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“Crowdfunding” and Other Recent Capital-Raising Initiatives for Startup Companies

In recent years, the U.S. capital markets have become less attractive to issuers with the number of initial public offerings in the United States dropping precipitously from the venture capital heydays of the 1990s (with an annual average of 530 IPOs) to 126 in 2010.¹ Meanwhile, the value of private company share transactions has grown to \$4.6 billion in 2010 and is expected to increase to \$6.9 billion for 2011.² Against this backdrop, the House of Representatives has approved a number of bills that would (1) provide a registration exemption for “crowdfunding,” (2) lift the ban on general solicitation of “accredited investors” in private placement transactions, and (3) raise the Regulation A registration exemption from \$5 million to \$50 million.

“Crowdfunding”

Crowdfunding, a relatively new method of capital formation in which large groups of individuals pool money to support the efforts of small businesses, typically involves small individual contributions. In the past, crowdfunding did not trigger securities law issues since these groups did not receive a profit participation in the businesses they funded. However, recent

trends show that more and more crowdfunding pools are offering a return on investment capital, and thus require the securities offered for sale to be registered or exempt from registration under the Securities Act of 1933, as amended (the “1933 Act”). In response to the concerns raised by many small business owners, on November 3rd, the House approved H.R. 2930 - the “Entrepreneur Access to Capital Act,” a bipartisan supported bill, which received some support from the White House. The bill proposes to exempt from registration under Section 4(6) of the 1933 Act securities offered for sale by companies raising \$1,000,000 or less (\$2,000,000 or less if the issuer provides audited financial statements to investors), provided that individuals may invest no more than \$10,000 or 10% of their income, whichever is less.³

As passed, the bill also requires that an intermediary or the issuer provide disclosure to prospective investors on the issuer’s website on the speculative nature of investments in startups, including risks related to illiquidity; provide the Securities and Exchange Commission (“SEC”) with the same level of access to the issuer’s website; and mandate certain sophistication and suitability requirements of investors. An

¹ See <http://theinvestmentsblog.blogspot.com/2011/04/best-ipo-market-on-earth.html> and see also http://www.usatoday.com/money/perfi/columnist/krantz/2011-01-26-ipos_N.htm.

² See <http://www.rimonlaw.com/blog/2011/06/29/trading-on-the-secondary-market>.

³ The U.S. Senate is also considering S.B. 1791 or the “Democratizing Access to Capital Act of 2011,” which, like H.R. 2930, exempts crowdfunded securities from registration, but with two additional investor protections. Under S.B. 1791, the exemption only applies if an intermediary is used and an investor’s aggregate annual investment does not exceed \$1,000.

amendment has been proposed by Rep. Caroline Maloney (D-NY) to require a notice filing to state securities regulators, which notice filing would provide information necessary to prevent fraud. The bill in its current form also exempts transactions in crowdfunded securities from state registration by way of amendment to Section 18(b)(4) of the 1933 Act. This has drawn the ire of state securities regulators who have expressed a desire to regulate crowdfunded securities. In a November 3rd letter to House Speaker John Boehner (R-OH) and Minority Leader Rep. Nancy Pelosi (D-CA), NASAA President Jack Herstein voiced his concern about the preemption of state authority. To allay state regulator concerns over preemption, the House adopted an amendment to the bill allowing states to enforce violations stemming from crowdfunded securities. State regulators, however, have indicated that the amendment does not adequately address investor protection concerns and seek further powers in order to review securities prior to their offering.

Lifting Ban on General Solicitation

H.R. 2940 – the “Access to Capital for Job Creators Act,” like its companion bill H.R. 2930, aims to foster capital formation and spur job growth by lifting the long-standing ban on general solicitation of accredited investors in securities offerings relying on the private placement exemption under Section 4(2) of the 1933 Act and/or Rule 506 under the Regulation D safe harbor.⁴ The bill directs the SEC to revise Rule 502(c) under Regulation D no later than 90 days after the date of enactment of this Act so the general solicitation and general advertising prohibitions do not apply to Rule 506 offerings.

The SEC is still studying this issue, and the agency’s new Advisory Committee on Small and Emerging Companies recently met to discuss lifting the ban. Some, particularly regulators, continue to support the ban on the grounds that it helps prevent securities fraud by making it more difficult for an unsavory issuer to attract investors. Others believe removing the prohibition will effectively widen the pool of accredited investors as potential capital for small businesses, spurring innovation and job growth in the United States.

Raising the 499 Shareholder Cap under Securities Exchange Act of 1934

H.R. 2167 seeks to amend the Securities Exchange Act of 1934, as amended (the “Exchange Act”) to change the threshold number of shareholders for required registration. Section 12(g) of the Exchange Act requires a company to register its securities with the SEC within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are “held of record” by 500 or more persons and the company has “total assets” exceeding \$10 million. H.R. 2167 proposes to increase the shareholder threshold from 500 to 1,000 and exclude from the definition of “held of record” persons receiving securities pursuant to an employee compensation plan in transactions exempt from registration under the 1933 Act.

The SEC is also in the midst of conducting a study on the right test for reporting triggers under the Exchange Act. Of particular concern is shareholders that hold their shares in “street

⁴ The U.S. Senate is considering S.B. 1831 which is identical to H.R. 2940.



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name” where the record holders are broker-dealers holding shares on behalf of thousands of shareholders. Companies such as Facebook have recently attempted to circumvent the current record-holder threshold by using special purpose vehicles for the purposes of facilitating investments without registering their securities. However, the SEC has raised concerns about issuers violating Rule 12g5-1(b)(3) of the Exchange Act - if an issuer knows that the form of holding securities of record is primarily used to circumvent Section 12(g), the beneficial holders in these special purpose vehicles will be counted as record owners of the issuer. The SEC has broad authority under Section 12(h) and Section 36 of the Exchange Act to define the terms “held of record” and “total assets” so the SEC may conclude that revising these definitions is consistent with their investor protection charge.

Increase in Regulation A Offering Threshold

Finally, H.R. 1070—the “Small Company Capital Formation Act of 2011”—was passed on November 2nd raising the 1933 Act Regulation A

registration exemption from \$5 million to \$50 million. The current threshold of \$5 million and its lack of blue sky registration exemption have been a significant deterrent in the past to small businesses utilizing this exemption to access the capital markets. The SEC has not yet taken action to raise the Regulation A cap but has discussed the prospect of doing so, including relabeling Regulation A as a “small public offering.”

The House bills, which passed with overwhelming bipartisan support, seek to spur economic growth by reducing the impediments for smaller companies to access capital markets. However, there is some concern among those on Capitol Hill that the House bills may not make it past a Senate vote. Shipman & Goodwin will continue to monitor the progress of the House bills as the legislative process unfolds.

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