GUNDERSON DETTMER

SEC Commissioner's Recommended Reforms to Regulation D Could Have a Significant Impact on Private Financings

Insights
March 7, 2023

Current SEC rulemaking agenda targets April 2023 for issuance of proposed amendments to Regulation D, including updates to the accredited investor definition, and Form D

Overview

In keynote remarks titled "*Big 'Issues' in the Small Business Safe Harbor*" delivered before the recent Northwestern Pritzker School of Law Securities Regulation Institute, U.S. Securities and Exchange Commission (SEC) Commissioner Caroline Crenshaw recommended "incremental, but essential" reforms to Regulation D of the Securities Act of 1933 (Reg D), the predominant method of raising capital in the private markets. Her comments, detailed below, may foreshadow the nature and contours of the SEC's formal rulemaking proposal to amend Reg D anticipated this spring. While proposed amendments are still developing, the commissioner's statements provide much-awaited visibility into the SEC's potential approach to Reg D reform.

Reg D enables issuers to conduct a securities offering that is exempt from SEC registration. By allowing issuers to forgo the registration process and provide less extensive disclosures, Reg D generally affords issuers greater speed and flexibility in raising capital, reduced compliance costs and a lower risk of sharing proprietary information with competitors. Form D serves as the official notice of an exempt securities offering in reliance on Reg D that is required to be filed with the SEC within 15 days after the first sale of securities in the offering.

Over the past decade, there has been a steady increase in both the number of offerings and amounts raised under Reg D, and total capital raised annually in the Reg D market now surpasses that raised in the registered offering market. Commissioner Crenshaw, a frequent critic of the rapid growth and opacity of the private securities markets relative to the public markets, suggested in her remarks that "[t]here should be more transparency to ensure a basic level of disclosure that allows investors, even the most sophisticated, to make informed investment decisions. And other regulatory obligations should be tailored for size." To that end, her suggested reforms contemplate:

- **revisions to Form D** that, among other changes, would expand the information required to be reported on the publicly filed form; and
- **a two-tiered disclosure system** that would require more information from more mature private issuers and larger private offerings.

If adopted, these reforms would significantly increase costs, complexity and potential federal securities law liability for private companies seeking to raise capital under Reg D, particularly larger private companies that could be forced into a public-like reporting regime.

In addition, the enhanced disclosure obligations would provide competitors access to certain operational and financial information about private companies that has previously been unavailable.

Reg D Today

Commissioner Crenshaw noted that, from its inception, Reg D was intended as a limited exception to facilitate access to capital by small businesses. "Private markets were meant to be the exception to the proverbial rule," she observed. "But, through decades of legal, regulatory and market developments, private companies now have access to increasing amounts of private capital, inflating their sizes and significance to investors and our economy, and all without the concomitant safeguards built into the public markets."

Unfettered access to capital through Reg D has had what Commissioner Crenshaw described as a "bloating effect" on private issuers, the clearest evidence of which is the ubiquity of once-mythical "unicorns" — private companies valued in excess of $1 billion. Private company unicorns have grown dramatically in both number and size (from approximately 40 a decade ago when the term was first coined to more than 1,200 today, with purported overall valuations of roughly $4 trillion), consistently relying on Reg D to raise billions of dollars in capital to fund their growth. "Make no

mistake, Reg D has helped pave the way for the advent of the unicorn," she said. "Not only can the companies rely on Reg D to raise capital as small businesses, but they can keep raising capital, and keep growing, indefinitely while staying in private markets. The exception is no longer narrow."

Allowing companies to grow so large without sufficient regulatory oversight can have adverse consequences, she posited, especially for investor protection. "Many would say…that large private issuers are backed by the most sophisticated investors in the world and don't need the SEC to impose disclosure or corporate governance protections," she said. "I am concerned, though, that sophistication is not quite the safeguard it's presumed to be."

In fact, she asserted, "[a]s private companies have gained increasingly large market power and as the pool of accredited investors has expanded — including venture capital, private equity funds, mutual funds, pension funds and individuals that meet the requisite wealth thresholds — the *de facto* presumption that accredited investors need no disclosure isn't panning out."

