Regulatory Relief for Small Businesses in the US

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ABSTRACT

This paper discusses important regulatory relief for small businesses. Emerging growth companies will now have an easier time raising money primarily due to a new law in the US that creates an opportunity for small businesses to ‘crowdfund’. The United States enacted the Jumpstart Our Business Startups Act in 2012, and the SEC has recently promulgated the rules allowing the process to be utilized. Designed to stimulate economic growth and expand job creation by improving access to public capital markets for small emerging growth companies, the law is an example of regulatory relief that will aid entrepreneurs nationwide. The primary focus of the law was to ease the very strict requirements of the US securities laws to enable small businesses to use a technique known as ‘crowdfunding’ to raise equity capital. The future of access to capital for small business entrepreneurs could very well be significantly expanded through the use of this process.

Keywords: small business, crowdfunding, securities laws, jobs, regulation

INTRODUCTION

An example of the burdensome over-regulation of small business in the US has existed for years in the form of the securities rules for raising relatively small amounts of capital which date back to the 1930’s. Access to capital for small businesses in the US has been an arcane challenge, whether it’s an initial public offering (IPO) or borrowing money from a bank. Small businesses find the process to be frustrating using a system designed for large businesses. In fact small businesses are often shut out of the equity capital markets.

It is important to have access to capital for companies of all sizes in the US economy. Small businesses seeking capital should not be hindered by overly burdensome regulations. Therefore the US saw a need to reduce the cost of IPO’s while still protecting investors. The US now has a new law enacted in 2012, called the JOBS Act that addresses this problem. This new law will enhance access to private and public capital thanks to changes in US securities laws.

The JOBS Act will enhance the ability of companies to raise funds through transactions that are now exempt from registration under the securities laws. The law will make it easier for new or expanding companies to pursue an initial public offering under the Securities Act by easing the regulatory burdens associated with IPOs and phasing-in the obligations of being a public company. Simultaneously the law raises the dollar threshold that requires privately-held companies to register their securities with the SEC, and which are subject to the transparency and disclosure requirements applicable to larger publicly-traded companies.

The JOBS Act directed the U.S. Securities and Exchange Commission (SEC) to implement new rules and requirements through its rulemaking process. The JOBS Act will, once all the provisions are implemented, provide significant new benefits to small and mid-size businesses, which will now be referred to as ‘Emerging Growth Companies’ (EGC’s). When a small business is contemplating going public, it will be able to avail itself of liberalized communications restrictions and scaled-back disclosure requirements for a period of time, including exemptions from certain provisions of Dodd-Frank and SOX.
(Sarbanes Oxley), as well as many audit rules. The new law will increase access to capital by lifting the prohibition on general solicitation and advertising in certain private placements, permitting “crowd funding”, and increasing the offering amount for small business IPO’s.

Overview of US Securities Laws

There are four major law that together with the regulations promulgated pursuant by the SEC, have formed a complicated maze applicable to both small and large businesses. The two most important laws are the U.S. Securities Act of 1933 (Securities Act) and the U.S. Securities Exchange Act of 1934 (Exchange Act), which are complimented by the U.S. Investment Company Act of 1940, and the U.S. Investment Advisers Act of 1940.

New Securities Law: the JOBS Act

The JOBS Act of 2012 has several sections, each designed to address a specific aspect of the process of the access to capital, including sections on Emerging Growth Companies, Access to Capital for Job Creators, Crowdfunding, Exchange Act Registration and Deregistration. The new law requires the SEC to write new rules on capital formation, disclosure and registration requirements. This means the SEC promulgates rules to permit privately-held companies (including start-ups and entrepreneurs) to engage in “crowdfunding” IPO’s which will be exempt from registration under the Securities Act as long as it is for under $1M. Thus crowdfunding at a basic level is just way to raise small amounts of money from a potentially large number of investors through the use of the Internet rather than a traditional underwriter.

The law has always prohibited companies from offering or selling securities unless the offering has been registered with the SEC, unless it qualifies for one of a limited number of exemptions from registration. The registration process is very expensive and time-consuming, so much so that a registered securities offering is almost never a realistic financing option for a typical start-up company trying to raise small amounts of money from numerous investors. Additionally, by making a registered offering these companies become subject to the annual reporting requirements of the Exchange Act, which makes the process even more expensive. Although scaled-back disclosures are available for smaller reporting companies and the JOBS Act has reduced the disclosure burdens for IPOs by emerging growth companies, these relaxed registration provisions are not aimed at, and do not necessarily, fit a company desiring to raise small amounts of capital through crowdfunding.

In order to make it easier for privately-held companies to access capital through crowdfunding, the JOBS Act added a new section to the Securities Act that specifically exempts crowdfunding transactions from registration under the Securities Act.

Small Businesses Will Benefit

The monetary amount of securities an issuer may sell during a one year period preceding the date of the transaction is limited to $1 million. The only companies eligible to rely on, and to avail themselves of, the Crowdfunding Exemption are small US businesses that are domestic entities and are not already subject to the regular reporting requirements.

