Emerging businesses have more room to raise capital under the JOBS Act

On April 5, 2012, President Barack Obama signed into law the JOBS Act. Those unfamiliar with it may be surprised to learn that it concerns neither jobs nor employment — at least not directly. Its name — an acronym for Jump-start Our Business Startups — was a clever means of encouraging political support for the bill given that the nation's employment growth was still sluggish despite being several years into recovery from the Great Recession.

The purpose of the act was to make it easier for small businesses to raise capital, essentially by easing restrictions imposed by the federal securities laws, Sarbanes-Oxley Act of 2002 and Dodd-Frank's Wall Street reforms. Will the act affect job growth? It's too soon to tell. But it did result in significant changes in the law. This article summarizes some of the more salient ones.

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Certain provisions of the act went into effect immediately. Others are subject to regulations that have yet to be promulgated. It is unclear when the various regulations will be in place. The U.S. Securities and Exchange Commission is still neck-deep in finalizing Dodd-Frank reforms and is undergoing a leadership transition. That said, Mary Jo White, the new SEC chairwoman, indicated in her confirmation hearings that full implementation of the act would be a top priority under her leadership.

Titles of the act now in effect

Title I, "Reopening American Capital Marketing to Emerging Growth Companies," established the classification of Emerging Growth Companies. Its purpose is to ease an EGC's transition from private to public company by limiting the impacts of the Securities Act of 1933, the Securities Exchange Act of 1934, Sarbanes-Oxley and Dodd-Frank.

An EGC has total annual gross revenue of less than $1 billion. The company (unless it went public before Dec. 8, 2011) will enjoy that designation until its revenue exceeds $1 billion, five years after its initial public offering, the date it issues more than $1 billion of nonconvertible debt or when it becomes a large accelerated filer, as defined under the Exchange Act.

The principal benefits of being an EGC are as follows:

- They may begin the process of going public on a confidential basis before publicly filing. Available data illustrates that 65% of the EGCs going public since the inception of the act have taken advantage of this facet of the new law.
- They may engage in oral or written communications with certain potential investors to test the waters for an initial public offering without such communication being deemed an offer under the Securities Act.
- They are relieved from certain regulatory and disclosure requirements in the registration statement filed when they go public and for a period of five years thereafter and generally are subject to relaxed accounting, auditing and disclosure requirements.
- Before the act, new public companies were afforded a two-year phase-in with respect to certain Sarbanes-Oxley obligations (for example, assessment of internal controls). The act extends that period by an additional three years for EGCs.

Title V, "Private Company Flexibility and Growth," raises the threshold for mandatory registration of a company with total assets exceeding $10 million from 500 shareholders of record to 2,000, or 500 people who are not accredited investors. For this purpose, shares held "of record" do not include securities held pursuant to an employee compensation plan in certain exempt transactions. In addition, "crowdfunding" investors (as discussed below) are excluded from this cap.

Title VI, "Capital Expansion," raises the threshold for mandatory registration of a bank with total assets exceeding $10 million — a "community bank" — generally from 500 shareholders to 2,000, with no limit on the number of nonaccredited investors. In addition, this title raises the threshold for triggering deregistration of a bank from 300 shareholders to 1,200 shareholders. The higher threshold may encourage community banks to determine that the benefits of registration outweigh the costs of registration and securities law compliance and, therefore, to elect to terminate their registration.

As seen in the August issue of BUSINESS NORTH CAROLINA magazine.

Though Title VI went into effect immediately, the act called for regulations within one year of enactment, and none have been promulgated. Consequently, banks and bank-holding companies likely won't be able to take advantage of the higher deregistration threshold until regulations address it.

Titles awaiting implementation

Titles II, III, IV and VII of the act are not yet in force and are subject to rule making by the SEC. These titles, upon implementation, would:

• Lift the ban on general solicitation and advertising for offerings under Rule 506 (requires all purchasers be accredited investors) and Rule 144A (requires the issuer "reasonably believe" that the buyer be a "qualified institutional buyer") under Title II, "Access to Capital for Job Creators." The act did not change the basic requirements of Rule 506 or Rule 144A.

• Create an exemption for issuances of small amounts to a large number of investors, under Title III, "Crowdfunding." This crowdfunding exemption would allow use of Internet-funding portals registered with the government. Specifically, this exemption would be available to an issuer where the aggregate amount sold to all investors is not more than $1 million during any 12-month period and the aggregate amount sold to any one investor is less than certain thresholds. For example, if either annual income or net worth is less than $100,000, the amount sold may not be more than the greater of $2,000 or 5% of the annual income or net worth of the investor. If either annual income or net worth is equal to or more than $100,000, the amount sold may not be more than 10%. Furthermore, the amount sold to any investor may not exceed $100,000. Title III would also impose a number of requirements on securities intermediaries, such as the obligation to register as a funding portal subject to regulation by the SEC or other regulatory organization. The N.C. General Assembly also is considering passage of a bill that would provide for the state's own crowdfunding exemption. If the bill is enacted, as many hope, the state's version of the exemption would improve upon the federal one because it would be available sooner, involve lower transaction costs (i.e., audited financial statements would not be required for offerings of less than $1 million) and be simpler (i.e., individual investments would be limited to $2,000, though accredited investors would be excluded from that cap, making the exemption "angel friendly").

• Increase the limit of offerings under Regulation A from $5 million in any one-year period to $50 million under Title IV, "Small Company Capital Formation." Title IV also mandates that the federal Comptroller General conduct a study on the impact of state blue-sky laws regulating securities offerings.

• Require the SEC to provide online information and conduct outreach to businesses owned by veterans, minorities, women and to all other small- and medium-sized businesses under Title VII, "Outreach on Changes to the Law."

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Controversial, but early indications are encouraging

The act enjoyed bipartisan support in Congress and has been applauded by the startup, venture-capital and technology communities, as well as by many in the nonprofit world, where crowdfunding is increasingly seen as a key tool for raising capital. The act, however, has not been free from criticism. Various consumer and investor advocates opposed the legislation based on concerns that the loosening of restrictions could result in less protection for investors and expose unsophisticated investors to fraud and the like.

As of this writing, since the act became law, 21 North Carolina-based companies have filed registration statements with the SEC as EGCs, and available data demonstrates that EGCs are eagerly availing themselves of the benefits afforded to them under the act. Given that a large percentage of EGCs operate in the technology, energy, health-care and financial-services sectors, and that these industries are well-populated by North Carolina players, the act should ultimately prove to be a real boon for North Carolina businesses — and all the more so if job growth is a result.