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Government Responds to New **Sense of Urgency** For Securities Reform

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FOR YEARS, business leaders and commentators have observed that the regulatory requirements to be met to finance companies in the United States have become overly burdensome and discourage entrepreneurship. As attention in the United States has turned to promoting economic activity, the dialogue related to regulatory burdens and their effect on capital formation, job creation and general financial security has taken on a new sense of urgency. Congress is listening and there are several significant legislative proposals that would ease the regulatory burdens of smaller companies.

Background

The exchanges between U.S. Rep. Darrell Issa, R-Calif., Chairman of the House Committee on Oversight and Government Reform, and Mary Schapiro, the Chairwoman of the SEC, earlier this year crystallize the concerns that are now at the center of this debate on capital formation reform. Mr. Issa's March 2011 letter to Ms. Schapiro raised concerns regarding the potentially chilling effect of SEC regulations on capital raising by small and emerging companies. Mr. Issa cited statistics on the IPO market and asked whether the SEC had studied whether the decline in the number of IPOs, and especially IPOs for smaller companies, was associated with Sarbanes-Oxley or other regulatory burdens. He also asked that the SEC consider current restrictions on offering related communications, especially in light of technological advances.


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In fact, many market participants have questioned whether securities regulations have kept pace with technology, especially with the growth of social media. Mr. Issa also pointed to the challenges posed for smaller companies that must conduct various financing rounds and may inadvertently find themselves subject to mandatory Exchange Act reporting requirements. Finally, Mr. Issa asked that the SEC consider the changing financing landscape and cited the emergence of phenomena like crowdfunding.

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This exchange has been followed by the introduction of a number of legislative measures that would facilitate capital formation. One measure would change Regulation A under the Securities Act to permit companies to conduct offerings to raise up to $50 million through a "mini-registration" process. Several bills are pending that would modify the triggers for SEC reporting obligations. Legislation is also proposed that would modify the prohibition against general solicitation in connection with private placements. The SEC is taking a close look at the regulations governing offering-related communications. Regulators also are examining the disclosure and other obligations imposed on newly public companies with a view toward modifying these to promote IPOs.

Initial Public Offerings

The capital markets have undergone significant changes in recent years. Initial public offerings, or IPOs, are no longer the gold standard for successful, growing companies. Indeed, many more companies are choosing to defer pursuing IPOs. Over the last 20 years, foreign issuers that often sought out listings in the United States, both to access the deep, liquid markets in the United States and to obtain what had been the ultimate imprimatur of success, now have a number of other securities markets to choose from for their IPOs. If one takes a close look at statistics for IPOs in the United States over the last 10 years, it is undeniable that there are fewer IPOs for smaller, mid-cap companies.

Grant Thornton LLP has published several studies that indicate that prior to 1997, almost 80 percent of U.S. IPOs were below $50 million, while by 2000, the percentage of these smaller IPOs had declined to less than 20 percent. There have been several credible theories advanced to explain this phenomenon. Market structure and regulatory changes, especially those related to Sarbanes-Oxley and more recently the Dodd-Frank Wall Street Reform and Consumer Protection Act, may have had a chilling effect on the IPO market in the United States.

Other commentators speculate that smaller or emerging companies postpone IPOs for other reasons, some of which are unrelated to Sarbanes-Oxley and corporate governance requirements. For example, many note that the obligations related to ongoing SEC reporting requirements result in significant added expense. Others note investment bank consolidations and changes involving research analyst coverage have left smaller or emerging companies that have completed IPOs "orphaned," since the remaining investment banks generally concentrate their attention on large companies. This means that a smaller company contemplating an IPO cannot be assured that it will attract widespread interest from the research analyst community.

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Finally, others believe that it is the litigious environment in the United States that deters many domestic and foreign issuers from pursuing an IPO. Regardless of which hypothesis finds most support, a strong consensus has formed in favor of undertaking an examination of the impediments to IPOs for emerging growth companies. Recently, a group called the IPO Task Force presented a report to the U.S. Treasury Department in which it presented a number of suggestions for promoting IPOs, including a phasing in of disclosure requirements for newly public companies. In various public remarks, representatives from the SEC have noted that this notion of an "IPO on-ramp," or phased disclosure approach, merits careful consideration.

Offering Related Communications

In her response to Mr. Issa's letter, Ms. Schapiro noted that the SEC staff would embark on a review of the agency's rules in order to assess whether there were ways to promote capital formation while protecting investors. She discussed the communications rules applicable to offerings, including the streamlining of many of these rules undertaken in connection with Securities Offering Reform in 2005. Indeed, the measures undertaken in 2005 provided much greater certainty regarding the types of communications that were permissible in connection with a registered public offering.

For example, a number of safe harbors were adopted, including Rule 163A, which provides eligible issuers with a bright-line safe harbor for communications made more than 30 days before filing a registration statement. Rules 168 and 169 were adopted, which allow issuers to continue to communicate factual business information in the ordinary course of business, even during an offering. Larger issuers were permitted to use free writing prospectuses. These 2005 reforms principally benefited seasoned public companies and the largest, most well known seasoned issuers, which, in any event, always have had greater access to capital. The reforms did not provide much more flexibility for smaller public companies, and also did not address communications in the context of exempt offerings. Changes in market structure, shortened holding periods under Rule 144 for restricted securities, and the emergence of secondary trading markets have led to greater reliance by smaller, emerging companies on exempt offerings. Moreover, technological advances, especially the proliferation of social media tools, have rendered the prohibition against general solicitation in connection with private offerings conducted in reliance on §4(2) of the Securities Act, or Regulation D promulgated thereunder, outmoded.

