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# Legislative and Regulatory Proposals Affecting Capital Raising

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There have been several recent legislative and regulatory initiatives which, if adopted, could significantly affect the manner in which companies can raise capital, both in public capital markets and on a private basis. Following are brief descriptions of the more noteworthy proposals.

While it is not possible to predict whether the proposals currently before Congress will ultimately become law, the introduction of such legislation demonstrates congressional intent to moderate some of the legislation and regulations that have been adopted in recent years.

## "Crowdfunding" Exemption

Congress is currently considering legislation that could facilitate the ability of issuers to raise funds from individuals. Under the current private placement exemptions in the Securities Act of 1933 (the Securities Act), companies often restrict retail participation in unregistered private offerings to "accredited investors," including individuals with a net worth of at least $1 million or with an annual income of at least $200,000.

Under the Entrepreneur Access to Capital Act (H.R. 2930), which was passed by the House of Representatives on November 3, 2011, a "crowdfunding" exemption from registration would be added to the Securities Act for offerings by an issuer, or by an intermediary on behalf of an issuer, that meet the following criteria:

a) The aggregate dollar amount of securities sold in a 12-month period in reliance on the exemption is limited to $1 million (or $2 million, if the issuer provides audited financial statements to prospective investors).

b) The aggregate dollar amount of securities sold to any investor in a 12-month period does not exceed the lesser of (i) $10,000 or (ii) 10% of the investor's annual income.

The exemption would impose several disclosure, notification, and recordkeeping obligations on the issuer or an intermediary acting on behalf of an issuer, including the following:

- Warning potential investors of the speculative nature of the investment, including on the issuer's or intermediary's website.

- Providing the Securities and Exchange Commission (SEC) with the issuer's (or the intermediary's) physical address, its website address, and the names of the issuer's (or intermediary's) principals and employees, and providing the SEC with "investor level" access to the website.

- Taking “reasonable measures” to reduce the risk of fraud.

- Providing the SEC with notice of the offering not later than the first day on which securities are offered to potential investors and again upon completion of the offering.

- Establishing a target offering amount and not utilizing funds until 60% of the target amount has been raised.

- Outsourcing cash-management functions to a qualified third-party custodian such as a broker-dealer or depository institution.

- Requiring prospective investors to answer questions to demonstrate competence in recognizing the potential risks involved in the investment.

- Making available on the issuer’s or intermediary’s website a method of communication permitting the issuer and investors to communicate with each other.

If an intermediary is used to facilitate sales pursuant to the exemption, the intermediary would not be treated as a “broker” under the federal securities laws, with the result that the intermediary would not be required to be registered as a broker-dealer under the Securities Exchange Act of 1934 (the Exchange Act). However, H.R. 2930 requires the SEC to adopt disqualification provisions that would render issuers and intermediaries ineligible to rely on the exemption if they have been subject to certain disciplinary sanctions from the SEC and other regulatory bodies.

For a period of one year after a sale, an investor would only be able to resell the securities to the issuer or to an “accredited investor.”

An intermediary conducting an offering would be required to carry out a background check on the issuer’s principals.

H.R. 2930 would also amend Section 12 of the Exchange Act to provide that persons acquiring securities pursuant to the crowdfunding exemption would not be counted as record holders for purposes of determining whether the issuer’s securities are subject to the registration requirements of the Exchange Act.

With respect to state securities law compliance, a sale made pursuant to this exemption would be added to the category of “covered securities” and as such, state registration or qualification requirements would be preempted, although presumably a state could require some type of notification to be filed. It should be noted that state broker-dealer registration requirements would not be preempted for crowdfunding transactions and an intermediary may need to be licensed as a broker-dealer or exempt from licensing under applicable state laws.

The Senate is also currently considering a bill establishing a crowdfunding exemption, the Democratizing Access to Capital Act of 2011 (S. 1791). While similar to the House version, the Senate crowdfunding exemption would *require* the use of an intermediary and limit individual investments to $1,000 annually.

