In addition, thirty-six percent of executives stated that access to equity financing was one of their greatest challenges.[138] As for the issue of hiring new workers, the survey found that eighty-three percent of startups have plans to add to their workforce over the next twelve months.[139] When asked about the "importance of potential changes in providing capital," sixty-nine percent of respondents answered that the IPO on-ramp structure was important.[140] Seventy-two percent answered that making it easier for private companies to raise capital from accredited investors was important.[141] Even though this survey was completed after the passage of the JOBS Act, it is the kind of persuasive evidence that forms the narrative that the JOBS Act is genuinely concerned about job creation.

Efforts to support the job creation story came on all fronts. Perhaps, most impactful, from a visceral perspective, were statements from small businesses owners themselves. Speaking to the House of Representatives, months before the passage of the final legislation, one small business owner made a plea that embodies the spirit of the job creation narrative:

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132. *See supra* note 5, at 6.

133. *Id.*

134. *Id.* at 7.

135. *Id.*

136. *See generally* SILICON VALLEY BANK, STARTUP 2012 OUTLOOK (2012), *available at* http://www.svb.com/startup-outlook-2012/.

137. *Id.* at 5.

138. *Id.*

139. *Id.* at 10.

140. *Id.* at 21.

141. *Id.*

> [A]s a small business owner, I know that it's tough to get access to capital . . . . If a company doesn't have the resources it needs to grow and expand, then it's virtually impossible to hire new workers. Without a doubt, by allowing companies access to the markets, we give them the opportunity to succeed, and, in turn, they will have the opportunity to create additional jobs, which is what we desperately need. With an unemployment rate of over 8 percent for the past 34 months and at least 9 percent for 28 of those months, it's about time that we moved forward on the jobs package that we're trying to push in the House. We need to step up and get America back to work.[142]

It is interesting to note that Congress, not the SEC, was the body to enact the JOBS Act (although the SEC plays a central role in various of the Act's rulemaking provisions). It supports the job creation story that Congress spoke so affirmatively. Job creation, after all, is an issue rife with political underpinnings. Had the SEC been the principal architect, I suggest that their reforms would have been narrower and more attuned to the principle of investor protection, not job creation.

2. *Story Two: The JOBS Act as More Than Meets the Eye*

Story two is a darker or at least a deeper story than story one. Story two is summarized by a statement from Senator Carl Levin (D-MI) who succeeded in amending the original house bill:

> The problem is that in the guise of job creation, this legislation rolls back important investor protections and transparency requirements that are fundamental to our capital markets. Under the legislation the House has sent us, investors will know less about the companies they are solicited to invest in. They will have less confidence those companies follow standard accounting practices. They will have no assurance that the solicitation they've just received over the Internet or by telephone is for a legitimate company and not a boiler room fraud operation.[143]

In other words, story two suggests that while job creation may have been a concern under the JOBS Act, it is at best a background issue. And if jobs are created through the various mechanisms that define the Act, that is all the better. But the primary objective is to scale back allegedly draconian disclosure regulations that have been piling up for decades, highlighted by the passage of Sarbanes-Oxley in 2002. Instead of using transparent language about its primary purpose, proponents of the JOBS Act found it more politically expedient to couch the reforms in terms of job creation. After all, what politician would wish to be seen as unsupportive of job-creating legislation?

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142. 157 CONG. REC. H9801-01 (Dec. 16, 2011) (statement of Mr. Dold).

143. 158 CONG. REC. S1776-02 (Mar. 19, 2012) (statement of Sen. Carl Levin).

As previously mentioned above, a vocal and influential deregulatory movement arose in the wake of Sarbanes-Oxley. Much attention was given to the issue of small public company compliance with Sarbanes-Oxley Section 404. For example, in 2007, The Heritage Foundation stated that the SEC underestimated the compliance cost of Sarbanes-Oxley Section 404.[144] They highlighted that some compliance cost estimates "put the average cost of direct compliance costs and outside auditing fees in 2006 at 2.5 percent of a company's revenues."[145]

Another critical piece of evidence that supports the second story is objective insight on which kind of entity is using the JOBS Act's job-creating provisions. Take the IPO on-ramp for example. In his assessment of fifty-seven EGC registration statements (filed pursuant to Title I of the JOBS Act), Berkeley Law Professor Robert Bartlett uncovered interesting data on who is taking advantage of the lessened disclosure. He found that at least twenty of the fifty-seven entities listed a Standard Industrial Classification for being a shell corporation or holding company and that at least nine were so-called blank check acquisition companies. Some were wholly owned subsidiaries of non-EGCs.[146]