Ms. Schapiro acknowledged that the prohibition on general solicitation in connection with private placements might be seen as an impediment to capital formation. In her letter, she committed to having the SEC staff review restrictions on communications and the prohibition against general solicitation. Many practitioners have been calling for the SEC to remove the ban on "offers" given that the prohibition against general solicitation may be unnecessary. Offerees who might be located through general solicitation and who do not purchase the securities would not be harmed. In various public statements, the SEC staff has committed to analyzing the regulatory framework for communications and addressing the general solicitation ban, while remaining focused on investor protection.

The House of Representatives recently approved H.R. 2940, which would allow for the use of general advertisements to solicit investors in offerings of non-publicly traded securities, so long as privately held companies market only to accredited investors. The bill would direct the SEC to revise its rules to remove the prohibition against general solicitation or advertising for sales made only to accredited investors.

Mandatory Reporting Threshold

Mr. Issa also expressed concerns regarding the shareholder threshold under §12(g) of the Exchange Act, which he suggested functioned as a roadblock for smaller companies that sought to defer becoming subject to SEC reporting requirements. Currently, §12(g) mandates SEC reporting (even in the absence of a company having conducted a public offering) once a company has 500 or more shareholders of record and the company has total assets exceeding $10 million. Perhaps historically, this threshold was not so significant, but market developments have rendered the threshold an impediment.

As discussed above, emerging companies that defer pursuing an IPO finance their growth by conducting multiple private placements, which typically serves to increase their shareholder count. Emerging companies also rely on stock-based compensation as an important incentive in recruiting and retaining talented personnel. In addition, there has been an unmistakable progression toward providing employees who hold stock options (or other stock-based compensation), as well as investors in privately held companies, with enhanced liquidity. This has led to the growth of many new "secondary market" opportunities for holders of securities of privately held companies.

These developments have created enormous challenges for emerging U.S. private companies that do not want to become subject to SEC reporting requirements. In her response, Ms. Schapiro noted that the mandatory reporting requirement, enacted in 1964, would need to be examined by the SEC staff, especially in light of market developments. She also stated that the SEC is monitoring secondary trading on a number of platforms that facilitate trading of stock in private companies, noting that a balance must be struck between the benefit of increased liquidity and the investor protection concerns that may arise due to a lack of information about private companies.

In November 2011, the House of Representatives overwhelmingly approved H.R. 1965, which increases the shareholder threshold under §12(g) from 500 to 2,000 for banks and bank holding companies and increases the threshold for total assets of an issuer required to register with the SEC from $1 million to $10 million. Another bill that would increase the shareholder threshold for all companies is still pending.

Crowdfunding

Mr. Issa also raised questions regarding "crowdfunding." Crowdfunding typically involves soliciting small individual contributions (usually through the Internet) to fund a project or an initiative. Early crowdfunding efforts tended to focus on raising money for not-for-profit ventures, or to involve soliciting donations, with no promise that the individual contributors would receive a profit interest or a security. As a result, these efforts did not trigger securities law issues.

However, over time, crowdfunding has grown in popularity and entrepreneurs are soliciting funds from individuals to whom they promise a profit interest or a security. This is a public offering that requires either a valid exemption from registration or registration with the SEC. Ms. Schapiro noted that the SEC is exploring various approaches to address this emerging funding approach, including, potentially, assessing whether modifications to Rule 504 (promulgated under Regulation D) would provide an appropriate methodology. Ms. Schapiro indicated that the review to be undertaken by the SEC staff would include an evaluation of the recommendations of the annual SEC Government-Business Forum on Small Business Capital Formation, as well as recommendations from a new Advisory Committee on Small and Emerging Companies.

In November 2011, the House of Representatives approved H.R. 2930, introduced by U.S. Rep. Patrick McHenry, R-N.C., which adds a crowdfunding exemption to §4 of the Securities Act and §12(g) of the Exchange Act. The crowdfunding exemption is somewhat limited in that it imposes a $1 million cap on these transactions, subject to an individual investment cap equal to the lesser of $10,000 and 10 percent of the investor's annual income. An issuer in a crowdfunding transaction would be required to state a deadline for reaching the desired offering proceeds and notify the SEC once the offering has been completed. The notification must include the aggregate offering proceeds and number of purchasers. Persons acquiring securities in a "crowdfunding" offering would be excluded from the calculation of holders of record under §12(g).

Regulation A

In November 2011, the House of Representatives also overwhelmingly approved the Small Company Capital Formation Act of 2011. This act would increase the offering threshold from $5 million to $50 million for offerings exempt from registration under the Securities Act pursuant to Regulation A. The exemption permits 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 relying on Regulation A may test the waters prior to preparing and filing an offering statement with the SEC. As a general matter, the offering statement requirements are less onerous than those associated with a registration statement on Form S-1. Companies are not subject to periodic reporting obligations under the Exchange Act or any of the Sarbanes-Oxley Act obligations after completing a Regulation A offering, unless the shareholder threshold is breached or the companies voluntarily list their securities on an exchange. For certain companies, these features of Regulation A may be beneficial, especially compared to an IPO.

Conclusion

It appears to be different this time. In the past, regulatory reform in the financial sector often has had its origin in one or more well-reported financial frauds or regulatory lapses. This time, it is the changes resulting from new technology, the need to remain successful as global competitors, and the need to reinvigorate American entrepreneurial excellence for the benefit of our current work force and future taxpayers that is driving these initiatives.