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CAPITAL FORMATION REFORM

In an effort to ease access to private capital for small businesses, bills now in Congress would in various ways raise the number of shareholders required for registration under the Exchange Act, remove the prohibition on general solicitation in Reg. D offerings, raise the dollar ceiling for Reg. A offerings, and provide exemptions from the attestation requirements of Sarbanes-Oxley. The House has already passed certain of these costless measures with strong bipartisan support, and the SEC is planning to issue a concept rule release to test public sentiment on the subject.

By Bradley A. Jacobson, Robert E. Puopolo, and Daniel J. Blanchard *

Gone are the days of the late-90's tech boom where one of the primary regulatory concerns was "hot issues."[1] Also past are the days of the mega-leveraged buyout where a primary concern of the Delaware courts was the respective merits of strategic and financial purchasers, and their implications for shareholder value maximization. Today, irrational exuberance has been replaced with austerity. Yesterday's big deal can easily become today's big bankruptcy. Needless to say, this environment has created great anxiety about the future of the United States' economy.

Underlying this anxiety, and of most concern to the average American, is the fear that the formerly inexorable U.S. job-creating machine is broken. According to the U.S. Bureau of Labor Statistics, the unemployment rate has been above 9% since May of 2009 – the highest level since 1983.[2] With jobs a top political priority, there is newfound interest in reforming the U.S. capital markets, particularly with respect to small businesses. The goal of these reforms is to create more jobs without spending more money, which is likely why they appear to enjoy a measure of bipartisan support. Proponents of these reforms believe that easing access to private capital by reducing certain regulatory burdens on small business capital formation will ignite a new burst of entrepreneurship that, in turn, will create the jobs of tomorrow.

In Washington, there has been increased attention to a lackluster IPO market and the effect Securities and Exchange Commission regulations have on restricting U.S. capital formation. On May 10, 2011, the House Committee on Oversight and Government Reform held a hearing on "The Future of Capital Formation." Meanwhile, the SEC has formed an Advisory Committee on Small and Emerging Companies to focus on interests and priorities of small businesses and smaller public

[1] Rel. No. 34-42325 (2000).

[2] U.S. Bureau of Labor Statistics, *available at* https://www.bls.gov.

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companies,[3] and has announced plans to issue a "concept rule release" seeking public input on the advisability and the costs and benefits of retaining or relaxing certain regulatory restrictions affecting private capital formation. Among these restrictions are the so-called "500 shareholder rule" and the ban on general solicitation in the context of an exempt private placement.[4] Mary Schapiro, Chairman of the SEC, and Congressman Darrell Issa, Chairman of the House Committee on Oversight and Government Reform, while laying out their positions in correspondence to each other and in other public forums, have shown a tendency towards agreement on certain capital formation issues, such as the need to consider amendment of the 500 shareholder rule.[5] In response to a letter from Chairman Issa concerning capital formation issues, Chairman Schapiro indicated that the SEC is "taking a fresh look at our rules to develop ideas for the Commission about ways to reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection." Specifically, the SEC will focus on issues such as: (i) the restrictions on communications in initial public offerings; (ii) whether the general solicitation ban should be revisited in light of current technologies, capital-raising trends, and the SEC's mandate to protect investors and facilitate capital formation; (iii) the number of shareholders that trigger public reporting, including questions surrounding the use of special purpose vehicles that hold securities of a private company for groups of investors; and (iv) regulatory questions posed by new capital-raising strategies.[6] At the same time, Congress and the White House are considering various proposals on these matters. It is clear from the sponsors of these proposals that this is a bipartisan effort.

Below is a summary of the various proposals currently pending in Congress or being promoted by the White House, each of which, to a certain extent, is designed to liberalize the regulations concerning capital formation and, it is hoped, help jump start the U.S. economy.

SHAREHOLDER REGISTRATION THRESHOLDS

Section 12(g) of the Securities Exchange Act of 1934, which sets forth certain registration requirements for securities, generally requires registration once an issuer has reached the level of 500 or more shareholders of a particular class of equity securities and assets in excess of $10 million.[7] If the securities are "held of record" by 500 or more shareholders at the end of its fiscal year, the issuer must register its securities under Section 12(g) within 120 days of the end of the fiscal year and thereafter become subject to the Exchange Act reporting requirements.[8]

Some, like Chairman Issa, believe the 500 shareholder rule is a "fundamental roadblock to private equity capital formation" due to the substantial costs arising from the regulatory, legal, compliance, and accounting burdens of SEC regulation.[9] Others have stated that the 500 shareholder rule creates "a disincentive for private companies to hire new employees, or acquire other businesses for stock, as these private companies are fearful of taking on too many shareholders."[10] Recently, Chairman Schapiro told the House Financial Services Committee that addressing requests to relax the 500 shareholder rule is

[3] The first meeting of the Advisory Committee was held on October 31, 2011, and the agenda included in-depth discussions of (i) triggers for registration and public reporting and suspension of reporting obligations, (ii) scaling of regulations, (iii) new capital-raising strategies, and (iv) restrictions on general solicitation.

