

CAPITAL RAISING MADE EASIER? SEC-ESTABLISHED COMMITTEE PROPOSES TO EASE RESTRICTIONS ON GENERAL ...

One common piece of advice that securities lawyers often provide to clients is that there are three ways to raise capital by selling securities: (i) by registering the securities with the U.S. Securities and Exchange Commission (“SEC”), (ii) by utilizing an exemption from registration, or (iii) illegally. The first of these options is time consuming and expensive, particularly for startups. The third option is, well, illegal. However, the second option, utilizing an available exemption from registration, is commonly used by startups to raise seed capital and in subsequent venture rounds. An SEC-established committee has now made a recommendation that would make the capital-raising process even less burdensome to startups in certain cases.

The SEC established the Advisory Committee on Small and Emerging Companies (the “Advisory Committee”) in 2011 to seek advice on SEC rules and regulations as they relate to emerging companies, privately-held small businesses, and certain smaller publicly traded companies. On January 6, 2012, the Advisory Committee voted to adopt a recommendation to relax or modify restrictions on general solicitation and general advertising in connection with the most commonly utilized exemption from registration.

That exemption, known as Rule 506, currently provides that neither the company seeking capital nor anyone acting on its behalf may offer or sell securities by any form of general solicitation or general advertisement. This prohibition effectively prevents a startup from raising capital from anyone with whom the startup does not have a substantial pre-existing relationship. The rule prohibits, for example, seeking investors via a general notice placed on the company’s social media sites.

The Advisory Committee found that these restrictions prevent many companies from gaining sufficient access to sources of capital. Additionally, the Advisory Committee found that the investor protections afforded by these restrictions are unnecessary in cases where securities are sold solely to accredited investors. The term “accredited” investor includes, among others, individuals that meet certain net worth or income thresholds, as well as business entities that have a specified minimum total asset valuation. Under the Advisory Committee’s recommendation, as long as a company’s securities are sold only to accredited investors, the current prohibitions on general solicitation and general advertisement would not apply.

It remains to be seen what action, if any, the SEC will take with respect to the Advisory Committee’s recommendation. However, there is momentum in Washington to ease certain securities law restrictions in order to make it easier for closely held companies to raise capital. If fully implemented, the Advisory Committee’s proposed changes to the most commonly utilized exemption from registration could provide startups with a useful pathway to seed or venture financing from individuals or entities with whom the startup does not have a substantial pre-existing relationship.