The lack of information about the business and operations of private companies puts even the most sophisticated investors at a disadvantage, she argued, citing examples dating back to the 2008 financial crisis and recent implosions involving blood-testing company Theranos, workspace provider WeWork and cryptocurrency exchange FTX. These corporate failures, in her view, illustrate that, even among a set of accredited and sophisticated private-market investors, there is a need for a baseline level of disclosure.

Potential Reforms

Having concluded that "Reg D is not serving its intended purpose," Commissioner Crenshaw outlined the following two "incremental, but essential" reforms to enhance investor protections and increase visibility into the private markets:

Form D Revisions

- Require that issuers file Form D prior to any solicitation under Reg D (rather than within 15 days after initial sale).
- Impose consequences for failure to file Form D, such as the inability to rely on Reg D in future offerings.
- Require that executive officers (rather than authorized representatives) sign and certify Form D so that executive officers would be accountable for the contents.

- Require an amendment or closing statement of amounts actually raised under the offering.
- Mandate disclosure of “useful, substantive” information about the issuer and offering (though short of the level of detail required in an IPO prospectus), such as:
  - size (by assets, investors and employees);
  - operations;
  - management;
  - financial condition and revenues;
  - volume and nature of the securities offerings;
  - use of proceeds;
  - nature of the investor base (including information about accredited and non-accredited investors and steps taken to assure accreditation);
  - expected returns through distributions;
  - findings of securities fraud, enforcement actions or non-compliance with the securities laws;
  - material risks and conflicts of interest; and
  - availability of secondary trading.

Two-Tiered Disclosure Framework

- Impose heightened disclosure requirements on larger private issuers and offerings (based on market cap, value or the size of the investor base), beyond those required on Form D, both at offering and on an ongoing basis.
- Require larger private issuers to engage independent auditors and provide investors with audited financial statements and auditor opinion letters confirming the adequacy of their internal control over financial reporting.

What’s Next

The SEC’s current rulemaking agenda targets April 2023 for issuance of proposed amendments to Reg D, including updates to the accredited investor definition, and Form D. The SEC’s target dates are not binding and often aspirational, however, and

it may propose changes sooner or later than planned. Whether any of Commissioner Crenshaw's recommended reforms are among the proposed changes remains to be seen. Although her views represent only one of the SEC's five voting members, she is one of a three-member Democratic majority under the current administration that has been pushing for stronger disclosure and liability protections, and other regulatory safeguards, for private-market investors.

A related item on the SEC's regulatory agenda similarly aimed at enhancing transparency, disclosure and oversight in the private markets is a proposal to amend the definition of "held of record" for purposes of Section 12(g) of the Securities Exchange Act of 1934, which establishes the threshold for SEC registration. That proposal also has a projected release date of April 2023. Any rulemaking proposals released by the SEC will be subject to a public comment period typically ranging from 30 to 60 days, after which the SEC will review and consider the feedback received as it works toward developing final rules.

We are closely monitoring and will continue to keep you updated on the status of the SEC's rulemaking efforts in this area.

If you have any questions or would like more information about the issues discussed in this client alert, we invite you to contact your regular Gunderson Dettmer attorney.

Related Services

Private & Public Companies

Featured Insights

CLIENT NEWS

Brazilian Carbon Capture Company Mombak Announces $30M Financing

CLIENT NEWS

Africa B2B OmniRetail Announces $20M Financing

CLIENT NEWS

Glacier Announces Series A Financing to Expand Robot Recycling Fleet

CLIENT NEWS

Dataminr Announces $100M Investment Led by Fortress Investment Group

CLIENT NEWS

Omnidian Announces $87M Series C for Renewable Energy Performance

INSIGHTS

Splitting the Pie: How Savvy Founders Divide Ownership and Navigate Other Founder Equity Decisions

CLIENT NEWS

Chainguard Announces $356 Million Series D Led by Kleiner Perkins and IVP

INSIGHTS

Client Insight: California AI Transparency Act

INSIGHTS

Client Insight: Prepare for BE-10 Benchmark Survey of US Direct Investment Abroad

INSIGHTS

Tech Brew Interviews Aaron Rubin in “Where the legal battle stands around copyright and AI training”

CLIENT NEWS

Latin America Fintech Belvo Announces $15M Funding

INSIGHTS

Legal 500 Country Comparative Guides 2025: Venture Capital (Singapore)