Professor Usha Rodrigues has provided further insight into the connection between Title I and non-operating companies that are taking advantage of the IPO on-ramp provisions. She notes that special purpose acquisition corporations ("SPACs") are finding it attractive to use the IPO on-ramp. A SPAC is a blank check or shell corporation that engages in a public offering to raise a pool of cash in search for a target company to acquire. Investors buy interests in the SPAC itself, which derives returns from the target company that it acquires. Rodrigues calls SPACs "in essence, a one-off private equity fund."[147] SPACs permit ordinary investors to invest in pooled investment vehicles that, but for its public offering, retain a private equity strategy and investment opportunity that most public securities do not. Rodrigues notes that SPACs are not the operating companies that Congress envisioned using Title I.[148] Rodrigues uncovered certain findings with regard to SPAC use of Title I:

> Indeed, in the eight weeks after the JOBS Act's passage, over a dozen of

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144. David C. John & Nancy M. Marano, *The Sarbanes-Oxley Act: Do We Need a Regulatory or Legislative Fix?*, THE HERITAGE FOUNDATION (May 16, 2007), http://www.heritage.org/research/reports/2007/05/the-sarbanes-oxley-act-do-we-need-a-regulatory-or-legislative-fix#_ftn19.

145. *Id.*

146. *See* Bartlett Presentation, *supra* note 94, at 11.

147. Usha Rodrigues, *SPACs and the JOBS Act*, 3 HARV. BUS. L. REV. ONLINE 17 (2012).

148. *Id.* at 20.

> the companies taking advantage of the new on-ramp option were SPACs. Four months after the JOBS Act's passage, one out of every nine EGCs was a SPAC. The trend has not abated; in the first half of August 2012, one out of five firms that made use of the IPO on-ramp provision were SPACs. To say the least, SPACs are making good use of the EGC option.[149]

We should expect to see very little job creation coming out of SPAC use of Title I, which leads to the next line of narrative in story two. Rodrigues notes that "[n]othing in the JOBS Act requires that EGCs be job creators – they just have to have 'total annual gross revenues of less than $1 billion.'"[150] While we may take the definition of an EGC for granted, it is an incredibly important issue because it is the threshold question for whether a company (SPAC and operating company alike) may use Title I. If the JOBS Act was intended to create jobs, why not tie the definition of EGC to, well, job creation? This could be done in numerous ways. Before using EGC status, a company could be required to show detailed projections on how it will create jobs, which kinds of jobs, and how long they would last for. Alternatively, a company could be required to show that after, say, two years, it has created a certain threshold amount of jobs or risk losing EGC status. In any event, it is worth noting the complete lack of job creation metrics that go into the determination of whether or not a company may use Title I. This supports story two's concern that the JOBS Act has little or nothing to do with job creation and that it has everything to do with ratcheting back disclosure regulations at the cost of investor protection.

While the two narratives tell diverging stories about the purpose of the JOBS Act, it is also likely, of course, that the heart of the story is somewhere in between. Perhaps even the most cynical political observer would have difficulty suggesting that the JOBS Act was in no way about creating jobs. Likewise, it would be almost bad faith for an industry representative to suggest that there were not serious efforts to scale back disclosure requirements. The difficult, and for now unanswerable question, is whether the JOBS Act will create jobs, and if so, how many and whether the decrease in investor protection will have been a worthy tradeoff.[151]

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149. *Id.* at 19.

150. Usha Rodrigues, *SPACs and JOBS*, THE CONGLOMERATE (Jun. 5, 2012), http://www.theconglomerate.org/2012/06/spacs-and-jobs.html.

151. *America's JOBS Act, Still Not Working*, THE ECONOMIST (Mar. 30, 2013), *available at* http://www.economist.com/news/finance-and-economics/21574516-law-designed-jump-start-businesses-cant-get-ground-still-not-working.

B. *Unintended Consequences of Reforming Disclosure Law Through the Gloss of Gob Creation*

As noted above, the SEC's mission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[152] It could reasonably be argued, therefore, that the JOBS Act simply made the decision to favor capital formation over investor protection. However, I argue that job creation and capital formation are not the same and that reforming securities disclosure through the politically efficient guise of job creation can have various unintended consequences on United States securities markets.