[4] Ira Teinowitz, *Fixing the Facebook Rule*, THE DEAL MAGAZINE, September 30, 2011.

[5] Letter from Chairman Schapiro to Chairman Issa, dated April 6, 2011; letter from Chairman Issa to Chairman Schapiro, dated March 22, 2011.

[6] Letter from Chairman Schapiro to Chairman Issa, dated April 6, 2011.

[7] Exchange Act §12(g); Exchange Act Rule 12g-1.

[8] Exchange Act §12(g).

[9] Letter from Chairman Issa to Chairman Schapiro, dated March 22, 2011.

[10] Joshua Gallu, *Schapiro Says SEC Reviewing Stock Rules for Unlisted Firms*, BLOOMBERG, May 10, 2011.

the top priority of the Advisory Committee on Small and Emerging Companies.[11]

The White House has shown similar resolve on this issue by working with the SEC and publicly supporting the establishment of a "crowdfunding"[12] exemption from SEC registration requirements for firms raising less than $1 million (with individual investments limited to the lesser of $10,000 or 10% of investors' annual income).[13] Meanwhile, in Congress, the Entrepreneur Access to Capital Act (H.R. 2930), sponsored by Representative Patrick McHenry (R-NC), seeks to amend the Securities Act of 1933 by adding a new exemption from the registration requirements of the Act for transactions involving the issuance of securities for which (A) the aggregate annual amount raised through the issue of the securities is (i) $1 million or less or (ii) if the issuer provides potential investors with audited financial statements, $2 million or less; and (B) individual investments in the securities are limited to an aggregate annual amount equal to the lesser of (i) $10,000 and
(ii) 10% of the investor's annual income.[14] In addition, the bill seeks to exclude investors who purchase pursuant to this crowdfunding exemption from the 500 shareholder threshold by excluding those investors from the definition of "held of record."[15] The House of Representatives passed this bill with strong bipartisan support on November 3, 2011.[16]

In the Senate, the Democratizing Access to Capital Act of 2011 (S. 1791), sponsored by Senator Scott Brown (R-MA), also seeks to create a crowdfunding exemption by amending the Securities Act of 1933 by adding a new exemption from the registration requirements of the Act for transactions involving the issuance of securities, through a "crowdfunding intermediary," for which: (A) the aggregate annual amount raised through the issue of the securities is $1 million or less; and (B) individual investments in the securities are limited to an aggregate annual amount of no more than $1,000.[17] Such securities would be considered restricted securities subject to a one-year holding period. A "crowdfunding intermediary," which would be excluded from the definition of "broker" under Section 3(a)(4) of the Securities Act of 1933, would have to comply with a number of requirements designed to ensure that investors are informed of the possible risks associated with a new venture. This bill also seeks to exclude investors who purchase pursuant to this crowdfunding exemption from the 500 shareholder threshold by excluding those investors from the definition of "held of record." Additionally, this bill would instruct the SEC to promulgate rules or regulations under which a person would not be eligible to utilize the exemption.

The Private Company Flexibility and Growth Act (H.R. 2167), sponsored by Representative David Schweikert (R-AZ), seeks to amend Section 12(g)(1)(B) of the Exchange Act by increasing the registration threshold to 1,000 shareholders.[18] The bill further seeks to amend Section 12(g)(5) of the Exchange Act by revising the definition of "held of record" to not include securities held by persons who qualify as accredited investors or securities that are held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act.[19]

H.R. 1965, sponsored by Representative Jim Himes (D-CT), and S. 556, sponsored by Senator Kay Bailey Hutchison (R-TX), seek to amend Section 12(g) of the Exchange Act by increasing the shareholder threshold in the case of an issuer that is a bank or a bank holding company to 2,000 persons.[20] The bill also makes it easier for banks and bank holding companies to deregister and cease public company compliance requirements by increasing the threshold for deregistration for those entities from 300 persons to 1,200 persons.[21] The bill further requires that the Chief Economist and the Director of the Division of Corporation Finance of the SEC conduct a joint study,

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[11] William McConnell, *SEC Considers Changing 500 Shareholder Rule*, THE DEAL MAGAZINE, September 16, 2011.

