Private Capital-Raising Inched Ahead In '16, But Hurdles Loom

By **Tom Zanki**

Law360, New York (December 12, 2016, 4:15 PM EST) -- Private companies saw their capital-raising avenues expand in 2016 — aided by the enactment of landmark rules governing equity crowdfunding and the defeat of a legal challenge that threatened to block so-called mini-initial public offerings — but experts say the novel funding methods are only slowly gaining acceptance.
The private-capital raising landscape continued to evolve over the past 12 months, four years after the Jumpstart Our Business Startups Act expanded the menu of choices for smaller, private issuers.

Equity crowdfunding launched as U.S. Securities and Exchange Commission rules took effect May 13 following years of debate in which the agency sought to balance demands for increased capital access by small business with concerns that the new funding avenues would lead to fraud. Additional JOBS Act measures, such as so-called Regulation A+ offerings that were already in place, passed a key legal hurdle in 2016 while the marketplace for private placements continued to develop as well.

Equity Crowdfunding Rules Go Live

The most significant change was the authorization of equity crowdfunding, which allows mom-and-pop businesses to sell small amounts of stock to large masses of investors online without the registration process that has defined federal securities law for more than 80 years. From a legal perspective, the change was historic, but whether equity crowdfunding — in effect since May — resonates in the marketplace remains uncertain.

Lawyers say word is slowly spreading among businesses, but more education is needed before issuers and investors embrace the concept.

“It’s so new, and it’s still going to take a long time before the general capital markets public gets comfortable with it,” Gould & Ratner LLP partner Jordan Uditsky said, adding that he believes investors will come to see this option as “another arrow in their quiver.”

Crowdfunding was authorized by the JOBS Act, a legislative package Congress passed in 2012 to expand capital-raising options for smaller, private companies that need funding but can’t afford much larger costs of registered public offerings. U.S. Securities and Exchange Commission data through Oct. 31 show 139 crowdfunding offerings have been launched since May 13, seeking to raise $15.9 million with an average target of $114,500 per offering. Of those, 19 completed offerings raised $6.6 million for an average of $348,800 each.

Those fundraising totals are widely considered modest in the context of private capital-raising nowadays. But some experts note that equity crowdfunding, also called Title III crowdfunding after the section of the JOBS Act that created it, wasn’t likely to explode overnight given the newness of the concept and considerable obligations required of issuers and funding portals that are still learning the ropes.

“The ecosystem is slowing getting built out,” said Flaster/Greenberg PC attorney Mark Roderick, who specializes in crowdfunding. “People are trying to figure how to do the process efficiently.”

Since crowdfunding rules **took effect May 13**, businesses can raise up to $1 million in equity over a 12-month span, provided they file annual reports and accountant-reviewed financial statements to regulators, among other things. Additional rules cap individual investments based on a person's wealth. Plus, the SEC requires issuers to conduct their offerings through a middleman registered with the Financial Industry Regulatory Authority. Those online portals, which channel offerings to investors, must also comply with comprehensive rules intended to **deter fraud**.

Attorneys say many issuers are still trying to determine whether the hassle is worth the benefit.

"It certainly doesn't seem to be gaining a lot of traction to us," Rutan & Tucker LLP partner Gregg Amber said. "I think that's largely because the way the rules operate — it's just too prohibitive for the small amount of capital you can raise."

Political debate also continues as to whether the JOBS Act went far enough — or too far — in creating the crowdfunding regime. A so-called Fix Crowdfunding Act in the House of Representatives **dropped a controversial provision** that would have raised the annual fundraising limit to $5 million, something critics fear would invite fraud.

But the remaining bill, H.R. 4855, which has yet to be taken up by Senate, contains other provisions intended to benefit issuers. They include a measure to simplify administrative burdens on issuers by allowing smaller shareholders to pool their investments into single-purpose funds, something venture capital and other institutional investors tend to look favorably upon.

Equity crowdfunders also compete against an array of other JOBS Act avenues, most of which took effect before 2016, including revised Regulation A rules that now allow quasipublic offerings of up to $50 million, plus new rules regarding private placements that allow issuers to advertise online.

Crowdfunding advocates see the option as ideal for small companies that have a local following in their community, like a coffeehouse or microbrewery. Larger and more sophisticated issuers could be more inclined to pursue expanded Regulation A offerings — or Reg A+, as it is called — as well as more conventional private placements.