First, the assumption that lowering the regulatory burden on issuers will leave them with more flexibility and room to create jobs is not without problems. Harvard Law School's John Coates testified in front of the House Subcommittee on Securities, Insurance, and Investment about the potential effects of the JOBS Act. Professor Coates began his remarks by suggesting that the framework for thinking about reformation of securities laws has not been communicated properly.[153] Coates stated that the JOBS Act proposals change the balance between the costs of raising capital on the one hand and the combined costs of fraud risk, asymmetry of information, and unverifiable information on the other.[154] Coates noted that investors charge a higher cost for their capital if there is an anticipation of fraud or the inability to verify information about their investment.[155] It follows, according to Coates, that disclosure, anti-fraud rules, and enforcement mechanisms lower the cost of capital.

Interestingly, lowering disclosure and other regulatory requirements can reduce job creation. This is because, as Professor Coates describes, "a reduction in [offering] costs can be more than offset in an increase in capital costs, if the reduction in direct offering costs decreases investor confidence or the content or reliability of information required by investors."[156] This may depend, as Coates concedes, on just how much the reforms lower offering costs, how widespread the use of the reforms is, how often fraud can be expected from the new reforms, and how much more difficult, if at all, it will be to verify company information.[157] While

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152. *See supra* note 6.

153. *Examining Investor Risks in Capital Raising, Hearing Before the Subcommittee on Banking, Housing, and Urban Affairs*, 112th Cong. 2 (2011) (written testimony of Professor John C. Coates IV).

154. *Id.*

155. *Id.*

156. *Id.* at 33.

157. *Id.*

the notion that disclosure can lower the cost of capital is well-supported,[158] as discussed in the previous section, the connection between disclosure and job creation has not traditionally been made.

Second, ensuring that small businesses gain fair access to investor capital is an interest that the SEC must meet, but the goal should not necessarily be that all small businesses receive investor-backed capital. For example, if more companies can access capital through the IPO on-ramp, through crowdfunding, or through various of the JOBS Act's other provisions, what does this say about job creation? If all provisions include lessened disclosure and fewer investor safeguards, more cash in the hands of new companies might create something of a bubble effect. Kathleen Shelton Smith, Co-Founder of Renaissance Capital, LLC testified in front of the Senate Committee on Banking, Housing, and Urban Affairs about just this problem.

> Measures to ease costly regulatory burdens that weigh most heavily on small firms may be helpful. At the same time, care must be taken in waiving certain disclosure and stock promotion rules that could result in misallocating capital to weak or fraudulent companies. Weak companies that ultimately fail cause job losses, not job creation, and result in serious stock market losses to investors who abandon the IPO market, as was the case after the internet bubble burst.[159]

While Congress nor the SEC will be able to perfectly locate the dividing line between job creation and job destruction, Shelton Smith's caution is a valid one. If nothing else, it cautions Congress, and the SEC as rulemaking implementer, that we should not get blinded by the excitement that more small businesses will receive investor money. Former SEC Chief Accountant Lynn E. Turner agrees. Testifying at the same hearing as Shelton Smith, Turner recalled the dotcom bubble of the late 90s:

> In fact, during the heydays of the IPO market of the 1990's, many companies went public and took money from investors that never should have. Yet shortly after going public, as Exhibit 2 notes, many failed, causing investors great losses in their retirement and college education savings accounts, and destroyed over a hundred thousand jobs. Many large pension funds have never been able to recover to their pre dot com bust funding levels, leaving Americans wondering where the money will come for their retirement.[160]

158. *See supra* note 116, at 179.

159. *Spurring Job Growth Through Capital Formation While Protecting Investors, Hearing Before the Committee on Banking, Housing, and Urban Affairs*, 112th Cong. 44 (2012) (written testimony of Kathleen Shelton Smith).

160. *Spurring Job Growth Through Capital Formation While Protecting Investors, Hearing Before the Committee on Banking, Housing, and Urban Affairs*, 112th Cong. 10 (2012) (written testimony of Lynn E. Turner).

The second unintended consequence, in summary, is that of a bubble effect. Just because more companies can issue securities to a wider audience, it does not necessarily follow that these are sound investments. Best case scenario, investors will have more companies to invest in, perhaps diversifying their portfolio. Worst case scenario, investors rush to place capital in untested companies without regard for fundamentals, leading to a small issuer bubble. In any event, the SEC should be vigilant in bringing enforcement actions against fraudulent issuers, setting the precedent that systemic risks will be monitored closely.

