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Small Company Capital Formation Act of 2011; Regulation A Revival?

On March 14, 2011, Representative David Schweikert (R-AZ) introduced the Small Company Capital Formation Act of 2011 (the "Small Company Capital Formation Act") in the U.S. House of Representatives (the "House").[1] The bill seeks to increase the offering threshold from $5 million to $50 million for public offerings of smaller companies exempt from registration under the Securities Act of 1933, as amended (the "Securities Act") pursuant to Regulation A. The bill also will require the Securities and Exchange Commission (the "Commission") to review the threshold every two years.

Representative Schweikert, Vice Chairman of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, said: "Taking a small business public is an important, but expensive process that requires millions in underwriting costs.... Raising the Regulation A threshold to $50 million is one way to lower those costs and promote economic growth and job creation. At a time when so many small businesses are in need of capital, this is a common sense proposal that will make our capital markets more vibrant and competitive."[2]

Background

Regulation A was enacted during the Great Depression to help the economy by improving small businesses' access to equity capital. While the initial offering threshold of $100,000 has been increased over the years to the current $5 million set by the Commission in 1992, it has not been increased to reflect the rising costs associated with bringing a small company public over the last two decades. Due to the low offering threshold, and without a corresponding state "Blue Sky" exemption for Regulation A offerings, Regulation A has not provided a viable capital-raising vehicle for smaller companies in recent years. Amplified by increased difficulties for smaller companies resulting from the recent financial crisis, these shortcomings of Regulation A have invited renewed focus on this regulation.

The Small Company Capital Formation Act is designed to encourage small companies to access the capital markets — allowing them to invest and hire employees.[3] As part of a broader effort to tie the financial regulatory environment to U.S. job creation and economic competitiveness, the Small Company Capital Formation Act was

[1] This is bill H.R. 1070. See http://www.gpo.gov/fdsys/pkg/BILLS-112hr1070ih/pdf/BILLS-112hr1070ih.pdf.
[2] See press release issued by the House Financial Services Committee, available at http://financialservices.house.gov/press/PRArticle.aspx?NewsID=1817.
[3] See Id.

introduced — along with other legislation — to supplement, amend or repeal certain sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

On March 16, 2011, a hearing was held in the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, chaired by Representative Scott Garrett (R-NJ), regarding these legislative proposals to promote job creation, capital formation and market certainty, including the Small Company Capital Formation Act.[4] However, already during the lame-duck session of Congress in December of last year, a proposal to increase the offering threshold under Regulation A to $30 million was discussed at a hearing before the House Committee on Financial Services on December 8, 2010.[5]

Preceding these hearings and the introduction of the legislative proposal, the topic of increasing the Regulation A threshold was discussed at the Commission's Government-Business Forum on Small Business Capital Formation on November 18, 2010. Moreover, in 2009, the recommendation made it into the final report of the Government-Business Forum on Small Business Capital Formation.[6]

Regulation A

Currently, Regulation A, or the "Conditional Small Issues Exemption,"[7] provides an exemption from registration with the Commission for public offerings of up to $5 million in any 12-month period by non-reporting companies, without any restrictions on the types of investors that can participate in the offering. As with registered offerings, the securities can be offered publicly. The securities are eligible to trade freely, immediately after the offering, in the over-the-counter market.

Companies that issue securities under Regulation A must provide the Commission with an offering statement on Form 1-A, which includes a notification, an offering circular and exhibits, for its review. However, they do not have to submit audited financial statements (provided the company is not already filing reports pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). In addition, they are not subject to periodic reporting obligations under the Exchange Act or any of the Sarbanes-Oxley Act obligations after the offering.[8] Issuers in Regulation A offerings are permitted to "test the waters" by soliciting interest in the offering before filing any offering statement with the Commission to determine if there is enough interest in the securities.

These features of Regulation A are beneficial to a smaller company considering a capital raise, including by means of a small IPO, as opposed to a more costly and time-consuming IPO process using a comprehensive Form S-1 registration statement. The fact that there are no restrictions on the type of investors also makes Regulation A advantageous compared to Regulation D offerings. The offering threshold of $5 million, however, poses a major disadvantage.

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[4] See press release issued by the House Financial Services Committee summarizing the legislative proposals, available at http://financialservices.house.gov/press/PRArticle.aspx?NewsID=1810.
[5] Industry representatives at that hearing testified that a $50 million threshold would make Regulation A offerings more useful to companies engaged in capital-intensive sectors.
[6] See the final report of the 2009 SEC Government-Business Forum on Small Business Capital Formation, available at http://www.sec.gov/info/smallbus/gbfor28.pdf.
[7] Regulation A consists of Rules 251-263 and was adopted as an exemption from registration by the Commission pursuant to Section 3(b) in 1933.
[8] If an issuer subsequently grows to have more than $10 million in assets and more than 500 shareholders, it will become subject to Exchange Act registration and filing obligations pursuant to Section 12(g)(1) of the Exchange Act.

