

## SEC leader signals revised rules

*The commission is considering new regulations governing capital formation for smaller companies via crowdfunding, social and other new media*



Louis Lehot and Jason Schendel

### Securities

**O**n April 6, Mary Schapiro, chairwoman of the Securities and Exchange Commission, sent a letter to Rep. Darrell Issa, chairman of the Committee on Oversight and Government Reform, responding to a March 22 letter from Issa concerning capital formation issues. In her letter, Schapiro indicated that the SEC would consider revising the rules that govern the way in which small businesses are able to tap into equity markets in the new era of crowdfunding, social media and other new communications media that did not exist when the current SEC rules were established.

Issa's letter discussed a number of perceived problems encountered in recent securities offerings, including the January decision by Goldman Sachs and Facebook Inc. to offer shares in a \$1.5 billion private offering only outside the U.S. In her letter, Schapiro indicated that the review is intended to give the SEC "a fresh look at our rules to develop ideas for the commission about ways to reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection." In addition, Schapiro indicated that the SEC's review will be focused on (1) communications in connection with

*Louis Lehot is a partner and Jason Schendel is an associate practicing in the corporate, securities and mergers and acquisitions group of Sheppard, Mullin, Richter & Hampton in Palo Alto.*

securities offerings; (2) capital formation and the regulatory environment; (3) initial public offerings; (4) the shareholder threshold for public reporting; (5) new capital raising strategies; and (6) investments in startups.

### RESTRICTIONS UNDER CURRENT SEC RULES

In her letter, Schapiro suggested that the general solicitation ban applicable to offerings of securities "has been supported on the grounds that it prevents securities fraud by, for example, making it more difficult for fraudsters to attract investors or unscrupulous issuers to condition the market." Schapiro also stated that the communication bans have been used primarily to control "gun jumping" issues during an IPO. Finally, she noted that since 2007, the SEC has been interpreting the prohibition on general solicitation to involve an analysis of whether investors participating in the offering were actually solicited through the activities that could be viewed as a general solicitation. This was a change from the prior long-standing SEC staff position that any general solicitation tainted all sales of securities, regardless of whether investors saw the general solicitation, unless such sales could be distinguished as a separate plan of financing from the offering to which the general solicitation applied.

Schapiro also indicated that the SEC staff is monitoring the secondary trading activity on a variety of online trading platforms, many of which are facilitating the trading of securities of private companies. She stated that "[t]rading that develops on online trading platforms can be beneficial in that it can provide much desired liquidity to investors, which can assist in attracting investors to smaller private companies. This benefit, however, must be balanced with investor protection concerns that can be raised when there is a

lack of information available to investors about these private companies."

### 500 HOLDER RULE

With respect to the shareholder trigger for public offerings, §12(g) of the Securities Exchange Act of 1934 and SEC Rule 12g-1 require companies with a class of equity securities held of record by 500 or more persons and more than \$10 million in assets at fiscal year end to register under the exchange act. This is known as the "500 Holder Rule." Schapiro did not suggest what a new shareholder threshold might be for the 500 Holder Rule. She noted proposals to increase the threshold and to exclude from the count accredited investors, qualified institutional buyers (QIBs) or other sophisticated investors. She also mentioned proposals to look at beneficial owners as well as record owners, which would have the effect of making it more difficult for already public companies to cease public reporting.

Schapiro mentioned that the 500 Holder Rule has been liberalized over the years, including in 2007 through the adoption of Rule 12h-1(f) under the exchange act, which provides an exemption to the application of §12(g) for compensatory stock options. This eliminated the need for private companies to go through a no-action letter procedure with the SEC in order to obtain an exemption once the company had issued stock options to more than 500 people. Notably, Schapiro did not mention any change to the \$10 million asset threshold, which is the other trigger for registration under Section 12(g).

### CROWDFUNDING

Schapiro noted in her letter that the SEC staff has received numerous requests and has held a number of discussions regarding whether a special exemption from the SEC registration requirements would be appropriate for crowdfunding.

She described crowdfunding as “a form of capital formation whereby groups of people pool money, typically composed of very small individual contributions, to support an effort by others to accomplish a specific goal.” She mentioned an example described to the SEC staff, where a company would conduct an offering of up to a maximum of \$100,000, with a cap on individual investments of \$100. Schapiro noted the need to balance facilitating capital formation with the protection of investors, but she did not take a particular stance on crowdfunding in her letter.

#### **COMMITTEE ON SMALL AND EMERGING COMPANIES**

Schapiro announced the formation of a new advisory committee on small and emerging companies. She did not provide any specifics on how this committee would be constituted or what its specific man-

dates will be. The SEC previously formed an Advisory Committee on Smaller Public Companies in 2005. That committee consisted of securities lawyers, accountants, executives from small businesses, academics, venture capitalists and boutique investment banks. That committee issued a final report with recommendations in April 2006. Many of those recommendations, such as scaled disclosure and the elimination of the auditor opinion on internal controls for smaller public companies, were fully or partially adopted either by SEC rulemaking or by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The earlier committee recommended a new private offering exemption that would not prohibit general solicitation and advertising for transactions with purchasers who do not need all of the protections of securities act registration, and a limited ability to “test

the waters” for a private offering.

#### **NEXT STEPS**

In terms of the next steps, Schapiro indicated the SEC staff would specifically focus on issues such as: (1) the restrictions on communications in initial public offerings; (2) whether the general solicitation ban should be revisited in light of current technologies, capital-raising trends and the SEC mandates to protect investors and facilitate capital formation; (3) the number of shareholders that trigger public reporting, including questions surrounding the use of special purpose vehicles that hold securities of a private company for groups of investors; and (4) the regulatory questions posed by new capital raising strategies. Schapiro’s letter did not indicate a time line regarding any proposed rule changes regarding these matters.