CONGRESS ACTS TO EXPAND CAPITAL FORMATION RULES WHILE ROLLING BACK DODD-FRANK REGULATION

Date: 19 June 2018

U.S. Investment Management and Emerging Growth Venture Capital Alert

By: Gary J. Kocher, Sonia R. Gioseffi

Since the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") was enacted in 2010, many Republicans have advocated for its repeal. However, in one of the first bipartisan banking laws to be adopted in over a decade, on May 24, 2018, the Economic Growth, Regulatory Relief and Consumer Protection Act (the "Act") was signed into law. The Act repeals many of the regulations applicable to small and mid-size banks adopted under the Dodd-Frank Act. To engender more bipartisan support, the Act also includes provisions aimed at encouraging capital formation. This alert highlights three of these provisions: a new exemption from registration under the Investment Company Act of 1940 (the "Investment Company Act") for micro venture capital funds and investor syndicates; an increased threshold before mandated disclosures are required in connection with equity compensation grants to employees under Rule 701 under the Securities Act of 1933 (the "Securities Act"); and an expanded application of Regulation A+ under the Securities Act.

QUALIFYING VENTURE CAPITAL FUND EXEMPTION

The Act includes a new exemption from registration as an investment company under the Investment Company Act for a newly created category of "qualifying venture capital funds." Previously, venture capital funds and other investor syndicates or groups could have up to 100 "beneficial owners" or investors who are accredited investors and rely on an exemption from registration [1]. The new exemption allows qualifying venture capital funds [2] to have up to 250 "beneficial owners" or investors who are accredited investors as long as the fund has no more than $10 million in commitments. The Act directs the Securities and Exchange Commission ("SEC") to index the $10 million limitation for inflation every five years.

Key Takeaway: This exemption will likely have a positive impact on start-up and emerging growth companies that receive funding from angel investors that participate in syndicates through online investment platforms and so-called "side car" investment funds that many angel investor groups have formed.

INCREASE IN EQUITY COMPENSATION THRESHOLD UNDER RULE 701

The Act contains amendments to SEC Rule 701 that increase the dollar threshold above which issuers must begin delivering financial and other prescribed information to equity plan participants from $5 million to $10 million in any consecutive 12-month period. Private companies often provide stock options and shares to employees as compensation and as a retention incentive, which can trigger some of the same disclosure requirements applicable to public companies. The Act increases the threshold before these disclosures are required to $10 million [3] in any consecutive 12-month period. These amendments are subject to SEC enacting rules that are called to be issued within 60 days of the enactment of the Act.

Key Takeaway: This aspect of the Act likely will reduce the cost of compliance for private companies that rely on equity-based compensation as a key component to attract and retain talent in a competitive labor market.

EXPANSION OF REGULATION A+

The Act also expands the range of eligible issuers that may rely on Regulation A+ for capital raising activities. Regulation A+ allows eligible companies to engage in offerings of securities, essentially "mini IPOs," in amounts of up to $50 million with significantly reduced regulatory and reporting obligations compared to a fully registered offering under the Securities Act. While this exemption was previously limited to issuers that did not have a class of securities registered under the Securities Exchange Act of 1934, the Act now permits public companies to utilize Regulation A+.

The SEC adopted the Regulation A+ rules in 2015 [4] under the premise that it would provide a cost-effective path to raising capital while also providing suitable investor protections. Regulation A+ also seems to have been designed with an intention to work well with the emergence of online deal syndication platforms that are playing a more important role in financings for smaller companies. However, there have been significant and legitimate reservations in the minds of investors about the lack of liquidity in the secondary markets for securities that are sold under Regulation A+, which has limited the use of this exemption. Until active secondary resale markets develop for these securities, the use of Regulation A+ will likely be somewhat tepid, but the emergence of viable exchange platforms may help tip the balance toward more wide-scale use of Regulation A+.

Key Takeaway: It is likely that more companies will rely on this exemption due to the changes in the Act that open it up to public companies, which, in many cases, have an existing market where the securities can trade.

While the effects of the Act on raising capital are not yet known, the Act reflects that in a time of political polarization, there is bipartisan support to increase the flexibility of start-up and small companies to raise capital.

Notes

[1] Note that the Act only provides an exemption for federal requirements and funds may need to comply with applicable state law requirements. Also, if the fund manager is a registered investment adviser with the SEC, the investors would need to be qualified clients.

[2] As defined in SEC Rule 203(l)-1.

[3] This amount refers to the aggregate sales price of the securities or strike price of options issued in reliance on Rule 701 during any consecutive 12-month period. The amount will also be indexed to inflation every five years.

[4] A copy of our prior alert on Regulation A+ is available at: The SEC Delivers A+ Effort: New Rules Designed to Breathe Life into Regulation A.

KEY CONTACTS

GARY J. KOCHER
PARTNER

SEATTLE
+1.206.370.7809
GARY.KOCHER@KLGATES.COM