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SEC Considering New Regulations Governing Capital Formation for Smaller Companies, Crowdfunding, Social and Other New Media

On April 6, 2011, Mary L. Schapiro, Chairman of the Securities and Exchange Commission ("SEC") sent a letter to Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, responding to a March 22, 2011 letter from Rep. Issa concerning capital formation issues. In her letter, Chairman Schapiro indicated that the SEC would consider revising the rules that govern the way in which small businesses are able to tap into equity markets in the new era of crowdfunding, social media and other new communications media that did not exist when the current SEC rules were established. Rep. Issa's letter discussed a number of perceived problems encountered in recent securities offerings, including the January 2011 decision by Goldman Sachs and Facebook to offer shares in a \$1.5 billion private offering only outside the U.S. In her letter, Chairman Schapiro indicated that the review is intended to give the SEC "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."

Which rules are under review by the SEC?

In her letter, Chairman Schapiro indicated that the SEC's review will be focused on

- communications in connection with securities offerings
- capital formation and the regulatory environment
- initial public offerings
- the shareholder threshold for public reporting
- new capital raising strategies
- investments in start-ups.

With respect to the shareholder trigger for public offerings, Section 12(g) of the Securities Exchange Act of 1934 and SEC Rule 12g-1 require companies with a class of equity securities held of record by 500 or more persons and more than \$10 million in assets at fiscal year end to register under the Exchange Act. This is known as the "500 Holder Rule".

What is the SEC's view of the current rules regarding communications in connection with securities offerings?

In her letter, Chairman Schapiro indicated that the general solicitation ban applicable to offerings of securities "has been supported on the grounds that it prevents securities fraud by, for example, making it more difficult for fraudsters to attract investors or unscrupulous issuers to condition the market." Chairman Schapiro also stated that the communication bans have been used primarily to control "gun jumping" issues during an IPO. Finally, Chairman Schapiro noted that since 2007, the SEC has been interpreting the prohibition on general solicitation to involve an analysis of whether investors participating in the offering were actually solicited through the activities that could be viewed as a general solicitation. This was a change from the prior longstanding SEC staff position that any general solicitation tainted all sales of securities, regardless of whether investors saw the general solicitation, unless such sales could be distinguished as a separate plan of financing from the offering to which the general solicitation applied.

What is the SEC's view on secondary trading of private company stock on online trading platforms?

In her letter, Chairman Schapiro indicated that the SEC staff is monitoring the secondary trading activity on a variety of online trading platforms, many of which are facilitating the trading of securities of private companies. Chairman Schapiro stated that "[t]rading that develops on online trading platforms can be beneficial in that it can provide much desired liquidity to investors, which can assist in attracting investors to smaller private companies. This benefit, however, must be balanced with investor protection concerns that can be raised when there is a lack of information available to investors about these private companies."

Did the SEC indicate whether the 500 Holder Rule will be amended and what the revised threshold under the new rules will be?

Chairman Schapiro did not suggest what a new shareholder threshold might be for the 500 Holder Rule. She noted proposals to increase the threshold and to exclude from the count accredited investors, qualified institutional buyers (QIBs) or other sophisticated investors. She also mentioned proposals to look at beneficial owners as well as record owners, which would have the effect of making it more difficult for already public

companies to cease public reporting. Chairman Shapiro mentioned that the 500 Holder Rule has been liberalized over the years, including in 2007 through the adoption of Rule 12h-1(f) under the Exchange Act, which provides an exemption to the application of Section 12(g) for compensatory stock options. This eliminated the need for private companies to go through a no-action letter procedure with the SEC in order to obtain an exemption once the company had issued stock options to more than 500 people.

Chairman Shapiro did not mention any change to the \$10 million asset threshold, which is the other trigger for registration under Section 12(g).

Will the SEC provide a special exemption from registration for crowdfunding?

Chairman Schapiro noted that the SEC staff has received numerous requests and has held a number of discussions regarding whether a special exemption from the SEC registration requirements would be appropriate for crowdfunding. Chairman Shapiro described crowdfunding as "a form of capital formation whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal." She mentioned an example described to the SEC Staff where a company would conduct an offering of up to a maximum of \$100,000, with a cap on individual investments of \$100.

Chairman Schapiro noted the need to balance facilitating capital formation with the protection of investors, but she did not take a particular stance on crowdfunding.

What is the Advisory Committee and what will it do?

Chairman Shapiro announced the formation of a new Advisory Committee on Small and Emerging Companies. She did not provide any specifics on how this committee would be constituted or what its specific mandates will be.

We note that the SEC formed an Advisory Committee on Smaller Public Companies in 2005. That committee consisted of securities lawyers, accountants, executives from small businesses, academics, venture capitalists and boutique investment banks. That committee issued a [final report](#) with recommendations in April 2006. Many of those recommendations, such as scaled disclosure and the elimination of the auditor opinion on internal controls for smaller public companies, were fully or partially adopted either by SEC rulemaking or by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The earlier committee recommended a new private offering

exemption that would not prohibit general solicitation and advertising for transactions with purchasers who do not need all of the protections of Securities Act registration, and a limited ability to "test the waters" for a private offering. Those recommendations have not been implemented, and we would expect them to be revisited by the new Advisory Committee.

What are the next steps?

Chairman Schapiro indicated the staff would specifically focus on issues such as:

- the restrictions on communications in initial public offerings;
- whether the general solicitation ban should be revisited in light of current technologies, capital-raising trends and the SEC mandates to protect investors and facilitate capital formation;
- 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
- the regulatory questions posed by new capital raising strategies.

Chairman Schapiro's letter did not indicate a timeline regarding any proposed rule changes regarding these matters.

What if you have questions?

For any questions or more information on these or any related matters, please contact please contact any attorney in the firm's corporate practice group. A list of such attorneys can be found by clicking "Attorneys" on this [page](#).

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