TWO'S COMPANY, TWO THOUSAND IS A CROWD: NEW LAW RELAXES RESTRICTIONS ON "CROWD-SOURCED" FUNDING

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Craig McCrohon

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Bowing to the backlash against government regulation in the financial markets, Congress and the President have approved changes to securities laws that loosen rules on selling stock and other securities. The American Jobs Act, enacted this spring, permits companies to raise private capital from thousands of buyers regardless of their wealth, instead of only a few dozen non-accredited purchasers. In addition, the law includes a smorgasbord of reforms relaxing prior restrictions on private capital raising.

Crowd Funding

The highest profile provision legalizes “crowd funding,” a recent internet-inspired trend in fundraising based on “crowds” that gave money in small amounts to non-profits and start-ups. The trend had become sufficiently popular that businesses lobbied Congress to bless this novel fundraising technique.

The Way It Was: Before the Act, regulations permitted sales of securities to a virtually unlimited number of purchasers, up to $1 million per offering. However, if a company raised more than $1 million, the law restricted the number of buyers to 35 non-wealthy non-accredited investors.

The Way It Will Be: After the Jobs Act, and the adoption by the Securities and Exchange Commission of rules implementing the law, companies will be permitted to issue an unlimited amount of money to an unlimited number of investors — regardless of the wealth of the investor. As usual, the rules will include much fine print. First, the aggregate offering amount for securities sales may not exceed $1 million in any year. Second, purchasers of securities are limited in any year to the greater of $2,000 or five percent of the purchaser’s annual income or net worth (for those with annual income or net worth of less than $100,000). Persons with annual income or net worth greater than $100,000 may invest up to ten percent of their annual income or net worth.

To qualify for crowd funding, companies must use a broker registered as a funding portal with the SEC, or registered under the rules of the financial authority that regulates all other brokers. Issuers must file short-form disclosures with the SEC, which include financial statements and a description of the risks associated with the offering. Any broker assisting with a crowd-funded investment must confirm that purchasers do not invest more than the rules permit and that the company honor a promise not to take any money unless a specified minimum is raised. The broker must also obtain a background check on the principals of the issuer.
The company itself must provide the SEC with financial statements, audited in the cases of capital raises exceeding $500,000. The issuer must also provide descriptions of the use of the funds, methods for determining the price of the securities, and the capital structure of the firm.

Importance rating (five being the highest): *
The red tape involved in using the crowd-funding renders this option inefficient for most offerings.

Regulation A and the Mini-IPO
For years, Regulation A has enabled issuers to sell shares to a few hundred purchasers without fear of a full-blown IPO registration process. One big problem, however: the $5 million limit made this option attractive to only selected businesses that appealed to retail investors. Issuers rarely used this exemption given the complex rules combined with the low limit on the offering.

The Way It Was: Prior rules limited companies using this rule to a $5 million offering. Companies provided a detailed prospectus and followed the small public company disclosure guidelines. They avoided the agony and the ecstasy of selling shares on a public stock exchange to thousands of purchasers, which would have cost hundreds of thousands of dollars for the privilege of listing shares on a public exchange.

The Way It Will Be: Companies may issue up to $50 million as part of this “mini-IPO.” Firms must comply with state securities laws, file audited financial statements and other regulatory disclosure statements similar to those required of public companies. The SEC may require some periodic filings in the future, as are now required of public companies.

Impact rating: ****
This could be big. Real big. At $50 million, many companies may forego initial public offerings and accept the limits of this new Regulation A. Firms raising tens of millions of dollars may happily accept the inconvenience of the detailed rules that would otherwise suffocate an offering of only $5 million.

Exemptions for Periodic Filings with the SEC
The new law allows companies to accommodate many more shareholders, while avoiding periodic reporting requirements with the SEC. Smaller firms sometimes had hundreds of shareholders, such as 100-year-old banks or issuers whose shares are held by several generations of owners. As the numbers of owners quietly crept upward, rules were triggered forcing firms to file private financial information that became publicly available.

The Way It Was: If the number of shareholders of a company exceeded 500, the firm would be required to file annual and quarterly reports with the SEC. If the number of equity securities held by a public company dipped below 300, then the company was required to de-register securities and return to its status as a privately-held company.

The Way It Will Be: Companies may have up to 2,000 shareholders before triggering periodic filing requirement. In addition, up to (but not including) 500 of the shareholders may be non-accredited investors. Persons who acquired securities under the crowd-funding exemptions are also excluded from this 2,000 holder limit. Note, however, that as firms approach the shareholder limit, many of the same practical difficulties of being public will arise. These include making a market for stock, providing information to the shareholders, and adhering to corporate governance practices to shield officers and directors from shareholder claims of self-dealing and incompetence. For banks and bank holding companies that are also public firms, if the number of holders of securities declines to 1,200 or less, then the firm must de-register as a public company. The 300 threshold of the prior law still applies to non-bank firms.

Impact rating:: ***
Somewhere in the middle. Many public companies intentionally reduce the number of shareholders to trigger de-registration.

IPO-Lite
Companies have complained for years about the excessive burdens of Sarbanes-Oxley, especially on smaller firms. The Jobs Act is one of the most significant reductions of the regulatory burden of the Sarbanes-Oxley Act on smaller public companies.

The Way It Was: Companies with less than $1 billion in revenue (small by the standards of public markets) endured the expense of rules applicable to Fortune 500 firms.

The Way It Will Be: Firms with less than $1 billion in sales will need only provide two years of audited financial statements. Upon the adoption of regulations, executives and their investment bankers may discuss the state of their company more freely, even before the effective date of a registration statement. The new law also exempts smaller companies from detailed executive compensation disclosures, the Dodd Frank rules regarding “say-on-pay” voting, and Sarbanes-Oxley Section 404 rules regarding verification of the company’s internal financial procedures.

Impact rating: **
Hard to tell, but this will likely relieve smaller public companies materially from the burdens of SEC requirements.

The Beginning of a Trend?
Ironically, during this time of enhanced government regulation of many financial firms, these new rules demonstrate that the new climate in Washington is more accommodating of business capital raising efforts. With tight money, tight times, and tight elections, government officials are revising rules to encourage more investment and growth in entrepreneurial firms.