"Crowdfunding for the right situation is certainly attractive, but the number of transactions has not been as significant, as there are other avenues to raise small amounts of capital," Olshan Frome Wolosky LLP partner Spencer Feldman said.

Reg A+ Gets a Boost

SEC rules on Regulation A+ offerings **took effect in 2015** but started slow, something attorneys partly blamed on a legal challenge from regulators in Massachusetts and Montana, who argued the new federal rules preempted their authority by allowing issuers to bypass state approvals in certain instances. A federal appeals court **rejected their challenge** in August.

Many attorneys say interest in Reg A+ has picked up since that legal cloud was removed. They say such offerings could grow further if eligibility for Reg A+ deals, which are currently limited to private companies, are **expanded to public companies** as some are advocating.

"Reg A+ is definitely going to turn out to be interesting, especially if some proposed regulations that are tinkering around now make it more usable for all companies," Feldman said.

But questions remain as to whether Reg A+ offerings will attract significant support from investment banks, many of whom prefer to underwrite larger deals. The **lack of secondary trading options** is also a concern for liquidity-minded investors given significant restrictions that apply to the resale of private securities.

OTC Markets Group **provides a secondary trading venue** for Reg A+ issuers who want to list their shares over the counter, but so far only startup automaker Elio Motors has done so. Attorneys say Reg A+ securities could become more appealing if more issuers obtain approval to list on major exchanges like Nasdaq, which provides wider liquidity. But gaining Nasdaq or New York Stock Exchange access requires companies to complete the expensive process of becoming an SEC reporting company, possibly offsetting the cost savings of Reg A+.

Reg A+ was intended to provide small companies a simpler way to raise capital without the heavy disclosure requirements associated with a full-blown IPO. The JOBS Act lifted the old Regulation A cap from $5 million, which was so small it was barely used, to $50 million to encourage more participation.

Amber said his experience is that Reg A+ deals have gained "a fair amount of interest but not a lot of action." Reg A+ issuers must file a form 1-A offering statement with regulators, which is leaner than a traditional S-1 filing for IPOs, but is still quite lengthy, attorneys say.

"The cost savings aren't that much compared to a traditional IPO," Amber said.

Data show issuers are indeed using Reg A+ options, albeit at a clip that many consider modest. The SEC's Division of Corporation Finance reports that since its inception in 2015 through Oct. 31, 2016, Reg A+ issuers have completed 147 offerings, raising $2.6 billion total. That amounts to an average of $18 million each.

SEC data also show Reg A+ offerings are about evenly split between tier 1 and tier 2 offerings. The latter allows issuers to raise up to $50 million and bypass state regulators, while tier 1 deals are capped at $20 million and require state approval while permitting less disclosure.

Reg D Private Placements Begin to Evolve

Issuers not fond of the new options can still raise an unlimited amount of money through ordinary private placements under the SEC's Regulation D, which attorneys say remain the popular choice for private capital-raising, though those offerings are largely restricted to wealthier investors.

The JOBS Act also sought to modernize private placements by lifting the ban on advertising — called "general solicitation" — through new Regulation D offerings under Rule 506(c) that allow issuers to market their offerings online. The change, in effect since 2013, is meant to give startups that lack an existing investor base or connections to brokers the opportunity to use the internet to tap potential backers.

But such offerings come with requirements not mandated by traditional Regulation D private placements, also called 506(b) offerings. Mainly, 506(c) offerings can only be sold to "accredited investors" — a criteria based on income or wealth — and such issuers and their investors must take extra steps to verify that they are indeed accredited. The additional requirements are intended to deter fraud.

Lawyers say 506(c) offerings are slowly showing promise as issuers learn the process.

"There is a limitation there, but it really opens things up for you," Uditsky said. "I think you will see that gain some steam as well."

For now, SEC data show traditional Regulation D offerings continue to dominate. The Division of Economic and Risk Analysis reported earlier this year that 2,946 companies raised $26.7 million under the 506(c) rule from 2013 until the end of 2015, compared with 32,461 operating companies that drew $310.1 million under 506(b), or about 11 times more.

But Roderick said he is steadily getting more phone calls about 506(c) offerings. He said the same is true for new JOBS Act options available to retail investors, including Reg A+ and equity crowdfunding. Their success, he said, depends on the public becoming more comfortable with these new opportunities.

"That's what has to happen for any of these mechanisms to really get a lot of traction," Roderick said.

--Editing by Christine Chun and Philip Shea.