The third issue is part unintended consequence and partially a plea that SEC's "capital formation" mission not be considered synonymous with job creation. While capital formation can lead to job creation, it does not necessarily do so. If we were to operate under the assumption that the job creation goal behind the JOBS Act is simply exercising the capital formation directive, I argue that this is going too far because it misconstrues the various other factors that capital formation embodies. Consider the various ways, through the following non-exhaustive list, whereby capital can be raised with little to no job creation resulting. First, an issuer could raise capital to invest in a certain technology that, instead of creating jobs, makes current jobs duplicative and eventually unnecessary. Second, a company could raise money to pay off certain debt obligations without investing in infrastructure or personnel. Third, and finally, entities could raise capital not for the purpose of adding to an operating company's human resources as is common in the financing of private funds. As discussed above in Section II, there is strong evidence that the most frequent users of Regulation D are not operating companies, but they are private investment funds such as hedge funds and private equity funds. The direct purpose of this capital formation is not job creation, although an argument could be made that some job creation could result from these private fund activities. Rather, the purpose of this kind of capital formation is to realize investor gains and for the general partner to operate a successful and lucrative management firm. In any event, the noteworthy issue here is that capital formation and job creation should not be confused as being fully aligned. While they do converge under various conditions, they also diverge in important ways. Because this is true, calling the JOBS Act a "capital formation" act does not reveal the full nuance of what capital formation is and how the SEC attempts to both encourage it and restrain it. If we conflate capital formation with job creation, we risk scaling back investor protections because the politically expedient notion of job creation could easily trump investor protection. It is important that we understand the full scope of the underpinnings of reform before we start any cost/ benefit analyses.

C. *What Is the Proper Role of Job Creation in Securities Disclosure Reform?*

The vast history of American securities regulation demonstrates that job creation plays, at best, an indirect relationship with the reformation of disclosure. In most cases, job creation does not play a role at all. Over the last decade, a shift has occurred to include the jobs picture in the same conversation as securities regulation, especially on the issue of disclosure. A vocal critical mass has reacted to what is perceived as an overzealous response to the accounting scandals of the early 2000s and the financial crisis of 2008. I would go so far to say that the issue of job creation is now a bona fide factor that merits some attention when considering public company disclosure requirements. It would seem that, given our connected financial markets, the days of a dividing line between capital markets and macro economic concepts is blurrier than it ever has been.

This change is clearly demonstrated by Title I of the JOBS Act. I would suggest that there is indeed a legitimate connection between the IPO market and job creation. This point is not only intuitive; it is also supported by empirical evidence.[161] The decision of whether or not to raise capital in the public markets necessarily involves an analysis of whether existence as a public company is worth the regulatory oversight.[162] With a more robust set of public company regulations after Sarbanes-Oxley and Dodd-Frank, that public/private decision is not necessarily a simple analysis. If IPOs really are the job-creating events that the data suggest they are, then there is truly something at stake for the United States employment picture. In passing Title I, I would argue that Congress does not have to predict the arch of the IPO market. While small company IPOs are down, that does not mean that Title I is an invalid idea. Additionally, it is important to remember that Title I does not relieve EGCs from full public company disclosure requirements forever. As much as EGCs can initially avoid certain disclosures, they must attain full public company compliance in at most five years. In summary, I believe that there is a valid connection between jobs and disclosure in Title I. The regulatory climate has changed to incorporate rather than exclude securities disclosure from larger economic issues such as employment rates. How then, do the other parts of the JOBS Act hold up in this new model? When should jobs be part of disclosure reform and when should they be excluded?

The majority of the remaining provisions in the JOBS Act are a different matter. For example, Title III's crowdfunding provisions do not possess an innate connection with job creation. While the provision does afford small

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161. See *supra* note 5.

162. 15 U.S.C. § 78l(g) (2012).

businesses a unique new alternative to raise capital through equity sales, the net result is less about job creation and more about the ease with which capital formation takes shape. As I noted above, job creation and capital formation diverge in important ways. Small businesses, that could presumably take advantage of the crowdfunding provisions, have not had to rely on crowdfunding to form and operate their companies. Various sources of capital for such non capital-intensive businesses have and still are available: friends and family money, bank loans, and other loan financing and borrowing options. Whether jobs will all of a sudden be created by crowdfunding is a question that does not have an easy answer; time will tell whether such offerings produce jobs. A second example of the tenuous connection between jobs and the JOBS Act is found in Title V of the Act. Private companies may now avoid '34 Act reporting obligations (and therefore essentially refrain from being "forced" to go public) by maintaining fewer than 2,000 investors or fewer than 500 non-accredited investors. While the goal of permitting companies to stay private longer is not itself an ill-intentioned one, the job creation portion runs up against an internal inconsistency. If IPOs are the job-creating events that Tittle I suggests, then allowing companies to stay further and further away from an IPO may not align with the job creation vision. It could be argued that the JOBS Act is really a buffet line of choices for entrepreneurs to choose their best funding options. Be that as it may, it remains troubling to slap the "job creation" sticker on the entire Act even though various parts of the Act operate to the contrary.