Investors

The JOBS Act limits the total amount of securities an issuer may sell to any individual investor who purchases securities in a crowdfunding transaction in a one year period. The amount of such limitation is based on the individual investor’s annual income or net worth, but is approximately $100,000.
Online Funding Portals (Intermediaries)
Crowdfunding transactions must be conducted through an online funding portal that has registered with the SEC. A funding portal is a person acting as an intermediary involving the offer and sale of securities using the new crowdfunding rules. The officers, directors, and partners of an intermediary may not have a financial interest in the company using its services for a crowdfunding offering.

Intermediaries will be responsible for the following:
- Educating the public
- Screening potential investors
- Taking appropriate action to reduce the risk of fraudulent transactions
- Providing any required disclosure to the SEC
- Ensuring that the issuer does not receive any investors’ money until the target offering amount has been raised
- Taking steps to ensure that investors do not purchase more than their annual limit of securities of the issuer.

Transparency and Disclosures
Companies that intend to engage in a crowdfunding offering under the JOBS Act also must furnish the following information to the SEC and to potential investors:
- Names of the issuer’s directors, officers;
- Issuer’s business plan;
- Financial information of the issuer;
- Issuers must provide income tax returns and financial statements;
- Provide financial statements reviewed by an independent public accountant;
- Describe exactly how the proceeds will be used;
- The total amount of the target offering;

The JOBS Act also requires, somewhat similar to existing laws, that the SEC adopt rules that mandate ongoing financial disclosure on an annual basis.

Limits
In addition to the transparency and disclosure obligations to be satisfied in connection with a crowdfunding offering, companies may not advertise the terms of its offering, except through an intermediary, and may not compensate any person to promote its offering through communications provided by an intermediary. Additionally, companies must provide at least annually to the SEC and its investors reports of results of operations and financial statements of the company, and must satisfy any other requirements imposed by the SEC.

Although issuers are generally prohibited from advertising the terms of a crowdfunding transaction, they will be permitted to use advertisements that direct potential investors to the broker or funding portal intermediary. Since such advertisements will permit the issuer to direct the public to generally accessible intermediary websites that describe the transaction, issuers in crowdfunding transactions will have much greater leeway to offer and sell securities to strangers than they previously have had in traditional private placements, as these prohibit general solicitations of investors. However, as part of the JOBS Act, the holders of record thresholds for requiring Exchange Act registration were significantly increased to four times more people (2000) as the original law.
Two important final restrictions include a rule that shares that are sold pursuant to the Crowdfunding Exemption may not be resold by the investor until one year after the purchase of the shares. Furthermore, companies selling securities in a crowdfunding offering will be subject to civil liability under the Securities Act. As a result, a purchaser could bring an action against an issuer for misstatements or omissions made orally or in written materials in the course of the offer and sale of such securities.

Crowdfunding Outside the US

Canada has a rapidly growing directory of active crowdfunding platforms, internet finance, and online funding portals and service providers, numbering about ten so far.

EU countries have, for the most part, recently passed the necessary new laws, and crowdfunding is an emerging alternative source of financing. The EU Commission is studying the benefits and the risks of this relatively new and growing form of finance, as well as the national legal frameworks applicable to it, in order to identify whether there is value added in European level policy action in this field.

China has seen significant interest in peer to peer lending and crowdfunding since it was introduced in the past few years. As in several other countries, the government is in the process of creating regulations for the industry. The government recently officially announced that equity crowdfunding is a valuable supplement to conventional financing.

India has been home to emerging growth in crowdfunding techniques. Most of its crowdfunding however has been restricted to non-equity. The legal issues with conversion from donation to equity models in India are an integral part of crowdfunding, as they are in the US.

Prospects for Success of New Law

Crowdfunding transactions provide companies with the ability to attract investment from small investors who ordinarily cannot be meaningfully included in traditional IPO’s. This new law could help small businesses looking for additional sources of funding. Crowdfunding has the potential to be a very attractive fundraising vehicle for start-ups and other small companies because it provides them a new relatively inexpensive means, after considering the post-offering requirements, to find investors outside of the traditional IPO community. Companies selling securities pursuant to a crowdfunding offering will have a relatively large base of unsophisticated investors, which may require them to expend more time and resources in their shareholder communications and investor relations, but this is a small price to pay for capital. Companies engaging in a crowdfunding will be required to hire intermediaries to conduct the transaction. This will increase the costs of the offering and currently it is difficult to predict what those costs might be.

It may be more difficult for companies that have engaged in a crowdfunding offering to attract later financing or to engage in a merger or acquisition transaction due to likely requirement that shareholder approval be obtained. Further, most VC/JV investors, as well as most institutional investors, are reluctant to invest in an entity with a large base of unsophisticated investors. In any event, any such transaction will require substantial shareholder communication and will likely be more expensive to undertake.

The new JOBS Act will give many companies access to investors that they would not have been able to reach through traditional private placements prior to the passing of the JOBS Act. Companies willing to comply with the JOBS Act’s requirements will be able to use crowdfunding to find investors previously unavailable to them, which should open up entrepreneurial opportunities.
REFERENCES