[12] Crowdfunding is a process whereby large groups of individuals, generally accessed through the use of social networks or other internet platforms, are invited to invest small amounts of money in a startup or not-for-profit project.

[13] Factsheet and Overview - American Jobs Act, Office of the Secretary, The White House, September 8, 2011.

[14] The Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong., 1st Sess. (2011).

[15] *Id.*

[16] The Roll Call was recorded as 407 Yeas, 17 Nays, and 9 Not Voting.

[17] The Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong., 1st Sess. (2011).

[18] The Private Company Flexibility and Growth Act, H.R. 2167, 112th Cong., 1st Sess. (2011).

[19] *Id.*

[20] H.R. 1965, S. 556, 112th Cong., 1st Sess. (2011).

[21] *Id.*

including a cost-benefit analysis, of shareholder registration thresholds.[22] The House version of this bill was passed on November 2, 2011, also by a wide margin.[23]

PROHIBITION ON GENERAL SOLICITATION

Chairman Schapiro also asked the SEC staff to review the restrictions on rules imposed on communications in private offerings, in particular the restrictions on general solicitation.[24] One of the most commonly used exemptions from the registration requirements of the Securities Act is Section 4(2), and the Rule 506 safe harbor, which exempts transactions by an issuer "not involving any public offering." To qualify for the safe harbor under Rule 506, offers and sales cannot be made by any form of general solicitation or general advertising.[25] In his letter to Chairman Schapiro concerning capital formation issues, Chairman Issa asked her to "identify and explain the potential harm that may realistically result to an unaccredited investor by the receipt of an advertisement by an issuer of unregistered securities that is targeted at accredited investors or Qualified Institutional Buyers."[26] In response, Chairman Schapiro noted that "some continue to identify the general solicitation ban as a significant impediment to capital-raising."[27] She also noted that "some believe that the ban may be unnecessary because offerees who might be located through the general solicitation but who do not purchase the security, either because they do not qualify under the terms of the exemption or because they choose not to purchase, would not be harmed by the solicitation."[28] But she also recognized that others supported the ban as a necessary investor protection. Accordingly, her instructions to the staff with respect to reviewing this issue reflect a balanced approach, specifically that they should consider "whether the general solicitation ban should be revisited in light of current technologies, capital-raising trends and the SEC's mandate to protect investors and facilitate capital formation."[29]

With these considerations in mind, on November 3, 2011, the House of Representatives passed the Access to Capital for Job Creators Act (H.R. 2940), sponsored by Representative Kevin McCarthy (R-CA). The act would amend Section 4(2) of the Securities Act to read, "Transactions by an issuer not involving any public offering, *whether or not such transactions involve general solicitation or general advertising"* and cause the SEC to revise its rules to provide that the prohibition against general solicitation or general advertising contained in Rule 502(c) of Regulation D shall not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors.[30] A Senate version of this bill (S. 1831), sponsored by Senator John Thune (R-SD), was introduced on November 9, 2011.[31]

REGULATION A

Regulation A under the Securities Act provides an exemption from registration for capital-raising transactions by nonreporting companies of up to $5 million per year.[32] The exemption requires an offering document to be filed and reviewed by the SEC.[33] Regulation A offerings have information requirements that are generally lower and simpler than those required in registered offerings. Moreover, Regulation A offerings permit a public offering that is not limited to particular types of investors, and the securities purchased are not transfer-restricted under the Securities Act and, accordingly, are freely tradable following the offering.

Unlike registered offerings, companies that complete Regulation A offerings do not automatically become subject to ongoing reporting under the Exchange Act. Instead, reporting would be required only if the company has a class of securities listed on a national securities exchange or the company reaches the thresholds under Section 12(g) that require registration under the Exchange Act. Unlike Regulation D offerings, offerings conducted in reliance on Regulation A are not preempted

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[22] *Id.*

[23] The Roll Call was recorded as 420 Yeas, 2 Nays, and 11 Not Voting.

[24] *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearings before the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises*112th Cong., 1st Sess. (September 21, 2011) (testimony of Meredith B. Cross, Director, SEC Division of Corporate Finance.

[25] Securities Act Rules 506(b)(1) and 502(c).

