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Current proposals to alter the rules governing capital raises in the US

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The United States has suffered a declining IPO market in recent years, and has lost IPO market share to non-US securities exchanges. This, coupled with the adverse market conditions faced by smaller US businesses in raising capital in the current economic climate, has brought increased attention to the question of whether US securities laws and regulations need to be modified to facilitate both public and private offerings of securities. The focus is on both simplifying and making less costly the capital-raising process, as well as on lessening the regulatory burden placed on companies once they are public.

This discussion has become all the more acute in the wake of the regulatory reform efforts that resulted in the Dodd-Frank Act. In the wake of Dodd-Frank, Republican members of the US Senate and House have questioned broadly whether the current regulatory regime, writ large, is stifling to US businesses. More narrowly, their attention has focused on whether small businesses are disproportionately hindered in their ability to obtain financing, expand, and create jobs. We look briefly at several areas in which current US securities laws and regulations are most likely to face calls for change, and offer our observations on the likelihood and potential direction of such change.

Communications in connection with offerings

Under US securities laws, communications in connection with both public and private offerings are subject to substantial restrictions.

Private placements. Companies undertaking private placements of securities in the US are prohibited from engaging in any 'general solicitation or advertising' in relation to the offering. As this can be broadly interpreted to include communications or promotional information that favourably conditions the market for a company's securities, companies tend to take a conservative approach to any public statements made in connection with or around the time of private placements. Recently, Facebook attempted to complete a private placement of equity through Goldman Sachs. In the face of leaked information about the offering that garnered widespread press attention in the US, Facebook and Goldman Sachs decided to avoid sales to US investors, and complete the offering exclusively outside the US, in recognition of the risk that the press attention might be construed to violate the prohibition on general solicitation and advertising (even if, as has been maintained, the leaked information did not come from Facebook or Goldman Sachs).

Observers have noted that the harm of any general solicitation or advertising in the context of a private placement is hard to identify, given that actual sales of the securities must be made only to eligible investors that are limited in number and meet the sophistication and pre-existing relationship requirements of the private placement rules. Nonetheless, the Securities and Exchange Commission has favoured the existing restrictions on communications in private placements, suggesting that they make it more difficult for fraudsters to attract investors or for unscrupulous issuers to condition the market for stock offerings.

However, new technologies and methods of electronic communication also put pressure on the existing communications restrictions in private placements, as information is more easily and rapidly disseminated (including in the context of leaks outside the issuer's control). Moreover, smaller companies and potential investors can easily find each other via the internet without the involvement of a placement agent or other institutional middleman, and permitting broader solicitations by issuers could lead to much more efficient capital-raising practices. Clarification (with perhaps some liberalisation) of the rules regarding permitted communications during private placements could help companies avoid situations like that of Facebook, where capital-raising transactions are delayed or derailed by uncertainty about the risks related to publicly circulated information.

In light of these considerations, the SEC staff are currently engaged in a review of, among other things, whether the general solicitation and advertising ban in the context of private placements should be revisited to take account of current technologies and capital-raising trends. Senior staff have indicated that a concept release soliciting public comment on this issue will be released in the coming months. It is possible, although by no means certain, that some measured relaxation of these rules by the SEC could result, either through actual rule modification or a clarification of how current restrictions are interpreted and applied.

Public offerings. It seems less likely that the SEC staff will undertake a major liberalisation of existing rules governing communications in connection with IPOs and other public offerings. Under current US rules, companies are prohibited from making statements that could constitute an 'offer' of their securities in advance of filing a registration statement, and they are restricted in their use of written materials (other than the prospectus) in connection with soliciting investors. The broad interpretation of what constitutes an 'offer' and the risk that a communication (including statements made to media) may be deemed to constitute an

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illegal prospectus, has led to very conservative practices among issuers and underwriters in relation to public offerings in the US.

Before a registration statement is filed, any 'offer' of the securities is illegal (and commonly referred to as 'gun-jumping'). Communications to the public or to prospective investors that refer to the offering or the securities, or that tout the company, may create a gun-jumping risk. The SEC can force a delay in the offering process in the face of a gun-jumping violation, and the issuer and underwriters may face regulatory action.

After a registration statement is filed, offers are permitted, but must be made orally or through the use of a written prospectus meeting the requirements of the Securities Act of 1933. Any other written communication that may be broadly construed as offering the securities may be an illegal prospectus. This includes comments made by company officers to media that are published during the offering period.

In recent years, and in particular through the securities offering reform rules adopted in 2005, the SEC has sought to liberalise the regime governing the use of written materials in relation to offerings, and somewhat expanded a number of available exemptions. The SEC appears to view these reforms as striking an appropriate balance between the interests of issuers and investors in having free information flow in the context of offerings, on the one hand, and the preservation of investor protections and deterrence of fraudulent or manipulative market practices, on the other hand. We therefore see less likelihood for substantial further change in this area.

Going public triggers

An area in which regulatory modernisation seems particularly needed relates to the rules governing when private companies are so widely held that they should be subject to public financial reporting, and, conversely, the rules governing when public companies should be permitted to cease public reporting based on how closely held they are.

Under US securities law, a company becomes obligated to file annual, quarterly and other reports with the SEC, and thus is viewed as a 'public company', if: (i) the company sells securities (debt or equity) in an offering that is registered with the SEC; or (ii) at the end of a fiscal year, 500 or more people hold securities of the company 'of record' and the company has total assets in excess of $10m.

