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Congress Opens the Door to More Small Company Offerings

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Raising capital for small businesses has always been difficult and the economic downturn of 2008 did not help matters. Banks that were once a good source of small business financing are now paralyzed and afraid to take any real risk. Access to public markets has been reserved for a select few, especially considering the costs of being a public after the Sarbanes–Oxley Act of 2002. Unfortunately, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), triggered changes to the "accredited investor" rules under Regulation D and "qualified client" rules under the Investment Advisor's Act to effectively raise the bar for who could participate in certain types of private equity offerings. Fortunately, Congress is considering some relief that could open the door to more funding sources.

Abandonment of General Solicitation Prohibition

On November 3, 2011, the United States House of Representatives (the "House") passed the Access to Capital for Job Creators Act (the "Access Act") by a margin of 413-11 votes. The Access Act, now in Committee in the United States Senate (the "Senate"), allows for an issuer relying on the exemptions under Section 4(2) of the Securities Act of 1933 (the "Act") or Rule 506 under Regulation D of the Securities Act of 1933 ("Rule 506") to use general solicitation to offer and sell the issuer's securities.[1] Currently, general solicitation is prohibited by Section 4(2) of the Act and Rule 506, which has reflected the Securities and Exchange Commission's (the "SEC") and Congress's belief that restricting offerings to investors that have a prior existing relationship with the issuer will provide for greater disclosure and vetting of the offering by the investor.[2]

The abandonment of the general solicitation prohibition under Section 4(2) and Rule 506 opens the door to an unlimited amount of funding for small businesses. Under the Access Act, as long as certain sophistication standards are met, the issuer may raise an unlimited amount of money from practically any qualified investor without the regulatory burden of a registered offering. Furthermore, general solicitation would open the internet to issuers to conduct crowd funding offerings without the limitations that are present in the crowd funding bills that are currently pending in Congress.[3] As a result, the bill provides access to a larger pool of potential investors, while minimizing the regulatory costs of conducting a virtual public offering, allowing issuers the opportunity to raise greater amounts of capital and to grow the issuer faster.

Expansion of Regulation A

The House also passed the Small Company Capital Formation Act ("Formation Act") on November 2, 2011. Similar to the Access Act, the Formation Act allows for general solicitation when pursuing an offering under Regulation A pursuant to Section 3 of the Act, known as the "Testing the Water" exemption for issuers considering an IPO.[4] Under this act, the House has also proposed to increase the offering limitation in Section 3(b)(2)(A) of the Act and Regulation

A from $5 million to $50 million.[5] To ensure the $50 million threshold is adjusted appropriately over time, the bill requires the SEC to review the cap on fund raising under Regulation A every two (2) years.

While this substantially raises the potential capital that issuers may seek under Regulation A, the bill does provide for some additional restrictions. First, the bill includes a "Bad Boy" disqualification rule similar to Section 926 of the Dodd-Frank Act.[6] Consequently, issuers, officers, directors, or underwriters may be unable to use the Regulation A exemption if they: (i) are the subject of a final order from the Commission related to fraud claims; (ii) have been convicted of a felony or misdemeanor in connection with the sale or purchase of a security; or (iii) submitted false filings to the SEC.[7] In addition, and potentially more burdensome to issuers, the bill requires issuers to file audited financial statements with the SEC and provide disclosures regarding the financial and business operations of the company with both the SEC and investors.[8] Although these reports will not be overly burdensome for issuers obtaining the maximum levels of funding under the exemption, it may be cost prohibitive for smaller companies at the lower end of the offering threshold. Nevertheless, the fundraising potential under the proposed changes to Regulation A will allow small companies to stay private for an extended period of time and avoid the expensive registration process.

Changes to the Section 12(g) Investor Threshold

Two (2) versions of the Private Company Flexibility and Growth Act are currently being considered in the houses of Congress. Both seek to expand the investor limit caps contained in Section 12(g) of the Securities Exchange Act of 1934 ("Section 12(g)"). Currently, Section 12(g) requires any company with 500 or more investors and assets worth at least $10 million to register. The House bill increases this cap to 1,000 investors and explicitly excludes any employee participating in an "employee compensation plan" from being counted toward the 1,000 investor cap.[9] The Senate adopted the "employee compensation plan" provision, but further increased the investor cap to 2,000 investors.[10]

The passage of either of these bills will help ease the restrictions on small businesses by allowing these companies to seek capital from greater numbers of investors without registering with the SEC. Presumably this will allow issuers to raise more capital; or, alternatively, make more successful offerings by allowing issuers to lower the price per share of the offer to incorporate more investors. In addition, this bill would complement the current crowd funding bills in the Senate, that seek to create an exemption under Section 4(6) of the Act allowing issuers to use online social media outlets to make limited offers to numerous investors.