## SEC Registration Made Less Costly for Emerging Growth Companies

The House Financial Services Committee has overwhelmingly approved the Reopening American Capital Markets to Emerging Growth Companies Act (H.R. 3606), which seeks to reduce the cost of going public for small and medium-sized companies.

H.R. 3606 would create a new category of issuer, an "emerging growth company," defined as a company with annual revenues of less than $1 billion and a total public float of less than $700 million. The issuer would be granted "on ramp" status by being provided with exemptions from some of the requirements currently imposed on a company seeking to become public and on newly public companies. These exemptions would end (i) after five years, (ii) once the issuer achieves revenues of $1 billion, or (iii) when its public float reaches $700 million, whichever occurs first.

The following are among the benefits that H.R. 3606 would provide to emerging growth companies during their "on ramp" periods:

- An issuer would only need to include in its initial public offering (IPO) filing audited financial statements for the two fiscal years prior to filing rather than for the three fiscal years currently required. In addition, the issuer would be exempt from the Sarbanes-Oxley requirement that its independent accountants audit the effectiveness of its internal controls over financial reporting, although the issuer would be required to maintain such a system of internal controls and its executives would still be obligated to assess the system's effectiveness once the issuer becomes a public reporting company.

- The issuer's executive compensation would not be subject to a "say on pay" vote during the exemption period and, during that same period, it would not be required to provide disclosure describing the relationship between compensation and financial performance or between its CEO's pay and the median pay of all of its employees.

- A broker-dealer's publication or distribution of research reports on IPO or pre-IPO companies would not be considered an "offer" of the companies' securities, even if the broker-dealer is participating in the offering.

- In connection with its IPO, an emerging growth company would be allowed to submit its registration statement to the SEC for review in draft form on a confidential basis, similar to the manner in which foreign private issuers, until recently, were permitted to do.

H.R. 3606 would require the SEC to determine whether shares of an emerging growth company should be allowed to be traded in increments greater than the current $0.01. The SEC is also required to issue a report on the manner in which the registration requirements of Regulation S-K can be updated to reduce the cost of registration for emerging growth company issues.

The provisions of the Senate's version of the act (S. 1933) are similar to those contained in the House Bill.

## Proposed Removal of the Prohibition on General Solicitation and Advertising in Private Placements

Congress is also considering legislation that would remove the prohibition on general advertising and solicitation in private placements.

By interpretation, general solicitation and general advertising are not permitted in an offering made pursuant to the private placement exemption contained in Section 4(2) of the Securities Act, which is available for "transactions by an issuer not involving any public offering." Rule 506 of Regulation D, which is a safe harbor for Section 4(2) offerings, is specifically not available if such solicitation and advertising are utilized.

The proposed Access to Capital for Job Creators Act (H.R. 2940) would amend Section 4(2) to provide an exemption for "transactions by an issuer not involving any public offering, *whether or not such transactions involve general solicitation or general advertising*." In addition, H.R. 2940 would require the SEC to revise Regulation D to remove the prohibition against solicitation and advertising for Rule 506 offerings as long as all purchasers of the securities are "accredited investors."

It is unclear under the proposed legislation whether an issuer relying solely on Section 4(2), without the Rule 506 safe harbor, will be able to use general solicitation and general advertising when selling to nonaccredited investors, since the condition limiting sales to accredited investors would be applicable only to offerings made pursuant to the Rule 506 safe harbor.

The proposed act has also been introduced in the Senate as S. 1831.

## Increasing the Shareholder Threshold for Registration under the Exchange Act

Legislation has been introduced in both the House and the Senate to increase the number of equity security holders a company may have before the class of equity becomes subject to registration under the Exchange Act. Currently, Section 12(g) of the Exchange Act requires an issuer to register a class of equity securities if, on the last day of the issuer's fiscal year, the securities are held by 500 or more record holders and the issuer has total assets of more than $10 million.

Once registered, an issuer becomes subject to the periodic reporting requirements of the Exchange Act, as well as the Exchange Act's proxy rules, tender offer rules, and going-private rules. In addition, directors, officers, and significant shareholders of the issuer are required to comply with the beneficial ownership reporting rules of Section 16 and Regulation 13D-G under the Exchange Act.