In the case of a company that is a foreign private issuer, in addition to the 500 holder trigger, the company is not required to register with the SEC unless it also has 300 or more record holders resident in the US.

There are complexities to these seemingly simple rules.

'Going dark'. A company triggers the obligation to file periodic reports as a result of a registered offering even if there are fewer than 500 record holders at the end of the offering. However, if, at the end of a fiscal year, the company has fewer than 500 record holders, it is then permitted to deregister, and thus cease to be a public company. This is referred to as 'going dark'.

Thus, a public company can flip back to non-reporting private status in relatively short order. Many companies would not consider taking this step, having just gone through the effort and incurred the expense of preparing their first SEC reports, including their first audited financial statements. However, the option is utilised by some companies. From a policy point of view, it is not clear that public investors are well-served by permitting companies to toggle in and out of public reporting status this easily.

Determination of holders of record. 'Holders of record' is defined by a rule adopted in 1965, prior to the advent of book-entry securities. Under that rule, a record holder of a security is a person identified as an owner in the records of security holders maintained by the issuer in accordance with accepted practice. Since 1965, most public companies have shifted from physical to book-entry ownership of securities. In the US, securities are held through the Depository Trust Company, which maintains electronic book-entry records of ownership for its member organisations (primarily banks and broker/dealers), which in turn maintain electronic records of the ownership interests of their clients. Thus, for most US public companies, there is a single record holder for the vast majority of the company's securityholders.

In contrast, a privately held company will not utilise DTC, and thus beneficial owners of the company's securities will appear on the company's records. This creates the anomalous result of a privately held company transcending the 500-holder threshold as it grows (the $10m total asset threshold is rarely the issue), whereas a very large public company may not come close to that threshold.

The Chairman of the SEC recently stated that both the number of holders that should trigger registration, and how those holders are counted, needs to be examined. There are several potential alternatives:

Increase the number of holders. The current 500-holder limit could be increased. Suggestions include thresholds of 2000 or more holders. It would also be possible to increase the threshold only for certain types of issuers (for example, a bill was introduced in Congress in March 2011 to increase the threshold to 2000 holders for issuers that are banks). Much of the concern regarding this issue has arisen with start-up technology companies, however, so it is not clear why a change limited to banks would be useful.

Exclude institutional investors from the threshold. It has been suggested that sophisticated institutional investors could be excluded from any such calculation, as these investors do not need the information that public reporting provides. While this approach is very common in other areas of US securities law, it raises issues here. First, it will incentivise companies to exclude retail investors. There is already concern that US securities regulations may create incentives to favour institutional holdings at the expense of retail holdings. In addition, if an issuer relied on the presence of institutional investors to get below the then-current num-

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ber of holders limit, the presence of those investors would effectively divest remaining retail holders from the benefits of public reporting. While institutional investors may not need that information, there may not be a basis for also concluding that retail holders do not need it.

Change the method of calculating record ownership. It seems clear that the rules defining record ownership need to change to reflect current realities. The rule was designed to make it easy for companies to determine whether they were subject to registration. Conceptually, it should be possible for a DTC member (a bank or broker/dealer) to provide DTC with the number of clients for which it is holding a particular security, without naming those clients.

Of course, there would be issues in doing so accurately. For example, there will be double-counting due to clients holding positions in multiple accounts, and mutual fund holdings should only be attributed to the fund, not to the stockholders in the fund. The industry has, over the years, developed highly sophisticated reporting structures for tax purposes, for example in the mutual fund industry, and has also sought to identify multiple-account holdings in the same household to reduce the cost of distributing proxy statements to beneficial owners. The SEC would need to engage in fact-finding as to how best to address these issues as a part of any rulemaking on this point.

Modernisation of Regulation A

One potential way to ease the cost and complexity of public capital raising for smaller businesses may be to modernise and reinvigorate existing Regulation A under the Securities Act of 1933. Regulation A provides an exemption from the SEC's registration requirements for public offerings of $5m or less by private companies. The exemption permits sales of the securities to any type of investor, and does not require use of a prospectus meeting the requirements of the Securities Act. An offering statement is required to be filed with the SEC, but it does not have to include audited financial statements and is not subject to prior review by the SEC staff. Companies that undertake a public offering under Regulation A also do not become subject to periodic reporting obligations going forward and are not generally subject to Sarbanes-Oxley Act obligations thereafter.

Regulation A has been little used by smaller companies in recent years, mainly because of the very low $5m cap on offering size and because the rule does not provide any exemption from the various securities laws of the states ('blue-sky laws'). Legislation has been introduced in the US House of Representatives that would authorise the SEC to make changes to Regulation A, including increasing the cap on offering size to $50m, to make Regulation A more useful to smaller companies as an avenue to a public IPO. A higher threshold could, for example, permit listing of the stock on a national securities exchange. The SEC might also provide for a general exemption from blue-sky laws for Regulation A offerings. To address investor-protection concerns associated with allowing larger offerings under Regulation A, the SEC could adopt additional requirements (such as audited financials or ongoing periodic financial reporting). Small companies should continue to monitor proposed changes in Regulation A in the coming months, as it could lead to a revitalised method of capital formation for them.

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