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SEC Study On Unregistered Offerings

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

In October 2015, the SEC Division of Economic and Risk Analysis issued a white paper study on unregistered securities offerings from 2009 through 2014 (the "Report"). The Report provides insight into what is working in the private placement market and has been on my radar as a blog since its release, but with so many pressing, timely topics to write about, I am only now getting to this one. The SEC Report is only through 2014; however, at the end of this blog, I have provided supplemental information from another source related to PIPE (private placements into public equity) transactions in 2015.

Private offerings are the largest segment of capital formation in the U.S. markets. In 2014 private offerings raised more than $2 trillion. The SEC study used information collected from Form D filings to provide insight into the offering characteristics, including types of issuers, investors and financial intermediaries that participate in offerings. The Report focuses on Regulation D offerings and in particular Rules 504, 505, 506(b) and 506(c).

A summary of the main findings in the Report includes:

In 2014, there were 33,429 Regulation D offerings reported on Form D filings, accounting for more than $1.3 trillion raised.

Issuers in non-financial industries reported raising $133 billion in 2014. Among financial issuers, hedge funds raised $388 billion, private equity funds raised $316 billion and non-pooled investment funds (such as banks, insurance companies and investment banks) raised $375 billion.

Foreign issuers accounted for 20% of the 2014 total. Most foreign issuers are based on Canada, the Cayman Islands or Israel.

Rule 506 accounts for 99% of all private offerings. Rule 506 was used 97% of the time for offerings below the Rule 504 and 505 limits, showing that Rule 506 is preferred regardless of the amount of the offering (I believe this is firmly as a result of the state law pre-emption in a 506 offering).

Since the effectiveness of Rule 506(c) on September 23, 2013, allowing for general solicitation and advertising, only a small portion of raises – i.e., 2% of the total or $33 billion – relied on this exemption.

Capital raised through private markets correlates with the strength of public markets. The strength of the private market is closely tied to the health of the public market.

The median offer size of non-financial issuers is less than $2 million, indicating that small businesses rely on private, unregistered offerings the most.

Approximately 301,000 investors participated in Regulation D offerings during 2014. A large majority of these investors participated in offerings by non-financial issuers (presumably because financial issuers relied on a small number of institutional investors). Non-accredited investors participated in only 10% of the offerings.

Background on private offerings

All offers and sales of securities must be either registered under the Securities Act of 1933, as amended ("Securities Act") or made in reliance on an available exemption from registration. Public offerings generally must always be registered (with the exception of a Rule 506(c) offering) and private offerings can generally be completed in reliance on an exemption. The private offering rules have various investor restrictions (limits on sales to unaccredited investors), information requirements and/or offering limits to balance the competing directives of the SEC to assist with capital formation and protect investors.

The exemptions for private offerings are found in Sections 3 and 4 of the Securities Act. In particular, most private offerings are governed by Sections 4(a)(2), 3(b) and 3(a)(11) of the Securities Act. Rules 506(b) and 506(c) of Regulation D, Regulation S and 144A provide safe harbors under Section 4(a)(2). Section 3(b) provides the authority for Rules 504 and 505 of Regulation D. Section 3(a)(11) provides statutory authority for intrastate offerings.

Even after the JOBS Act, private offerings remain the biggest source of capital formation for small and emerging companies, which companies are the largest source for creating new jobs, driving innovation and accelerating economic growth. At $1.3 trillion raised in 2014, private offerings represented more than what was raised in public equity and debt offerings combined.

From 2009 – 2014, there were more than 64,000 offerings by small businesses with a median offer size of less than $2 million. Only 21% of private offerings reported using a financial intermediary such as a broker-dealer. For those that did use such a placement agent, the average commission size was 5%.

Although the Report was issued in October 2015, it only examines the private offering market through 2014. The Report indicates that the vast majority of offerings are completed under Rule 506(b) with Rule 506(c) being only a very small percentage.

The analysis in the Report takes into consideration factors that may affect an issuer's choice of private offering exemption, including pre-emption of state securities laws, ability to advertise, ability to sell to non-accredited investors, limits on amount of capital raise, geographical constraints, and levels of required disclosure. The Report is organized by discussions on the overall private offering market; capital formation in the market for Regulation D offerings and characteristics of market participants. This blog maintains that order of discussion.

The size of the private offerings market

The SEC Report does not give complete information on the size of the private offerings market. The information in the Report is based on Form D filings, which does not necessarily include offerings relying on straight Section 4(a)(2) or Regulation S as neither of these require a Form D filing. Moreover, many issuers that rely on Regulation D neglect to file a Form D and accordingly, the market size is somewhat larger than as stated in the SEC report.