[26] Letter from Chairman Issa to Chairman Schapiro, dated March 22, 2011.

[27] Letter from Chairman Schapiro to Chairman Issa, dated April 6, 2011.

[28] *Id.*

[29] *Id.*

[30] Access to Capital for Job Creators Act, H.R. 2940, 112th Cong., 1st Sess. (2011).

[31] Access to Capital for Job Creators Act, S. 1831, 112th Cong., 1st Sess. (2011).

[32] Securities Act Rule 251, *et seq*.

[33] Securities Act Rule 252.

from state registration under Section 18 of the Securities Act and, thus, are subject to compliance with state securities laws in the states in which the company offers or sells the securities. As a result of these burdensome state registration requirements and the low offering threshold, the Regulation A exemption is rarely used.

To make it easier for entrepreneurs to raise capital and create jobs, the White House supports raising the maximum size of Regulation A offerings from $5 million to $50 million. To accomplish this goal in Congress, the Small Company Capital Formation Act of 2011 (H.R. 1070 and S. 1544), sponsored by Representative David Schweikert (R-AZ) and Senator Jon Tester (D-MT), which the House passed on November 2, 2011, seeks to facilitate the capital formation process for small businesses by raising the Regulation A threshold to $50 million (and requiring the SEC to review the threshold every two years and increase the amount as it determines appropriate or explain to Congress its reasons for not increasing the amount).[34] According to Representative Spencer Bachus, Chairman of the House Financial Services Committee, "[a]mending Regulation A to make it a viable channel for small business to access capital will result in economic growth and more jobs. . . . [b]y lowering costs of raising capital, small businesses can more efficiently raise funds to invest and hire employees."[35]

As first proposed, the bill would have made the Regulation A exemption more appealing by making securities offered pursuant to the Regulation A exemption "covered securities" for purposes of the National Securities Markets Improvement Act ("NSMIA").[36] This would have made it unnecessary for those engaging in a Regulation A offerings to make a myriad of "Blue Sky" filings, thus further facilitating capital formation.[37] However, the North American Securities Administrators Association ("NASSA") successfully fought to remove the NSMIA exemption.[38] Heath Abshure, the chairman of NASSA's corporate finance section committee, testified before the Financial Services Committee on September 21, 2011 that, "[i]n the intervening months [since H.R. 1070 was reported out of committee], Representative Schweikert and his staff have worked with NASSA to improve and refine the legislation with respect to state authority, including a proposal to remove the critical [Blue Sky exemption] when this bill is considered by the full House."[39] The removal of the NSMIA exemption from the final bill approved by the House is likely to discourage issuers from using the revised Regulation A. However, the final bill contained a provision requiring the Comptroller General to conduct a study on the impact of Blue Sky laws on offerings made under Regulation A.[40]

PUBLIC COMPANY REFORMS

There has been increasing concerns about the costs for smaller companies of the internal controls over financial reporting attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002. The process of liberalizing the requirements of Section 404 started with the Dodd-Frank Act, which exempted issuers that were not "large accelerated filers" or "accelerated filers" from the Section 404 requirements.[41] However, there may be further liberalization to come.

Part of the White House's efforts to reduce the regulatory burdens on small business capital formation includes working with the SEC to reduce the costs that small and new firms face in complying with Sarbanes-Oxley disclosure and auditing requirements.[42] In furtherance of that goal, the Communities First Act (H.R. 1697 and S. 1600), sponsored by Representative Blaine Luetkemeyer (R-MO) and Senator Jerry Moran (R-KS), would create an exemption from the annual management assessment of internal controls requirement of Section 404 for any insured depository institution which, as of the close of the preceding year, had total assets, as determined on a consolidated basis, of $1 billion or less (*i.e.*, community banks).[43] The Startup Expansion and Investment Act (H.R. 2941), sponsored by Representative Ben Quayle (R-AZ), would create an elective exemption from Section 404 if the issuer has a total market capitalization for the relevant reporting

[34] The Small Company Capital Formation Act of 2011, H.R. 1070 and S. 1544, 112th Cong., 1st Sess. (2011).

[35] Administration Could Help Small Business Gain Access to Capital by Helping Pass the Small Company Capital Formation Act, Press Release, The Committee on Financial Services, March 22, 2011.

[36] Securities Act §18(b)(4).

[37] *Id.*

[38] Joe Gose, *Small Business Reform Gains Urgency,* THE PIPES REPORT, THIRD QUARTER REVIEW, October 18, 2011.

