Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

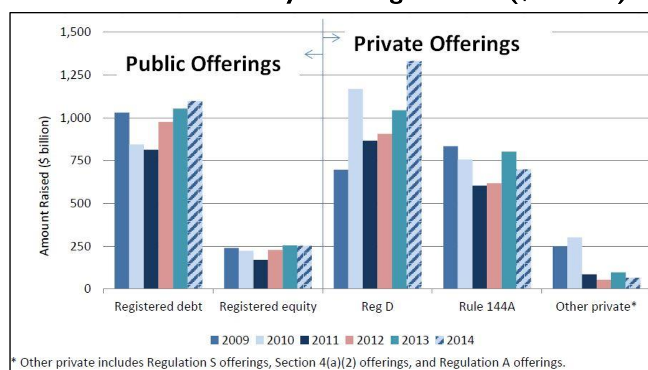
October 5, 2017

Private Securities Offerings: Background and Legislation

Companies turn to a variety of sources to access the funding they need to grow and make new investments. Among them are capital markets, segments of the financial system in which capital is raised through equity securities (assets that represent ownership stakes in a firm) and debt securities (assets that represent creditor relationships with a firm).

The Securities and Exchange Commission (SEC) is the principal regulator of the nation's securities markets. In general, the agency requires that offers and sales of securities either be registered with the SEC or be undertaken with an exemption from registration. A fundamental goal of registration is ensuring that investors receive financial and other significant information on the securities being offered for public sale.

Figure 1. Aggregate Capital Raised in Securities Markets in 2009-2014 by Offering Method ($Billions)



Source: Scott Bauguess *et al., Capital Raising in the U.S: An Analysis of the Market for Unregistered Securities Offerings*, 2009-2014, October 2015, https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf.

Registered offerings, often called public offerings, are available to all types of investors. By contrast, securities offerings that are exempt from SEC registration are referred to as private offerings, private placements, or unregistered offerings. They are mainly available to financial institutions or individual investors with certain financial or income wherewithal known as *accredited investors*. As such, the SEC registration process, which enables investors to access key financial information, can be viewed as a dividing point between public and private securities offerings.

Private offerings, which can range from $100,000 to tens of millions of dollars, have outpaced public offerings in recent years to become the preferred option for raising capital (see **Figure 1**). According to a SEC staff whitepaper, the private debt and equity offerings for 2012 through 2016 combined exceeded the public offerings by about 26%.

Public and Private Securities Offerings

As stated earlier, companies may be able to access a variety of funding sources. Some private companies do conduct private placements; some eventually go public via an initial public offering (IPO, the initial offering of the stock of a private company to the public). Public companies may also issue private offerings.

As both public and private companies issue private offerings, public and private offerings differ by SEC registration status, instead of issuer type. Below are descriptions of key registration exemptions under federal securities laws that enable the issuance of private offerings.

Regulation D (17 CFR §230.501 et seq.), Rule 144A (17 CFR §230.144A), and Regulation A (17 CFR §230.251 through §230.263) are examples of exemptions that establish private offerings.

Regulation D is the most frequently used exemption to sell securities in unregistered offerings. Companies relying on a Regulation D exemption do not need to register their offerings with the SEC, but they face limitations regarding size and investor type of their offerings.

Rule 144A is for resale transactions only. Issuers generally use it in a two-step process to first facilitate a primary offering on an exempt basis to financial intermediaries, and then resell to qualified institutional buyers (QIBs, a corporation that is deemed to be an accredited investor).

Regulation A is an exemption to facilitate capital access for small to medium-sized companies. It has fewer disclosure requirements than the registration process. Regulation A was updated in 2015 with a two-tiered structure (Regulation A+) to exempt from registration the offerings of up to $50 million annually, if specified requirements are met.

Going Public or Remaining Private

Companies choose to go public to access capital that would allow founders to cash out their investments, to provide substantial stock and stock options to employees and management incentive plans, and to fuel the company's future growth. Public companies also benefit from "liquidity premium," which translates into better share pricing compared with stock from comparable private offerings, among other things.

There are also advantages, however, for firms to remain private.

Compliance costs. Proponents of the proposals believe the costs of registration are large in magnitude and disproportionately burdensome for small and medium-sized businesses, including startup firms. The direct costs include underwriting, external auditing, legal and financial reporting fees.