In 2014 registered offerings accounted for $1.35 trillion compared to $2.1 trillion raised in private offerings. As reported by the SEC, Regulation D and Rule 144A are the most common offering methods, being primarily equity and Rule 144A being primarily debt. The Report includes comparative information on registered offerings as well. During the years 2009-2014, registered debt offerings far outweighed equity offerings.

The number of private offerings per year also far outweighs the number of registered offerings, though this is to be expected. A private offering can be completed far quicker and with greater frequency than a public offering that is subject to SEC filings, comment process and effectiveness procedures. As Regulation D is commonly used by smaller entities, it follows that there are significantly more of such offerings at smaller dollar values. Rule 144A, on the other hand, usually involves institutional investors at a much higher dollar amount and lower frequency. For instance, there were approximately 33,429 Regulation D offerings in 2014 compared to 1,534 Rule 144A offerings in the same year. In 2014 there were 1,176 registered public equity offerings and 1,576 registered public debt offerings.

The Report gives comparable information for each year from 2009 through 2014 as well. As a summary, 2010 was a very big year in the offering marketplace (both private and public), skewing the results somewhat, but other than that, the number of all offerings has increased year over year since 2009.

The Regulation D market

The Regulation D market is comprised of Rules 504 and 505 promulgated under Section 3(b) of the Securities Act and Rules 506(b) and 506(c), both of which are safe harbors under Section 4(a)(2) of the Securities Act. Again, the SEC Report is only based on Form D filings and, accordingly, is subject to deviation for offerings that did not file and/or inaccurate or incomplete information reported by issuers.

Both the number of and dollar value of Regulation D offerings has been increasing from 2009 through 2014. For instance, there were 13,764 reported Regulation D offerings in 2009 and 22,004 in 2014. The total amount sold in 2009 was $595 billion and in 2014 was $1,332 billion. Interestingly, the average offering size was larger in 2009 at $36 million than in 2014 at $24 million.

The SEC Report discussed the cyclicality of offerings as well. Although it is well documented that public markets are cyclical and depend on such factors as business cycle, investor sentiment and time varying information asymmetry, comparable information is not available for the private offering markets. Just based on Form D filings, the SEC Report considers whether there is support for the theory that companies rely on private markets when public markets are in distress, such as during a recession. There is not. In fact, rather it appears that the private offering market increases during strong public markets and decreases during weak public markets. The health of the private offering market correlates with the health of the public market.

As noted in the Report, “there is a strong, positive correlation of the incidence of new Regulation D offerings with the economic condition of the public markets. In particular the level of Regulation D offering activity closely follows the level of the S&P 500 index.” From 2009-2014 there has been an increase in Regulation D offering activity consistent with the steady increase in the S&P 500.

The Regulation D marketplace for non-financial issuers generally comprises equity offerings as opposed to debt offerings, which are more common in the public market. Moreover, equity is usually indicative of new money and capital whereas debt is often used as a refinancing tool for existing debt. Financial issuers generally use Rule 144A and such offerings are generally debt. In other words, small businesses looking to grow with new capital rely on Regulation D equity offerings.

Rule 506 of Regulation D continues to be the most common exemption. Since 2009, 95% of private offerings are completed under Rule 506. It is clear to me, and the SEC, that the reason for this is that Rule 506 pre-empts state law, avoiding state registration and other arduous blue sky process. The SEC points out that depending on state law, Rule 504 and 505 offerings can be sold to non-accredited investors and, under Rule 504, can be freely tradeable. Despite this benefit, issuers clearly find the state law pre-emption as a more important deciding factor and are willing to accept the restrictions under Rule 506 as a trade-off (i.e., either accredited only or a limit of 35 unaccredited, restricted securities, no general solicitation or advertising under 506(b) and added accredited verification under 506(c), etc.).

From September 23, 2013, the date of enactment, through December 31, 2014, a total of 2,117 Rule 506(c) offerings were reported on Form D by a total of 1,911 issuers (some issuers had multiple offerings). During this time a total of $32.5 billion was reported as being raised. As a comparison, during the same time period there were 24,500 Rule 506(b) offerings that raised $821.3 billion. Moreover, even after the enactment of Rule 506(c), the number of new 506(b) offerings continues to increase and vastly outpace the number of new Rule 506(c) offerings.