Assuming that the job creation and employment themes are here to stay in securities disclosure, what then should be the proper role of this theme in future disclosure debates? This section concludes with a framework that I suggest could be a way to thoughtfully decide if job creation should play a direct role in securities disclosure reform. Each of the framework's three components is discussed in turn.

First, some empirical evidence about the connection between job creation and disclosure should be presented and analyzed. Because job creation is a relatively new direct consideration in reforming disclosure, I suggest that the burden of production rest with the party making the job creation connection. While I am not offering a precise mechanism to determine exactly how and when such a burden is met, the evidence that supported Title I of the JOBS Act is a good starting point. The IPO Task Force Report contained a detailed overview and analysis on the connection between the IPO market and the employment health of the United States[163]

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163. While this data was disputed in the Ritter Report, my point is not to drum up controversy; rather, it is to suggest that some empirical work should be presented, leaving their merits up to Congress, the SEC, and the various other constituencies.

The remaining provisions in the Act were not accompanied by any such analysis. Because of the concerns about unintended consequences listed above, the job creation position should not simply be taken for granted as happened in the passage of the JOBS Act. There was almost a sense that Congress was scrambling to put all potential job creating options on the table despite a lack of reasoned analysis and evidence. In the future, the threshold step for job creation vis a vis securities disclosure should be a prima facie case demonstrating a legitimate connection.

Second, assuming a prima facie showing is made in step one, a cost/benefit analysis should be done to determine whether the interests of reform outweigh the existing disclosure mechanism. This step is not unique to the job creation element. As mentioned above, the cost/benefit analysis is a traditional method to understand the merits of disclosure. There is no reason why the cost/benefit analysis should be eliminated despite a significant shift in the disclosure paradigm. It could be said that a cost/benefit analysis is broad enough to permit parties to skew the analysis in their favor. The reality is that the SEC is generally the arbiter of such analyses, and interested parties will be incentivized to have their points of view considered before the SEC promulgates final rules. Interestingly, Congress, not the SEC, was the body that could have done such a cost/benefit analysis in the run up to the JOBS Act. In any event, the SEC will still have considerable JOBS Act discretion as it implements highly anticipated rules on crowdfunding and general solicitation, among others.

Third, and lastly, assuming that disclosure reform is perceived as the best way forward, the reform should be limited to the precise issue seen to be the burden on job creation. This final step comes from an observation about the JOBS Act. While the legitimate connection between job creation and disclosure was found in Title I, the job creation theme was used across the entire Act. In order to ensure that job creation is not an open ended label for non-job reforms, the reform should be "narrowly tailored" to use the United States Supreme Court's strict scrutiny language. One example of narrow tailoring in this context would be to examine which industry the proposed jobs would benefit. If we are discussing Internet or life sciences companies, there is a tighter fit between disclosure and job creation than in the manufacturing or services industries.[164] Similarly, if we are examining a disclosure proposal that would affect certain companies (regardless of industry sector) over others, what is the job-creation potential of such companies? While Title I does not condition its EGC definition to any job creation metrics, a more narrowly tailored examination of lessened disclosure would discover how such a company would produce jobs for the

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164. *See supra* note 98.

American economy. Had the narrow tailoring standard been applied to the JOBS Act, I suggest that Title I would have been the only provision to pass muster.

This framework is not intended to serve as an appellate court's standard of review. Nor is it easily applied to congressional action, which, apart from its constitutionally enumerated powers, need not follow any given formula to pass legislation. I would still argue that the framework offers useful guidance for explaining congressional action in the realm of securities disclosure law. The framework also applies to the SEC in its deliberations during the rulemaking process. Certainly the SEC will receive copious public comments about proposed changes to securities disclosure rules. The framework should be applied when those changes involve alleged job creating goals.