Conclusion

Congress has dedicated a substantial portion of its session to the securities laws in the wake of the recession and the Dodd-Frank Act. The Access to Capital for Job Creators Act, the Small Company Capital Formation Act, and the Private Company Flexibility and Growth Act all provide opportunities for small businesses and start-up companies that are currently unable to expand under the restrictive structure of the federal securities laws. If enacted, the bills being considered by Congress today will provide increased fundraising opportunities for these

businesses by: (i) removing the prohibition against general solicitation in Section 4(2) of the Act and Rule 506, ultimately tapping rarely used mediums for raising capital, such as the internet; (ii) increasing the dollar limitation ten-fold on Regulation A offerings; and (iii) increasing the investor limitation cap under Section 12(g), which currently limits the number of investors and capital raising opportunities for growing companies that are not ready to file for an IPO.

The following is a summary of the bills currently being considered by Congress:

BILL	**DESCRIPTION**	**STATUS**
H.R. 2940/S. 1831 "Access to Capital for Job Creators Act"	Allows for general solicitation for securities offerings under the exemptions in Section 4(2) of the Securities Act of 1933 and Rule 506 of Regulation D. Revises Section 4(2), Rule 502, Rule 506 and of the Securities Act of 1933.	Passed in the House on November 3, 2011. In the Senate Committee on Banking, Housing, and Urban Affairs.
H.R. 1070/S. 1544 "Small Company Capital Formation Act"	Revises Section 3(b)(2)(A) of the Securities Act of 1933 and Regulation A of the Securities Act to allow general solicitation for funds of up to $50,000,000. The securities will not be "Restricted Securities." Issuers may solicit interest prior to filing Form 1-A. Issuers would be required to file audited financial statements with the SEC annually and provide the SEC and investors with disclosures on the business operations, financial condition, corporate governance principles and use of investors' funds. Adopts the "Bad Boy" disqualification rule under Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC would be required to review the offering amount limitation every two (2) years.	Passed in the House on November 2, 2011. In the Senate Committee on Banking, Housing, and Urban Affairs.
H.R. 2167 "Private Company Flexibility and Growth Act"	Revises Section 12(g)(1)(B) of the Securities Exchange Act of 1934, which previously required registration for companies exceeding 500 investors and $10 million in total assets. Under the bill, the threshold for investors would be raised to 1,000 persons. In addition, pursuant to the revisions in Section 12(g)(5) of the Securities Exchange Act of 1934, any investor who received securities pursuant to an *employee compensation plan* would be exempt from the total number of investors. The SEC would be required to adopt safe harbor provisions that issuers can follow to determine if shares were received through a compensation plan.	Placed on the Union Calendar in the House.
S. 1824 "Private Company Flexibility and Growth Act"	Revises Section 12(g)(1)(B) of the Securities Exchange Act of 1934. Under the Senate bill, the threshold for investors would be raised to 2,000 persons. In addition, pursuant to the revisions in Section 12(g)(5) of the Securities Exchange Act of 1934, any investor who received securities pursuant to an *employee compensation plan* would be exempt from the total number of investors. The SEC would be required to adopt safe harbor provisions within one (1) year that issuers can follow to determine if shares were received through a compensation plan. The threshold for registration under Section 12(g)(4) of the Securities Exchange Act of 1934 expanded to include bank holding companies.	In the Senate Committee on Banking, Housing, and Urban Affairs.

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[1] Access to Capital for Job Creators Act, H.R. 2940, 112th Congress, §§ 2(a) and (b) (2001).
[2] 15 U.S.C. 77(e)(2) (2007) and 17 CFR § 230.506 (2007).
[3] Entrepreneur Access to Capital Act, H.R. 2930 (as read in the Senate on November 7, 2011), 112th Cong. (2011); Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. (2011); *and* Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (2011).
[4] Small Company Capital Formation Act, H.R. 1070, 112th Cong., § 2 (2011).
[5] Small Company Capital Formation Act, H.R. 1070, 112th Cong., § 2 (2011).
[6] Small Company Capital Formation Act, H.R. 1070, 112th Cong., § 2 (2011).
[7] Small Company Capital Formation Act, H.R. 1070, 112th Cong., § 2 (2011).
[8] Small Company Capital Formation Act, H.R. 1070, 112th Cong., § 2 (2011).
[9] Private Company Flexibility and Growth Act, H.R. 2167, 112th Cong., §§ 2 and 3 (2011). If enacted, the SEC is required to conduct rulemaking to define a "safe harbor" providing guidance on the definition of an "employee compensation plan."
[10] Private Company Flexibility and Growth Act, S. 1824m 112th Cong. § 2 (2011).