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THE U.S. MENU OF EARLY-STAGE CAPITAL-RAISING OPTIONS

LESSONS FOR THE EUROPEAN COMMISSION

THE U.S. MENU OF EARLY-STAGE CAPITAL-RAISING OPTIONS: LESSONS FOR THE EUROPEAN COMMISSION

The European Commission, in its green paper dated February 18, 2015, announced the "need to build a true single market for capital – a Capital Markets Union for all 28 Member States."[1] One of the goals of the Capital Markets Union is to unlock more investment for small and medium sized enterprises ("SMEs"). SMEs are Europe's equivalent to startups and small businesses in the United States. At present, small businesses in Europe receive five times less funding from the capital markets than their American counterparts.[2] So, the European Commission is looking for feedback from those who work in capital markets and others to develop an action plan to, among other things, make it easier for SMEs to raise funding and reach investors cross border.[3]

This article – which will also be published by Columbia Law School on its CLS Blue Sky Blog on corporations and capital markets – seeks to offer the European Commission lessons from the American experience in connection with recent legal changes meant to boost capital formation in the United States. While the United States has long had a successful private placement regime that is uniform throughout all 50 states, other early-stage capital-raising options in the American playbook are rarely used. The common wisdom is that they are either too expensive or afford insufficient access to investors. This article discusses various recent reforms in the United States that seek to viably expand the menu of early-stage capital-raising options from an effectively singular reality to one of bespoke and attractive options. It provides a high-level description of these recent efforts and evaluates the approach of the U.S. Securities and Exchange Commission (the "SEC"). ***See*** **Exhibit A for a visual depiction of the new U.S. menu.**

> The lesson for Europe is simple: a uniform private placement regime across all 28 member states that is inexpensive, poses no regulatory delay, and has no cap on offering amounts is advisable; building out a bespoke menu of alternatives should be a secondary priority.

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1 European Commission, *Green Paper: Building a Capital Markets Union,* COM (2015) 63 final, (February 18, 2015).

2 *Id.* at 2

3 *Id.*

Background

For decades, U.S. securities law and SEC rules and regulations have ostensibly provided a panoply of options to facilitate capital formation for startups and small businesses. These options have long included registered initial public offerings ("IPOs") as well as a variety of exemptions from full-scale registration, such as Regulation A, Regulation D, Rule 144A and the intrastate exemption. Yet, recent studies have shown that, in reality, early-stage capital-raising in the United States has been dominated by a single choice: Rule 506(b) under Regulation D (the "Private Placement Exemption").[4]

A comparison of offerings under the Private Placement Exemption against those under Regulation A and two other options available under Regulation D (Rules 504 and 505) between 2009 and 2012 reveals that, when all were "equally available"[5], approximately 88% of private offerings seeking proceeds of up to $1 million nonetheless relied on the Private Placement Exemption.[6] And, when Regulation A, Rule 505 and the Private Placement Exemption were equally available in offerings

> "in reality, early-stage capital-raising in the U.S. has been dominated by a single choice – the Private Placement Exemption."
>
> **Jonathan Zonis**, Partner, Clifford Chance

seeking between $1 million and $5 million over this same time period, reliance on the Private Placement Exemption jumped up to approximately 98%.[7] The number of offerings using the Private Placement Exemption also dwarf the number of small company registered IPOs by orders of magnitude.[8] One possible explanation is the relatively high cost of IPOs, which two surveys estimated to be, on average, $2.5 million initially followed by an average ongoing cost of $1.5 million per year.[9] The Rule 144A market has also been comparatively barren ground for startups and small businesses, limited primarily to financial institutions in sales of debt.[10] A possible explanation is that non-public companies do not benefit from state securities law preemption under Rule 144A, which means that such offerings would be burdened by the need to comply with 50 different state laws in addition to Rule 144A.[11]

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[4] *See* Vladimir Ivanov & Scott Bauguess, DIV. OF ECON. AND RISK ANALYSIS, U.S. SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012 [hereinafter, the Ivanov and Baugess Study] at 8; *See also* Crowdfunding, SEC Rel. No. 33-9470), 78 Fed. Reg. 66428 (Nov. 5, 2013), [hereinafter, the Crowdfunding Release] 318-321, available at http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

[5] Meaning that the total amount of capital raised from that offering could have also been raised using any one of the other aforementioned exemptions.