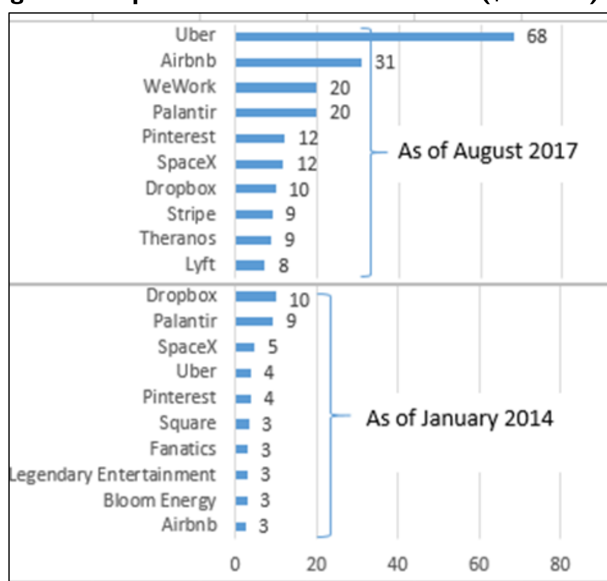
Business operations. Public companies are often perceived to face incremental market pressure for short-term performance, reduction in insider control and decision-making flexibility, and contention with increased shareholder activism (which sometimes could be to a firm's financial benefit). Some research has indicated that going

public can adversely impact corporate innovation; however, there are also many examples of innovative public companies.

Access to Private Offerings: Unicorns Versus Small and Emerging Companies

Although the vast majority of firms that conduct private offerings are small to medium sized, proponents of private offerings point to unicorns as an example of how private companies allow for rapid growth and innovation. The term *unicorn* refers to startup companies that have achieved a valuation of at least $1 billion, while remaining privately funded (which has often been done through private placements). According to the *Wall Street Journal* and Dow Jones VentureSource, the number of U.S. unicorns grew from 32 in January 2014 to 100 in August 2017.

Figure 2. Top 10 U.S. Unicorn Valuations ($Billions)



Source: *Wall Street Journal*, August 2017, http://graphics.wsj.com/billion-dollar-club/.

Note: U.S. companies valued at $1 billion or more by venture capital firms.

Mutual funds, hedge funds, sovereign-wealth funds and other institutional investors not traditionally known for investing in startups are now allocating capital toward private offerings. Going public is arguably no longer a necessity for certain private companies to raise capital.

However, concerns persist that small and less technology-driven companies face difficulties in accessing capital. SEC's Advisory Committee on Small and Emerging Companies stated in May 2017 that "identifying potential investors is one of the most difficult challenges for small businesses trying to raise capital."

Legislation That Would Broaden Private Placements

Signed into law in 2012, the Jumpstart Our Business Startups (JOBS) Act expanded various exemptions to facilitate capital formation. In the 115th Congress, the Financial CHOICE Act (H.R. 10) has provisions that would further modify the restrictions on private offerings. The following legislative provisions, as passed by the House, are aimed at increasing capital formation through private placements by expanding the exemptions for registration or adjusting related definitions.

Section 452 of H.R. 10. The provision would direct the SEC to revise Regulation D, which exempts certain offerings from SEC registration requirements but prohibits general solicitation or general advertising with respect to such offerings. Under this provision, the prohibition would not apply to events with specified kinds of sponsors, including "angel investor groups" that are unconnected to broker-dealers or investment advisers, if specified requirements are met.

Section 461 of H.R. 10. The provision would exempt certain micro-offerings from (1) state regulation of securities offerings and (2) federal prohibitions related to interstate solicitation. This exemption would allow for the participation of small offerings without triggering the Securities Act registration and state Blue Sky securities laws.

Section 497 of H.R. 10. The provision would expand the number of non-accredited investors allowed for private offerings under the SEC registration threshold.

Section 498 of H.R. 10. The provision would increase the upper limit of offerings that are exempt from registration, subject to eligibility, disclosure, and other matters as specified in Regulation A+.

Section 860 of H.R. 10. Private offerings are generally limited to more sophisticated institutional or individual accredited investors who have higher net worth and income levels than non-accredited investors. The provision would expand the category of investors that may be considered accredited investors for purposes of participating in private offerings. The proposed change would expand the size of the eligible investor pool for private offerings.

Key Policy Issues

The policy debate surrounding the legislative provisions to promote private placements is an illustration of the tradeoffs between investor protection and capital formation, two of the SEC's statutory mandates. Capital formation needs may be better met if issuers could elect their preferred methods of fundraising without regard to registration, as the registration process raises the cost of accessing securities markets. On the other hand, the investor protection challenges potentially increase as more investors gain access to private offerings. For example, will non-accredited investors and less sophisticated accredited investors be able to comprehend the higher relative risks often embedded in unregistered private offerings issued by the small, medium-sized, and start-up companies that dominate private placements? Other policy considerations include the choices between a "one size fit all" legislative approach and the more tailored regulations to account for factors such as a firm's size, a firm's industry, and the investment limits to non-accredited and/or accredited individual investors.

Eva Su, Analyst in Financial Economics

IF10747

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.