[39] *Id.*

[40] The Small Company Capital Formation Act of 2011, H.R. 1070, 112th Cong., 1st Sess. (2011).

[41] §989G Exemption for Nonaccelerated Filers, Dodd-Frank Wall Street Reform and Consumer Protection Act.

[42] Factsheet and Overview - American Jobs Act, Office of the Secretary, The White House, September 8, 2011.

[43] The Communities First Act , H.R. 1697 and S. 1600, 112th Cong., 1st Sess. (2011).

period of less than $1 billion and is not subject to the annual reporting requirement under Section 13(a) or 15(d) of the Exchange Act, or has been subject to such requirement for a period of fewer than 10 years.[44] An issuer electing to avail itself of this exemption would be required to disclose that decision in the next report required under Section 13(a) or 15(d) of the Exchange Act.[45]

The Small Company Job Growth and Regulatory Relief Act of 2011 (H.R. 3213), sponsored by Representative Stephen Fincher (R-TN), would create an exemption from the auditor attestation requirements of Section 404(b) for an issuer that has a total public float for the relevant reporting period of less than $350 million.[46]

On November 15, 2011, Senators Chris Coons (D-DE) and Marco Rubio (R-FL) introduced the American Growth, Recovery, Empowerment, and Entrepreneurship Act (S. 1866), or the "AGREE Act," which would provide a five-year exemption from Section 404(b) for the first five years of a company going public, or for those below $250 million in total gross revenue (whichever comes first).[47] The bill also directs the SEC to conduct and submit a report to Congress within nine months to (i) determine how the SEC could reduce the burden of Section 404(b) for companies with a market capitalization of between $250 million and $1 billion and (ii) assess the annual compliance costs posed by Section 404(b) for all companies with a market capitalization of below $1 billion.[48] On November 18, 2011, a companion to the AGREE Act (H.R. 3476) was introduced in the House by Representatives Richard Hanna (R-NY) and Bill Keating (D-MA).[49]

In the Senate, the Reopening American Capital Markets to Emerging Growth Companies Act of 2011 (S. 1933), sponsored by Senator Charles Schumer (D-NY), would create a new class of issuer, an "emerging growth company," under Section 2(a) of the Securities Act of 1933 and Section 3(a) of the Exchange Act of 1934.[50] An "emerging growth company" refers to an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. Such an issuer would continue to be an "emerging growth company" until the earlier of (i) the last day of the fiscal year during which it had total annual gross revenues of $1 billion or more; (ii) the last day of the fiscal year following the fifth anniversary of its initial public offering; and (iii) the date on which it is deemed a "large accelerated filer." An "emerging growth company" would have more lenient disclosure and compliance obligations with respect to executive compensation, financial disclosures, and new accounting rules. Further, an "emerging growth company" would be exempt from the auditor attestation requirements of Section 404(b) and be given a longer transition period for compliance with new audit, quality control, and independence standards under Section 103(a)(3) of Sarbanes-Oxley. The bill would provide a means by which "emerging growth companies" could "test the waters" on IPOs without having to go through the full registration process, so long as conversations were limited to qualified institutional buyers and institutions that are accredited investors. Finally, the bill would remove some of the restrictions on investment banks simultaneously underwriting public offerings, while providing research reports on a particular issuer.

CONCLUSION

In this difficult economic environment, lawmakers are seeking new ways to create jobs, and capital formation reform appears to be on the agenda. The weak economic climate, combined with prolonged unemployment is creating strong bipartisan support for these cost-free jobs creation measures. Because the reforms are still in their early stages, their final shape is still unknown. While some may question the impact these reforms may ultimately have on jobs creation, at this point in time, the stars appear to be aligning for some liberalization of capital formation rules. ■

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[44] The Startup Expansion and Investment Act, H.R. 2941, 112th Cong., 1st Sess. (2011).

[45] *Id.*

[46] The Small Company Job Growth and Regulatory Relief Act of 2011, H.R. 3213, 112th Cong., 1st Sess. (2011).

[47] American Growth, Recovery, Empowerment, and Entrepreneurship Act, S. 1866, 112th Cong., 1st Sess. (2011).

[48] *Id.*

[49] American Growth, Recovery, Empowerment, and Entrepreneurship Act, H.R. 3476, 112th Cong., 1st Sess. (2011).

[50] The Reopening American Capital Markets to Emerging Growth Companies Act of 2011, S. 1933, 112th Cong., 1st Sess. (2011).