[6] *See* the Crowdfunding Release, *supra* note 4, at 321 (The data set does not include offerings under Section 4(a)(2) or under Section 3(a)(11)).

[7] *See id.*

[8] The average number of offerings per year under Rule 506 between 2009 and 2012 was 10,188, which dwarfs the average number of small company IPOs per year even at its peak – 166. *Cf.* Ivanov and Baugess Study, *supra note 4,* at 8 (July 2013) and John C. Coffee, Jr., *Gone With the Wind: Small IPOs, the JOBS Act, and Reality*, THE CLS BLUE SKY BLOG (Feb. 1, 2013), http://clsbluesky.law.columbia.edu/2013/02/01/gone-with-the-wind-small-ipos-the-jobs-act-and-reality (citing Xiaohui Gao, Jay R. Ritter, Zhongyan Zhu, "Where Have All the IPOs Gone?" (Dec. 17, 2012) at p. 1, available at http://ssrn.com/abstract=1954788).

[9] *See* Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), SEC Rel. No. 33-9741 (Mar. 25, 2015), 256-257, available at http://www.sec.gov/rules/final/2015/33-9741.pdf.

[10] *See* Ivanov and Baugess Study, *supra note 4,* at 9 ("a larger fraction of non-financial issuers rely on Reg D for raising capital compared to the Rule 144A market, where the vast majority of issuers are financial institutions and over 99% of securities are debt securities").

[11] *See* Section 18(b)(4)(A) of the Securities Act as codified in 15 U.S.C. § 77r(b)(4)(A) (2012). Preemption is a doctrine that permits a uniform federal law to displace all inconsistent state law. When preemption does not apply, compliance with relevant state law, which may vary from state to state, is necessary.

Introduction of New and Expanded Options

The U.S. Congress passed the Jumpstart Our Business Startups Act (the "JOBS Act") in April 2012, which sought to introduce new and expanded capital-raising options to potentially change this dynamic and increase access to capital. The SEC was tasked to flesh out many of the features of each. Over the last three years the SEC has finalized amendments to Regulation A, adopted new Rule 506(c), and has proposed a new regulation to implement crowdfunding. This gives rise to a new menu of capital-raising options depicted in Exhibit A appended hereto.

The following is a brief summary of some of the key features associated with each of the recent changes and proposals:

- Registered IPOs. Without SEC assistance, the JOBS Act introduced a new category of issuer called an emerging growth company ("EGC"). Most pre-IPO companies fit into this category because it includes any company that has total annual gross revenue of less than $1 billion in its most recent fiscal year. The benefits of this status, which can last for up to 5 years after the company's IPO, include scaled back financial and executive compensation disclosure, an exemption from auditor attestations of internal controls, increased flexibility to market securities to a select institutional audience (known as "testing the waters"), and confidential SEC review of the company's draft registration statement, which results in a deferral of disclosure to competitors. Notably, many issuers have chosen not to take advantage of certain of these liberalizations due to perceived market demands,[12] but a recent study shows a trend toward increasing acceptance by EGCs of many of these liberalizations in year two when compared with year one.[13]
- Rule 506(c). On September 23, 2013, the SEC divided Rule 506 into two different offering methods.[14] The Private Placement Exemption preserves the existing features of the traditional exemption, including the long-standing ban on general solicitation and advertising and the limitation to accredited investors[15] and up to 35 sophisticated, but non-accredited, purchasers. New Rule 506(c) lifts the ban on general solicitation and advertising for offerings limited to accredited investors only, so long as the company verifies accredited investor status through tax forms or other reasonable means. This permits largely unfettered marketing of private placements through the internet and otherwise, which has given rise to a new phenomenon called "accredited crowdfunding."[16] The SEC also strengthened its bad actor disqualification rules under both exemptions.[17]

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12 One example of such a JOBS Act liberalization is the right of EGCs, at the time of their IPO, to provide two, rather than three, years of audited financial statements. Many have chosen not to utilize this benefit because of a perception that the market will penalize companies from a pricing perspective for doing so.