I am not surprised by this information as I think that the 506(c) marketplace has taken its time to find its place in the private offering market as a whole, and continues to do so. From my own experience it is clear that accredited investors do not just look at a website and send money! Offerings are sold, not bought, and the advertising and marketing is good for lead generation, ease of information flow, and general exposure, but does not cause a sophisticated investor to part with their money without more. Even though the accredited verification process has become easier with services such as Crowdcheck, it is clear that issuers, placement agents, and the investing public still prefer the old-fashioned Rule 506(b) and avoiding the accredited verification process. See, for example, my blog HERE discussing new SEC guidance and the Citizen VC no action letter.

I still strongly believe in the benefits of Rule 506(c) and its viability. The SEC Report does as well, pointing out that issuers will become more comfortable with market practices, accredited investor verification procedures, and methods of advertising and solicitation over time.

During this same time period there continues to be a decline in the use of Rules 504 and 505. For example, there were only 544 Rule 504 offerings and 289 Rule 505 offerings in 2014. The SEC Report contains quite a bit of comparative information on Rules 504 and 505 for those interested in further information. As I've previously written about, the SEC has proposed new amendments for Rules 504 and 505 which may increase their use, though I do not expect a big impact. My blog on these proposed rules can be read HERE.

Both foreign issuers and public companies rely on Regulation D. For example, 20% of all Regulation D offerings from 2009-2014 were completed by foreign issuers. Public issuers are active in PIPE transactions as well, with 13% of Regulation D offerings being completed by public companies. At the end of this blog I have a section with 2015 data on the PIPE market from other sources.

Regulation D market participants

Pooled investment funds such as hedge funds, venture capital and private equity funds represent the largest business category, by amount raised, utilizing Regulation D. From 2009-2014 pooled investment funds raised $4.8 trillion as compared to $905 billion by non-funds. Non-funds, however, use Rule 506(c) more than pooled funds, representing 75% of those offerings. Moreover, non-funds account for a much higher percentage of total offerings by number of offerings, representing 60% of all new Form D filings.

Companies completing Rule 506(c) offerings usually check the "other," "other technology," "other real estate," "oil and gas," or "commercial" industry boxes of their Form D filings. Counting all non-funds using all Regulation D offerings, the industries in order of most often used are banking, technology, real estate, health care and energy. Interestingly, the number of offerings by banking entities and manufacturing industries have both decreased during the study period. There has been a big uptick in real estate offerings in 2013 and 2014, which makes sense in light of the improved real estate market since 2008.

The median offering size for these non-fund issuers is $1 million compared to $11 million for hedge funds and $30 million for private equity funds. As mentioned above, this information indicates that small businesses are utilizing Regulation D, which the Report finds is consistent with the regulatory objectives.

The majority of issuers decline to disclose revenue and of those that did, most disclosed less than $1 million. This is consistent with the findings that Regulation D is widely used by small businesses. Beyond that, I can't find a lot of meaning in that information, other than that smaller issuers are most likely to file a Form D without the assistance of counsel, and counsel usually recommends not disclosing revenue.

The Form D's do show that a majority (67%) of companies that file a Form D are less than 3 years old. This is true for both fund and non-fund entities. I note that this is consistent with the SEC Advisory Committee on Small and Emerging Companies' consistent message that new entities are the most in need of methods to raise capital and secondarily that those same new entities create the most new jobs.

Most U.S. companies that file Form D's have their principal place of business in California and New York with Texas, Florida and Massachusetts following. These are also the most common states of investor location. Most investors are accredited.

Less than a fifth of all issuers reported repeat offerings but 25% of non-fund issuers had repeat offerings. Form D filings do not tell of the success of an offering; however, 31% of issuers had raised 100% of their offering at the time they filed the Form D, which is typical of PIPE transactions offerings with a small handful of investors.

Form D's will also not tell the final investor count or breakdown, but compiling Form D information shows that only 300,000 investors participated in Regulation D offerings in 2014 and only 110,000 in non-financial issuers. That seems to be a very small number of investors overall and clearly shows the importance of properly packaging an offering and presenting it to the right audience.

Only 21% of offerings for the period 2009-2014 used a placement agent, with a decrease in their use in 2014 compared to 2009-2013. Issuers in non-financial industries paid an average of 6% commission and in financial industries, an average of 1.4%. This is likely because the size of the offering is much larger and number of investors much smaller in the financial industry. On average, higher fees are paid for Rule 506(c) offerings than 506(b), which makes sense in light of additional work (verification of accreditation) and risk associated with advertising.

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2015 PIPE Market

A PIPE is a private placement into public equity, or in other words, a private placement by a public company. According to PrivateRaise, a private placement data service, PIPE's raised $89.97 billion in 2015, up 14.8% from 2014. The amount was spread over approximately 1,000 offerings.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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