Only holders of record are counted for purposes of the Exchange Act registration requirements. The beneficial owners of equity securities held in "street names" (e.g., customers of brokers) are not included in the 500-holder calculation. By rule, the SEC permits foreign private issuers that have 500 or more holders of record worldwide to avoid registration if they have fewer than 300 beneficial owners in the United States.

However, when calculating the number of U.S. resident beneficial owners, the foreign private issuer must include the number of U.S. holder accounts held by brokers, dealers, banks, and nominees.

Under the proposed Private Company Flexibility and Growth Act (H.R. 2167), the threshold for registration under the Exchange Act would be raised to 1,000 shareholders of record. In addition, persons who received their securities pursuant to employee benefit plans in transactions exempted under the Securities Act would not be counted as holders. In the Senate's version of the legislation (S. 556), the threshold would be increased to 2,000 record holders, but only for issuers that are banks or bank holding companies; the 500-holder limit would be retained for all other issuers.

## Adjustment of the Net Worth Calculation for Accredited Investors

One category of "accredited investor" under Regulation D is a natural person with a net worth or joint net worth with spouse of $1,000,000. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) required the SEC to provide that, in determining net worth, the market value of an investor's principal residence could no longer be included.

At the time the Dodd-Frank Act was adopted, the SEC advised that since the value of a principal residence could not be included as an asset, any indebtedness associated with the principal residence (e.g., a mortgage) up to the market value of the residence would not need to be included as a liability. However, any amount of indebtedness that exceeded the market value of the residence would have to be included as a liability.

In SEC Release 33-9287, the SEC promulgated a final rule (effective February 27, 2012) confirming that indebtedness secured by a primary residence up to the current market value of the residence will not be included as a liability, but adding the condition that any indebtedness secured by the residence that is incurred within 60 days prior to the sale of securities (other than as a result of acquisition of the residence) must be included as a liability, even if the value of the primary residence exceeds the amount of the indebtedness. The SEC stated that the 60-day look-back period was intended to prevent individual investors from attempting to manipulate their net worths by borrowing against their residences in order to reach the accredited investor level, either on their own initiative or at the urging of securities salespersons.

# Disqualifying Provisions to Be Added as a Condition of Rule 506 Regulation D Offerings

The Dodd-Frank Act requires the SEC to adopt rules that disqualify certain "bad actors" from reliance on the safe harbor of Rule 506 of Regulation D for private placement offerings. Currently, there are no such prohibitions imposed on Rule 506 offerings, although disqualifying provisions are applicable to offerings made under other Regulation D rules.

Under the Dodd-Frank Act mandate, the disqualifying provisions are to be "substantially similar" to those already contained in Regulation A under the Securities Act, which is an exemption available for certain small issuers.

In May 2011, the SEC issued Release 33-9211 describing the proposed revisions to Rule 506 and soliciting comments. In its release, the SEC stated that the persons subject to disqualifying provisions (Covered Persons) would include the following:

a) The issuer and any predecessor of the issuer or affiliated issuer, and the issuer's directors, officers, promoters, general partners, managing members and beneficial owners of 10% or more of any class of the issuer's equity securities.

b) Any person that has or will be paid remuneration for soliciting purchasers and the directors, officers, general partners, and managing members of such compensated solicitor.

Generally, the Rule 506 exemption would be unavailable to Covered Persons who had been subject to specified sanctions by courts and regulatory authorities such as the SEC, self-regulatory organizations (SROs), state securities commissions, and banking and insurance regulators. As proposed, there would be a five-year look-back period for some of the sanctions.

A disqualification would not serve to bar an offering if the SEC determines, upon a showing of good cause, that it is not necessary for the exemption to be denied, or if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed.

Once Rule 506 is amended to reflect the disqualification provisions, an issuer contemplating a Rule 506 offering may find it advisable to circulate questionnaires to the Covered Persons in their organization and/or to any participating intermediary receiving solicitation fees (such as a placement agent) prior to commencing an offering.