13 *See* The JOBS Act, Two Years Later: An Updated Look at the IPO Landscape, Latham & Watkins LLP (April 5, 2014).

14 *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (proposed July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239, and 242).

15 Accredited investors are generally individuals who regularly earn over $200,000 a year in income (or $300,000 with a spouse) or have a net worth, not including their primary residence, of over $1 million, and institutions. See 17 C.F.R. § 230.501(a) (2014).

16 *See* Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 282 (Summer 2014).

17 Also, on September 23, 2013, the SEC expanded the ability to market Rule 144A offerings by providing that such offerings could be marketed publicly (i.e., by means of general solicitation and advertising) so long as the securities are only sold to persons that the seller and the seller's agents reasonably believe are qualified institutional buyers ("QIBs").

- Regulation A. Beginning on June 19, 2015, companies will have two new available options for capital-raising under Regulation A.[18] Tier 1 offerings will allow capital-raises of up to $20 million in the prior 12 months without any limitation on investor type. While these offerings do not benefit from state securities law preemption,[19] the North American Securities Administrators Association ("NASAA") has implemented a multi-state coordinated review program that contemplates a twenty-one business day turnaround with respect to comments from State regulators. Tier 2 offerings will allow capital-raises of up to $50 million in the prior 12 months without any limitation on investor type. However, when Tier 2 securities are not listed on a national securities exchange, non-accredited individual investors will be limited to investing 10% of their net worth or annual income and non-accredited institutional investors will be limited to investing 10% of its revenue or net assets. In addition, Tier 2 offerings will have a heavier disclosure burden than Tier 1 offerings, including a requirement for audited financial statements and periodic annual, semi-annual, and current reporting.
- Crowdfunding. While the SEC has not yet announced a start-date for crowdfunding, it has proposed the required regulation.[20] The final version of this proposal is unlikely to change much in light of the tight parameters for rulemaking set forth in the JOBS Act. Crowdfunding offerings are expected to allow capital-raises of up to $1 million in the prior 12 months without any limitation on investor type. However, for investors with an annual income or net worth that is less than $100,000, individual investments are expected to be limited to a maximum of 5% of annual income or net worth, and for investors with an annual income or net worth that is $100,000 or more, individual investments are expected to be limited to 10% of annual income or net worth (up to $100,000) in these offerings. While crowdfunding offerings will benefit from state securities law preemption,[21] they will be subject to a unique regime of mandatory disclosure, mandatory intermediation, and marketing restrictions. This includes a requirement for audited financial statements in offerings seeking more than $500,000 and annual periodic reporting.

Evaluation of New Options Against the Private Placement Exemption

In light of the pre-JOBS Act dominance of the Private Placement Exemption, the following evaluates whether the new statutes, rules, regulations, and rule proposals to registered IPOs, Rule 506(c), Regulation A, and crowdfunding are likely to provide to viable alternatives to the Private Placement Exemption for startups and small businesses.

Registered IPOs

Recent preliminary research suggests that the JOBS Act changes to registered IPOs have increased IPO volume by 21 IPOs per year.[22] This

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[18] *See supra* note 9.

[19] *See supra* note 11.

[20] *See* the Crowdfunding Release, *supra* note 4.

[21] *See supra* note 11.

[22] *See* Dambra, M., L. Field, and M. Gustafson, 2014, *The JOBS Act and IPO volume: Evidence that disclosure costs affect the IPO decision*, JOURNAL OF FIN. ECON. (forthcoming), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2459591.

increase is 50% higher than the volume of U.S. IPOs in the previous two years and, by comparison to other markets, has been shown to be statistically significant. Field and Gustafson argue that selective disclosure through new "testing the waters" rights and the deferral of disclosure that come through confidential SEC review are the primary drivers of this increase. Another study, which may help explain why the increase is still fairly small in an absolute sense, suggests that the overall cost of an IPO has not decreased whereas certain indirect costs have increased.[23]

Compared to the Private Placement Exemption, registered IPO have various advantages, including (i) the prestige of public company status; (ii) a liquid secondary resale market; (iii) the ability to generally solicit and advertise, subject to various complex content and filing rules, and (iv) the ability to access all U.S. investors. Nonetheless, mandatory disclosure, the highest level of liability exposure, and delay from SEC review, make registered IPOs expensive and time-consuming. Accordingly, while the JOBS Act changes make the registered IPO relatively more attractive, these changes do little to cut against the general dominance of the Private Placement Exemption for early-stage companies that are not yet ready to go public.