CONCLUSION

What role, if any, should job creation occupy in the reform of United States securities disclosure laws? To consider the connection between jobs and disclosure, historical analysis provides time-tested baseline justifications for disclosure reform. Investor protection reforms have focused on enhancing both the strength of disclosure tools and the audience eligible to reap their benefits. Capital formation reforms emphasize the need for securities-issuing firms to obtain flexibility in their offerings, especially to so-called sophisticated investors who may intrinsically need less disclosure. Both justifications for reform do not directly intend to bolster job creation. Capital formation has historically been limited to facilitating transactions between private parties as opposed to making a larger impact on the real economy. As Commissioner Aguilar points out, however, that view is now in question.[165]

Changes in disclosure theory also abound. While, historically, disclosure theory has focused on disclosure's costs and benefits to those parties immediately involved in a securities transaction, a steady deregulatory narrative, low employment numbers, and an election year have all contributed in shifting the disclosure conversation. Disclosure's costs and benefits (although primarily its costs) are now considered in the context of the real economy. While little academic attention has been paid to this directional shift, some commentators have expressed doubt about the connection between jobs and the JOBS Act.[166]

While the justification for JOBS Act reforms may be questioned as

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165. *See supra* note 128.

166. *See* Guttentag, *supra* note 116; *see also* Langevort & Thompson, *supra* note 124.

having ulterior motives, there may be real and potentially damaging unintended consequences as a result of them. First, a reduction in offering costs (due to the lessened cost of disclosure) could be offset by an increase in the cost of raising capital due to lack of investor confidence in opaque investments. Second, allocating capital to weak or fraudulent companies (which attributes may more easily be kept hidden without robust disclosure) can cause job losses resulting from failed firms and potential market bubble effects caused by less informed and frenzied investor behavior. Finally, I argue that job creation is not necessarily capital formation and that capital formation reforms do not necessarily have to deemphasize investor protection.

It appears, however, that the real economy, with job creation as the cause du jour, is now a part of the disclosure conversation. This may be indicative of a broader trend toward the integration of the disparate facets of the global financial system, markets, financial institutions, and the economy sharing a common fate. Therefore, it is useful to consider how and when jobs should fit into the mix of variables that policymakers consider when reforming disclosure statutes and rules. First, some empirical connection between jobs and disclosure should be required. Without it, disclosure could take on an experimental character that could produce a less efficient capital markets system. Second, if there is a credible connection between jobs and disclosure, a traditional cost/benefit analysis should be done rather than assuming that disclosure's burdens outweigh its benefits. Should the disclosure reform prevail, it should be narrowly tailored to the precise issue that directly affects job creation. The JOBS Act's Title I is the best example of this closer fit; high technology and other venture-backed companies have turned away from the IPO mechanism in favor of strategic combinations through a merger or acquisition. However, no such direct connection exists (or has at least been convincingly shown) between small business owners looking to raise capital over the internet, as Title III will permit once the necessary crowdfunding rules are in place.

It is noteworthy that in May 2013, the period in which this paper concludes, the number of Americans seeking "initial jobless benefits" has decreased to the lowest level since January 2008.[167] The unemployment rate is down slightly at 7.5 percent.[168] Rarely do such reports discuss the

167. Eric Morath & Josh Mitchell, *U.S. Jobless Claims Fall to 5-Year Low*, WALL ST. J. (May 2, 2013, 11:24 AM), http://online.wsj.com/article/SB10001424127887324766604578458602085955608.html?mod=WSJ_hp_LEFTWhatsNewsCollection.

168. Sudeep Reddy, *Job Gains Calm Slump Worries*, WALL ST. J. (May 3, 2013, 8:20 AM), http://online.wsj.com/article/SB10001424127887323628004578460602683732428.html?mod=WSJ_hp_LEFTWhatsNewsCollection.

role that the JOBS Act plays in the employment sphere. In fact, the most recent jobs report disclosed that the increase of 176,000 private sector jobs occurred primarily in service industries.[169] The modest role played by the JOBS Act could be due to its relative immaturity and lack of fully implemented rules. We might not fully understand the job-creating potential of the legislation for years, until jobs data is available, particularly in the volume of venture-backed IPOs.

The story of the JOBS Act is one of fusion between capital markets and the macro economy. The reform is a sign of the times it was enacted in, much like the historical disclosure reforms before it. Yet, it is novel because never before has job creation served as such a direct justification for disclosure reform. This new direction must be understood and analyzed in the context of the larger disclosure regime that has been the foundation for United States capital markets since the Depression era. Instead of taking as a given the current premise that disclosure obligations hinder job creation, we should think critically about why we should reform our disclosure regime and what it will mean for the larger capital markets and each of its constituent parts. My hope is that this paper can contribute to just such a dialogue.

169. *Id.*