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Corporate Advisory

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Securities Exchange Act of 1934: SEC Considers Relaxation of Certain Capital Formation Rules to Energize Private Capital Raising Efforts

The Securities and Exchange Commission is considering making substantive rule changes to reduce the regulatory burdens on small business capital formation. The SEC's consideration of these rule changes stem from concerns raised by fast-growing private start-up and growth companies, most recently, Facebook, Inc., Twitter Inc. and Zynga, Inc. At issue are Securities and Exchange Act rules that presently require a company with 500 or more holders of record of a class of equity security and assets in excess of $10 million at the end of its most recently ended fiscal year to register that class of equity security.

Advocates for these rule changes argue that the "inadvertent public company rules" have caused a number of private start-up and growth companies to "go public" sooner than desirable and may have curtailed their ability to raise capital from potential domestic investors. For example, Google, in its Registration Statement on Form S-1, stated, in part, that "[b]y law, certain private companies must report as if they were public companies. The deadline imposed by this requirement accelerated our decision [to go public]."

In a letter from SEC Chairman Mary Schapiro to Congressman Darrell Issa (R., Calif.), the Chairman noted that the SEC is considering broadening the "500 shareholder rule" to allow private companies to exceed 499 shareholders without "going public." According to Schapiro, the SEC can change this threshold without congressional approval, which means there is no threat of legislative delay once the SEC makes a final decision.

Raising the shareholder number would allow companies such as Facebook, Zynga and Twitter to raise money from a greater pool of people without having to publicly disclose information. Jean Eaglesham, in his April 8, 2011 Wall Street Journal article, titled "U.S. Eyes New Stock Rules," wrote that "this change would allow private companies to raise money without the added expenses of SEC registration and reporting requirements." For start-ups in need of money and time, registration and reporting requirements burn both at a steady rate.

Apart from changes to this rule, the SEC is focused on potentially more sweeping regulatory changes. Schapiro's letter stated that "all the rules that affect share issues by privately held companies" are under review, and on April 8, she also noted that the SEC is determining "whether our rules have kept pace with changing market dynamics." The tone of the SEC's evaluation indicates that the Commission is prepared to make more changes, and if the proposed “500 shareholder rule” revision is any indication, the new rules will provide greater flexibility and support for capital raising efforts by smaller companies.

We continue to monitor these matters and will provide a further update as events transpire.

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