Rule 506(c) Offerings

The adoption of Rule 506(c), at least ostensibly, would seem to pose the greatest threat to the dominance of the Private Placement Exemption because of its similarity. The only difference is the lifting of the ban on general solicitation and advertising and the accompanying accredited investor verification requirement. In the first full year since the SEC adopted the new rule, preliminary research shows that Rule 506(c) offerings have eclipsed the recent annual averages of registered IPOs and offerings under Regulation A, Rule 504, and Rule 505.[24] Yet, between September 23, 2013 and September 22, 2014, approximately 92% of Rule 506 offerings were under the Private Placement Exemption while only 8% were under new Rule 506(c).[25] Accordingly, the Private Placement Exemption still dominates.[26]

This suggests that the increased freedom to generally solicit and advertise coupled with the need to verify accredited investors may not generally outweigh the cost-savings of a private placement that does not utilize general solicitation and advertising. One explanation may involve the small average number of investors who typically invest in startups and small businesses. Between 2009 and 2013, the average number was 9 in new Regulation D offerings for non-financial issuers.[27] Early literature

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23 *See* supra note 9 at 259 (citing Chaplinsky, S., K. Hanley, and S. K. Moon, 2014, The JOBS Act and the costs of going public, Working paper, *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2492241; Barth, M., W. Landsman, and D. Taylor, 2014, The JOBS Act and information uncertainty in IPO firms, Working paper, *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2465927; Westfall, T.J., and T. C. Omer, 2014, The impact of emerging growth company status on initial public offering valuation and the associated auditor risk and effort, Working paper, *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2512605).

24 *Cf*. the Crowdfunding Release, *supra* note 4, at 321 with John C. Coffee, Jr., *supra* note 8 and Field and Gustafson, *supra* note 22.

25 *See* Vladimir Ivanov, Senior Financial Economist, U.S. Sec. and Exch. Comm'n., *Capital Raising Through Regulation D* (Nov. 20, 2014), available at ://www.sec.gov/info/smallbus/sbforum112014-ivanov.pdf

26 *Id.*

27 *Id.* at 4.

on this subject predicted that the newfound marketing freedom associated with the use of general solicitation and advertising would be likely to increase this average number of investors,[28] but the empirical evidence does not yet bear this out. Accordingly, while Rule 506(c) has unquestionably provided a new capital-raising option for issuers, it is not yet a true competitor to the Private Placement Exemption.

Regulation A

Given that the Regulation A amendments will not be effective until June 19, 2015, there is currently no empirical evidence as to whether the amendments to Regulation A will make it a viable alternative to the Private Placement Exemption. For issuers seeking less than $50 million, Tier 2 of Regulation A has at least three advantages: (i) it has no resale restrictions for non-affiliates, which means that investors will generally be able to trade their securities immediately after purchase in the over-the-counter market or through a national securities exchange; (ii) it allows general solicitation and advertising through the internet or otherwise, so long as there is compliance with certain filing and disclaimer rules; and (iii) it allows access to all investors, whether or not they are accredited investors. Non-accredited investors, moreover, will only be subject to the 10% investment limitation described above when the securities are not listed on a national securities exchange.

For issuers seeking less than $20 million, Tier 1 of Regulation A has the same advantages, but the application of various state securities laws, which has long been considered a significant deterrent to the use of Regulation A, threatens to undermine this new method.

By contrast, the comparative advantages of the Private Placement Exemption are that it does not require initial or periodic disclosure (though initial private placement memoranda are customary), has lower liability exposure, and has no delay based on SEC review. For many companies, secondary trading, marketing, and access to non-accredited investors may not be necessary for capital-raising and the speed and lower costs of the Private Placement Exemption may justify its use. For such companies, the comparative advantages of the Private Placement Exemption may thus cause it to continue to dominate. To the extent, however, that companies value the differences that Regulation A will offer, a viable new option may truly emerge.