Certain practical issues may arise in the implementation of amended Rule 506 in view of the broad categories of Covered Persons. For example, a public company conducting a Rule 506 offering may find it difficult to obtain confirmation from an independent 10% shareholder that the shareholder is not subject to a disqualification. In addition, issuers and/or financial intermediaries may have officers and directors who could potentially trigger a disqualification even if such persons have no involvement with the private placement.

As an alternative to relying on the Rule 506 safe harbor and dealing with the disqualifying provisions, an issuer may choose to rely solely on the Section 4(2) exemption. However, in doing so, not only would it lose the safe harbor of Rule 506, it would also be unable to take advantage of the preemption of state securities laws provided for Rule 506 offerings. Without the preemption, compliance with state private placement exemptions can be a complicated, time-consuming, and expensive process.

## FINRA to Regulate Private Placements Sold by FINRA Members

The Financial Industry Regulatory Authority (FINRA) has submitted to the SEC proposed Rule 5123, which would create filing and disclosure requirements for a private placement in which a FINRA member is selling securities. The SEC is currently soliciting comments on the most recent version of the proposed rule.

Public offerings are required to be submitted to the FINRA Corporate Financing Department for review of the compensation terms and arrangements entered into with FINRA members. Private offerings have traditionally not been subject to filing with, or review by, FINRA. However, in 2009 FINRA adopted Rule 5122, which, subject to certain exemptions, requires that a FINRA member file a copy of the placement memorandum with the Department if it is participating in a private placement of its own securities or securities issued by a “control entity.”

Proposed Rule 5123 goes further than Rule 5122, mandating certain disclosures in offering materials and requiring a filing for *any* private placement in which a FINRA member is selling securities, whether the member is affiliated with the issuer or not.

As currently proposed, Rule 5123 would prohibit a FINRA member from selling securities in a private placement unless the member complies with the following requirements:

- If a private placement memorandum or term sheet has been prepared for use in the offering, it must disclose the use of proceeds, the amount of expenses incurred in the offering, and the amount and type of compensation to be provided to FINRA members and to sponsors, advisors, and finders. The placement memorandum or term sheet must be filed by the member with FINRA within 15 days of the first sale in the offering. Material amendments to such materials must also be filed.

- If no placement memorandum or term sheet is used, the member must make a notice filing with FINRA within 15 days of the first sale in the offering and include an affirmative statement that no disclosure documents are being used.

FINRA has stated that the sole purpose of the filing is to provide it with timely access to information about the private placement business of FINRA members. As such, FINRA will not provide comments on a submission nor will it issue an approval or no-objections letter.

Exemptions from Rule 5123 would be available for certain types of offerings, including Rule 144A offerings, and for offerings sold only to certain investors, including institutional “accredited investors” under Regulation D, “qualified institutional buyers,” and “qualified purchasers.” In addition, offerings made to employees and affiliates of the issuer would also be exempt.

In its initial proposal, FINRA had broadly defined “private placement” to mean an unregistered transaction in reliance on “an available exemption under the Securities Act,” which could have potentially imposed a filing requirement for transactions that do not involve private offerings. However, after public comment, FINRA revised the definition of a “private placement” to mean a “non-public offering” conducted in reliance on an available exemption under the Securities Act. FINRA has stated that the inclusion of this language is meant to ensure that certain transactions and securities exempt from registration under the Securities Act would not be subject to the new rule, such as secondary trading, offerings of bank securities, and transactions by an issuer exclusively with its existing security holders.

Commenters had raised the issue of the applicability of proposed Rule 5123 to merger and acquisition transactions in which a FINRA member is participating. In the most recent version of the proposed rule, FINRA proposes to add an exemption for “business combination transactions” as defined in Rule 165(f) under the Securities Act. While this would exclude many M&A transactions and exchange offers from the coverage of proposed Rule 5123, by no means would it exempt all such transactions, and a nonexempt transaction would still need to be reported to FINRA.

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