The Proposed Legislation

Increased Offering Threshold

The proposed legislation would amend Section 3(b) of the Securities Act by requiring the Commission to increase the aggregate offering amount to $50 million for exempt offerings of securities. Additionally, the proposed legislation would authorize, but not require, the Commission to adopt such other terms and conditions as it may determine necessary in the public interest and for the protection of investors, including, but not limited, to:

- a requirement to file audited financial statements with the Commission and distribute such statements to prospective investors;
- a requirement to submit the offering statement and related filings to the Commission electronically; and
- the establishment of "bad actor" disqualification provisions based on the disciplinary history of the issuer, its affiliates, officers, directors, underwriters, or other related persons.[9]

Periodic Disclosure

Under the proposed legislation, the Commission is also authorized to require an issuer to make available to investors periodic disclosures regarding the issuer, its business operations, its financial condition, its use of investor funds, and other appropriate matters. The Commission may also provide for the suspension and termination of such a requirement with respect to that issuer.

Adjustments

Within two years of the date of enactment of the Small Company Capital Formation Act, and every two years thereafter, the Commission must review the offering amount threshold and increase the amount as it determines appropriate. Note that if the Commission determines not to increase the offering amount, it must report to the House Committee on Financial Services and the Senate Committee on Banking on its reasons for not doing so.

Time for Regulation A Reform

A Regulation A reform could potentially revitalize public capital-raising opportunities for smaller companies by helping to jump-start the small IPO market, which has virtually disappeared over the last decade and a half,[10] and by providing access to capital for smaller companies — a topic that currently is attracting significant attention in Washington, D.C.[11]

By early indications, one should expect a Regulation A reform to not be "a partisan or terribly controversial one," as stated by Representative Barney Frank (D-MA) who chaired the hearing before the House Financial Services Committee in December 2010. In addition, industry representatives indicated support for a Regulation A reform at both the December 2010 and March 2011 hearings. Mr. David Weild, Senior Advisor of Grant Thornton LLP, testified at the March 16, 2011 hearing, applauding the Small Company Capital Formation Act as the beginning of a campaign to bring back the small IPO market. In addition to the cost benefits for small companies, Mr. Weild noted that an increased threshold opens up the Regulation A exemption to an offering size that will allow

[9] Rule 262 of Regulation A currently provides for certain disqualification provisions.
[10] See Market Structure is Causing the IPO Crisis (October 2009) by David Weild and Edward Kim, Grant Thornton LLP, available at http://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20Sep%202009%20-%20FINAL.pdf.
[11] Treasury Secretary Timothy Geithner held a conference on March 22, 2011, titled "Access to Capital: Fostering Growth and Innovation for Small Companies," examining the difficulty of funding for smaller businesses. See http://www.treasury.gov/press-center/news/Pages/access-to-capital.aspx.

companies to list on the NYSE and NASDAQ and to avail themselves of the so-called "Blue Sky" exemption, thus avoiding very costly state-by-state filings. Other observers have voiced a preference for an increased Regulation A threshold combined with Congress also pre-empting state regulation for these offerings similar to Regulation D offerings.[12] Mr. Weild also noted the importance of the "test-the-waters" provision of Regulation A, citing a steady increase in IPOs that are postponed, withdrawn, priced below the low end of the IPO filing range or that have broken the IPO price within 30 days of the completion of the offering as potentially ruinous to smaller companies.

Yet, the real question may be whether a Regulation A reform would be adopted as currently proposed, or whether mandatory provisions designed to enhance investor protections associated with Regulation A offerings, such as the requirement to file audited financial statements and periodic reporting requirements, are included as the bill proceeds through the legislative process.[13] Assuming, however, that the legislation is ultimately adopted in a form similar to this initial proposal, Regulation A reform would represent an important step towards improving public capital-raising opportunities for smaller companies.

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[12] Rule 506 offerings under Regulation D (used for private placements and PIPE transactions) are exempt from state registration under the National Securities Market Improvement Act of 1996.
[13] Mr. Damon A. Silvers, Policy Director and Special Counsel of American Federation of Labor and Congress of Industrial Organizations expressed concern at the March 16, 2011 hearing that the bill does not guarantee that these added protections would be imposed even as the bill sponsor requires that the Regulation A exemption be expanded.