Crowdfunding

Finally, there is the proposed crowdfunding regulation. In spite of the hype, recent studies have shown at length that Rule 506(c) provides a more desirable method for "crowdfunding" than the proposed crowdfunding regulation on most dimensions.[29] For example, crowdfunding offerings require initial and periodic mandatory disclosure (including audited financial statements for offerings above $500,000), mandatory intermediation, a $1 million offering cap, Section 12(a)(2) liability exposure, and advertising restrictions outside of the context of crowdfunding websites. Rule 506(c), by contrast, has no mandatory disclosure, no mandatory intermediation, no offering cap, a lower level of liability exposure (Rule 10b-5), and a largely unfettered ability to generally solicit and advertise.

[28] *See Parsont supra* note 16 at 285 ("Unlike traditional private placements, which, in 2012, had an average of eight and a median of four investors per deal, the new ability to broadly advertise in accredited crowdfunding encourages a much larger investor base.")

[29] *See id.* at 300-317.

The main advantage of the crowdfunding regulation is that it permits access to the full crowd of investors, whereas Rule 506(c) is limited to accredited investors only.

By contrast to Rule 506(c), the Private Placement Exemption does not allow general solicitation and advertising and thus does not truly permit "crowdfunding", which is commonly defined, in non-legal contexts, as raising small amounts of capital from a large number of people over the Internet. Notably, like Rule 506(c), Regulation A may also provide a better forum for "crowdfunding" than the proposed crowdfunding regulation given that it permits access to all investors and also permits widespread general solicitation and advertising with few constraints. Ironically, Rule 506(c) and Regulation A may thrive most in the "crowdfunding" space even though a different regulation was designed for this purpose.

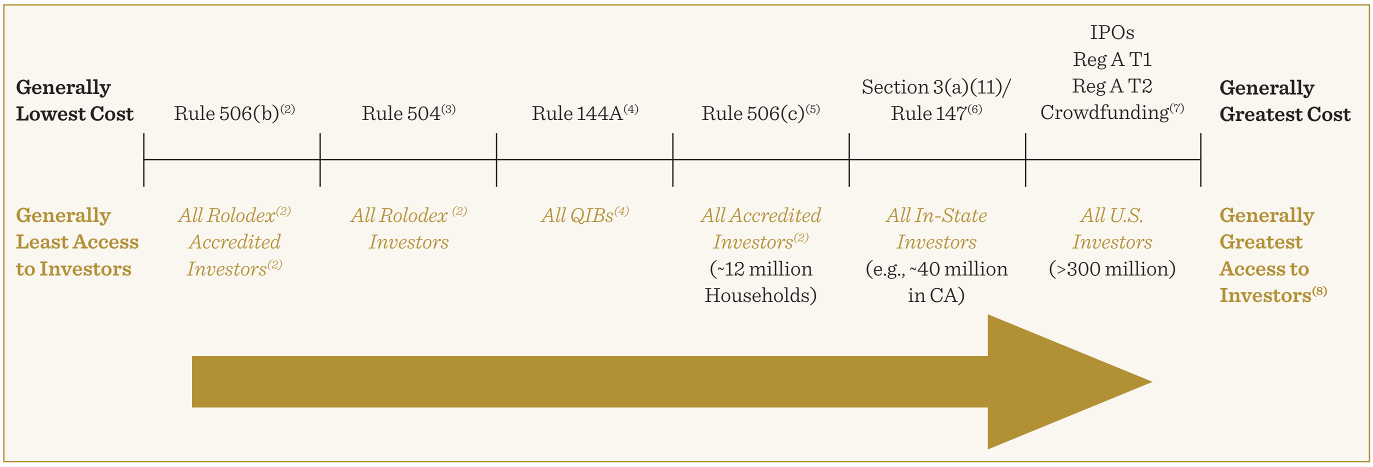
"The Private Placement Exemption continues to be so successful because it is inexpensive, consistent across all 50 states, poses no regulatory delays and has no cap on offering amounts."

