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Highlights of the SEC Forum on Small Business Capital Formation

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The 35th Annual Securities and Exchange Commission Government-Business Forum on Small Business Capital Formation was held on November 17, 2016 at SEC Headquarters in Washington, D.C.

A panel of learned practitioners and securities law experts held a discussion on the state of the union of small business capital formation moderated by the Director of the SEC Division of Corporation Finance and the Chief of the Office of Office of Small Business Policy SEC Division of Corporation Finance. The then current SEC Commissioners also were in attendance.

The discussion largely focused on the efficacy of the JOBS Act (chiefly Titles I through IV) and related rulemaking by the SEC in promoting capital raising by small businesses over the past four years. In this post, I have attempted to sift through the long discussion and bring to your attention below several noteworthy nuggets of information and insight from the panel discussion.

<u>TITLE I – IPO ON-RAMP FOR EMERGING GROWTH COMPANIES</u>

- Most companies, other than certain development stage companies, aren't taking advantage of using only two years of audited financials. This is driven perhaps by the investment community wanting to see more of the trajectory of a company's financial statements.
- EGC IPO Accounting fees have been lower for these kinds of development stage companies. As compared to tech IPOs, it's almost a third lower in cost. And compared to all IPOs, it's about 20 percent lower in cost, with respect to accounting fees.
- The confidential submission process is helpful from a stealth perspective, but not necessarily from a cost-saving perspective.

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- Testing the waters ("TTW") seems to be part of nearly every EGC IPO. Typically a TTW meeting is taking place right before the public filing is made to see if the messaging resonates, and see if the investors understand the story. Some companies are doing this ahead of the filing process even to gauge whether to proceed down the path to an IPO.
- Life science EGC IPO size has been in the range of $50 million to $75 million. Other EGC IPOs have been in the range of $75 million to $100 million plus.
- The post-IPO benefits of deferring certain governance and disclosure requirements are proving to be a key benefit. The ability to defer adopting new accounting standards, however, is not happening as much. This reflects that, as a practical matter, if everybody else in an industry is doing it, so too must the EGCs in order to be seen as comparable.

TITLE II – GENERAL SOLICITATION UNDER RULE 506(C)

- The final rules went into effect in September 2013. As one of the earlier rulemakings, many platforms started out as Title II platforms, which created a bulge in 506(c) offerings initially. But a majority of companies still prefer 506(b) as there is a perception that the cost of complying with accreditation verification outweighs the benefits.
- Title III and IV have since drawn interest away from Title II. Some of this is due to the fact that it's still new and we haven't seen enough completed offerings to give people confidence in the process – e.g. comfort that the accreditation process will always go smoothly.
- It is surprising that 506(c) has not been utilized more. Of those companies that are using it, they tend to be consumer facing companies that want to reach out to their existing customers who might be accredited. Or they are companies with preexisting large marketing bases.
- Some companies are exploring possible side by side offerings in which a company seeks to raise $1MM under Reg. CF while simultaneously raising an unlimited amount from accredited investors through 506(c) or even a traditional underwritten offering.
- Integration of offerings is still a concern. Recent guidance by the SEC, however, clarified that offers and sales of securities made in reliance on Rule 506(b) prior to the general solicitation would not be integrated with subsequent 506(c) offers and sales.

TITLE III – REGULATION A+

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- From effectiveness of the final rules in June 2015 through to the end of October 2016:
  - There have been 140 offerings seeking an average of $18 million average raise per offering.
  - Approximately 15 deals closed, raising an average of $12.6 million per deal.
- Offerings have largely been split between Tier 1 and Tier 2 offerings. In terms of investor base, deals to date have been roughly split between accredited and non-accredited investors. Most deals still require an underwriter.
- The SEC has been providing expedited review of filings, with a couple of dozen, relatively minor comments. Overall, most issuers are averaging 71 or so days in SEC review.
- Reg. A+ seems to be most popular with consumer-facing companies, and with more established companies that are looking to raise more than $3 million to fund growth.
- As there is some uncertainty with respect to what constitutes TTW material, when in doubt, if you mention anything about the IPO, treat it as TTW material and put a legend on it.
- In terms of negatives, the panel cited high fees charged by some states, audited financials and ongoing reporting requirements and a cumbersome coordinated review process.

TITLE IV – REGULATION CROWDFUNDING

- From effectiveness of the final rules in October 2015 through to the end of October 2016:
  - 130 offerings sought an average of $115,000 per offering.
  - Approximately 19 deals closed, raising an average of $350,000 per deal.
  - There are another 25 or so that are above their minimum numbers which are on track to close.
  - There are nearly 20 platforms that FINRA has approved as crowdfunding portals.
- About half of Reg. CF campaigns have come out of California.
- A lot of consumer product deals so far. Debt-focused platforms may become more prevalent.
- In terms of negatives, the panel cited Reg. CF's ongoing reporting requirements, cap table issues, and compliance cost and complexity in light of raising small amount of capital.

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- Also, aggregation rules and prohibitions on common ownership vehicles may be limiting the use of Reg. CF for real estate deals. There are pros and cons with loosening those rules, but it may be something worth exploring.

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