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SEC Advisory Committee On Small And Emerging Companies Reviews Capital Formation

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.

On February 25, 2016, the SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") met and listened to three presentations on access to capital and private offerings. The three presentations were by Jeffrey E. Sohl, Professor of Entrepreneurship and Decision Science Director, Center For Venture Research at University of New Hampshire; Brian Knight, Associate Director of Financial Policy, Center for Financial Markets at the Milken Institute; and Scott Bauguess, Deputy Director, Division of Economic and Risk Analysis at the SEC. The presentations expound upon the recent SEC study on unregistered offerings (see blog HERE).

The presentations were designed to provide information to the Advisory Committee as they continue to explore recommendations to the SEC on various capital formation topics. This blog summarizes the 3 presentations.

By way of reminder, the Committee was organized by the SEC to provide advice on SEC rules, regulations and policies regarding "its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation" as related to "(i) capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization; (ii) trading in the securities of such businesses and companies; and (iii) public reporting and corporate governance requirements to which such businesses and companies are subject."

Presentation by Jeffrey E. Sohl, Professor of Entrepreneurship and Decision Science Director, Center For Venture Research at University of New Hampshire

As I've written about many times, 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. 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. In addition Regulation Crowdfunding, expected to go effective in May 2016, will implement the much anticipated Title III crowdfunding as codified in the new Section 4(a)(6) (see HERE).

Crowdfunding generally is where an entity or individual raises funds by seeking contributions from a large number of people. Accordingly, any offering that allows solicitation of the crowd is viewed as a form of crowdfunding. Equity crowdfunding is currently accomplished through the use of: (i) Rule 506(c) offerings which allow for advertising and solicitation to a crowd as long as all sales are strictly limited to accredited investors, and such accredited status is reasonably verified by the issuer (see HERE); (ii) Intrastate offerings under Section 3(a)(11) and Rule 147 (see HERE); and (iii) Rule 504 state specific offerings (see HERE).

Mr. Sohl's presentation concentrates on a statistical analysis of capital raising for pre-seed, seed/start-up, early-stage and later-stage enterprises. Pre-seed funds almost unilaterally come from founders, friends and family. Generally, no unaffiliated third-party source invests at this stage. Mr. Sohl's presentation is in the form of a needs analysis illustrating the difficulties in accessing capital and the funding gaps for new businesses.

Third-party private equity can begin at the seed/start-up phase but grows with the level of maturity of the enterprise. Sohl begins with the premise that third-party private equity comes from three primary sources: crowdfunding, angels and venture capitalists, in that order, based on the maturity of the company. In other words, crowdfunding is likely to be involved in the seed/start-up phase followed by angels with venture funds stepping in at later series A and B rounds. According to Sohl, since 2013 equity crowdfunding has had a success rate of 19.6% with an average raise ask being $2,000,000 and an average actual raise being at $210,000. Of the funds raised, 21% have been convertible debt, 7% straight debt and 72% equity. Sohl presents similar statistics on the success of angel and venture capital rounds, average deal sizes and a breakdown by industry sector. The numbers are low. For example, only 4.2% of seed and start-up financing comes from venture capital sources.

Using Sohl's data analytics and assuming that a new business has successfully begun using founders, friends and family funds, Sohl points out that there remains a large funding gap for seed/start-up and early-stage companies.

Presentation by Brian Knight, Associate Director of Financial Policy, Center for Financial Markets at the Milken Institute

Brian Knight's presentation is titled "How Small and Mid-size Businesses are Funding Their Future." Mr. Knight and Milken Institute surveyed 636 owners and c-suite executive of private companies with annual revenues from less than $500,000 up to $1 billion on the topic of how these small and mid-size businesses are funding their businesses, accessing capital and planning for growth. Mr. Knight and the Milken Institute published a complete report on their findings. This blog is a short summary based on the presentation made to the SEC Advisory Committee.

The key findings in the report are (i) debt is the preferred method of financing; (ii) when choosing between financing sources, price, ease of access, speed of funding and certainty are the highest ranking considerations; (iii) there is no clear preference between bank and non-bank financing though banking relationships are valued; and (iv) businesses have a lack of understanding, and interest, in alternative sources of funding and recent securities law changes (nearly 80% of those surveyed were unfamiliar with recent changes to the laws).

I find this last point very interesting and think that the lack of understanding and interest is a result of a lack of reliable succinct sources of information, presented in layman's terms, together with a time of rapidly changing rules and regulations. The survey also found that 90% of businesses would not consider alternative financing such as crowdfunding, intrastate offerings or Regulation A. However, I think that this tells more about the pool of companies surveyed (only 636) and is a factor of the lack of knowledge by these companies.

The survey also asked what reasons a company would consider in using alternative financing sources, with those reasons being, in order of importance: (i) they believe it would be good for public relations/press; (ii) believe such funding could be achieved on better terms; (iii) believe such funding will be less expensive to pursue and have lower compliance costs; and (iv) they want to expand their investor base. To the contrary, the reasons for rejecting such financing options include: (i) lack of knowledge and understanding; (ii) uncertainty about legality; (iii) fear of investor fraud; and (iv) a desire to know their investors.

Of the firms surveyed, 32% had not raised capital in the last three years. Of those that raised capital, 32% did so through bank financing, 10% from non-bank loans, 9% from friends and family, 9% from family offices and 8% from other equity investment sources. The survey also showed that the majority of companies expected to be able to self-fund through current and retained revenues. The survey found what we all would logically expect, which is that the more advanced the business is in its life cycle, the less it needs outside funding sources.

Although debt is the preferred financing source, the same businesses almost unilaterally agree that little or no debt is best for a business's balance sheet. The decision to incur debt financing is needs-driven. Businesses borrow when they need cash flow.

Presentation by Scott Bauguess, Deputy Director, Division of Economic and Risk Analysis at the SEC

The presentation by the SEC was organized as a discussion of the findings of the SEC study on unregistered offerings and recent activity resulting from the JOBS Act implementation. As a reminder, Title I of the JOBS Act, creating emerging growth companies (EGC) and providing a more cost-effective IPO onramp with greater test-the-waters abilities, was enacted on April 5, 2012. Since the creation of the EGC category of business, close to 85% of IPO's are by EGC qualified businesses. Title II, creating Rule 506(c) allowing for general solicitation and advertising in private offerings, became effective on September 23, 2013. Title IV, creating Regulation A/A+, became effective on June 19, 2015. Very little Regulation A/A+ information is available as it is too new. Finally, Title III Crowdfunding is expected to become effective on May 16, 2016.

Continuing the trend discussed in the SEC survey, in 2014 and 2015, Regulation D remained the most often used method of raising capital. Small businesses continue to have the greatest need for capital and continue to be a driver of employment in the U.S. economy. Even amongst public companies, smaller reporting companies comprise the largest class of company at over 40% of all issuers. In 2013, there were more than 5 million businesses with fewer than 500 employees.

The SEC is hopeful that the JOBS Act provisions will both open opportunities to companies that would successfully raise capital from other sources, and provide an opportunity for businesses that otherwise could not raise capital from other sources.Related to Rule 506(c), the SEC has not seen any increase in fraud on the market as a result of general solicitation. However, the SEC also notes that Rule 506(c) has been slow to gain traction but continues to be more and more widely used. The SEC will continue to monitor its use and report statistical findings.

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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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