Jason W. Parsont, Associate, Clifford Chance

Conclusion

The recent experience in the United States, which is geared toward creating a menu of viable capital-raising options, generally shows that the best regulatory vehicle for startup and small business capital-raising remains the tried and true Private Placement Exemption, even though other options are making in-roads and a trend towards increased use of these other options may emerge in the coming years. The reason that the Private Placement Exemption has been, and continues to be, so successful is that it is inexpensive, consistent across all 50 states, poses no regulatory delays, and has no cap on offering amounts. Accordingly, a similar design, which would implement a pan-European private placement regime across all 28 EU member states, would likely be the best solution to help SMEs raise capital across borders. Designing a bespoke menu of capital-raising options, which is still on-going in the United States, should be a secondary priority given that it is a continuing experiment.

THE MENU OF CAPITAL-RAISING OPTIONS[1]



(1) Excludes, among other exemptions, Regulation S, §4(a)(2), §4(a)(5), Rule 505, Reg CE, and other §3(a) exemptions.

(2) Rule 506(b) is generally the least expensive exemption because it has no offering cap, no SEC review (i.e., no delay), no mandatory disclosure (when only accredited investors are involved), the lowest level of liability exposure (Rule 10b-5), state law preemption, and no requirement to verify accredited investor status. The main drawbacks are that (i) the pool of potential investors is limited to only those with whom the company or its placement agent has a pre-existing substantive relationship (the "Rolodex"), (ii) no general solicitation or advertising is allowed, and (iii) resale restrictions inhibit liquid secondary trading. "Accredited investors" are generally individuals who regularly earn over $200,000 a year in income (or $300,000 with a spouse) or have a net worth, not including their primary residence, of over $1 million, and institutions.

(3) Rule 504 is also generally inexpensive. It allows no mandatory disclosure so long as there is no general solicitation and advertising and resales are restricted. It is usually only preferable to Rule 506(b) for capital-raises under $1 million (its offering cap) where access to non-accredited investors also is needed. While all investors are theoretically eligible, only Rolodex investors are permitted where there is no general solicitation and advertising. But Rule 504 does not benefit from state securities law preemption.

(4) Rule 144A is technically a resale exemption under §4(a)(1). The first step is a Rule 506 offering to an initial purchaser. The second step is a resale to qualified institutional buyers ("QIBs") under Rule 144A. Given the sophistication of QIBs, disclosure often rivals that of registered IPOs even though there is no mandatory disclosure. While this may raise costs disproportionately, there are cost-savings compared with registered offerings on account of a lower level of liability exposure and no SEC review. Rule 144A is likely not popular among small businesses because there is no preemption under state securities laws for these offerings until the company becomes a public reporting company.

(5) Rule 506(c) is identical to Rule 506(b) except that it allows general solicitation and advertising so long as only verified accredited investors participate. Using general solicitation and advertising will raise legal and marketing costs and verification will also lead to further costs.

(6) Section 3(a)(11) is the intra-state exemption and Rule 147 is the related safe harbor from federal regulation. State regulation still applies to these offerings. The top 6 biggest states (CA, TX, FL, NY, IL, and PA) each have larger populations than the national population of accredited investors. For the other 44 states, the accredited investor pool would provide greater total access to investors than any one state.

(7) While IPOs, Reg A T1, Reg A T2 and Crowdfunding each provide access to all American investors, Reg A T2 limits non-accredited investors to a 10% investment threshold and Crowdfunding limits all investors to a 5% or 10% investment threshold depending upon income or net worth levels. This means that IPOs and Reg A T1 give access to the largest pool of capital, while Reg A T2 and Crowdfunding each have respectively less total access. IPOs will be the most expensive because of significant mandatory disclosure (in spite of the EGC rollbacks), the highest level of liability exposure (§11 and 12(a)(2)), SEC review, and complex marketing rules. Reg A T1 likely comes next given its $20 million offering cap, lack of state securities law preemption, scaled back disclosure, and § 12(a)(2) liability, followed by Reg A T2 (same as Reg A T1 except for a $50 million offering cap and state securities law preemption) and then Crowdfunding (most scaled-back disclosure, but heavy in light of $1 million offering cap and §12(a)(2) exposure).

(8) This chart is organized, in general, based on total investor access from least to greatest, which provides a rough proxy for access to total capital. However, total capital and total investors are not the same. While accredited investors are a small minority of the population, they control between 70% and 85% of the capital in the United States.

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