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U.S. Eyes New Stock Rules

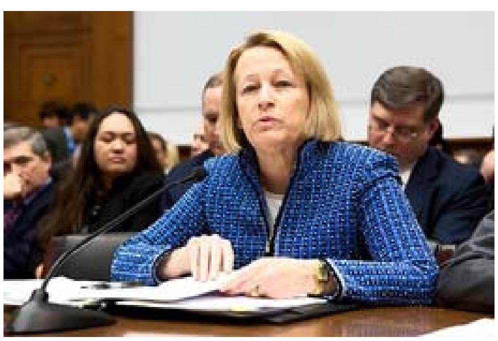
Regulators Move Toward Relaxing Limits on Shareholders in Private Companies

By JEAN EAGLESHAM

Federal securities regulators are moving toward easing decades-old constraints on share issues by private companies, in a sweeping review that could remake the way American start-ups raise capital.

The review by the Securities and Exchange Commission, disclosed in a letter to a lawmaker, could fuel the fast-growing market in private shares of technology firms such as Facebook Inc., Twitter Inc. and Zynga Inc. The steps under consideration would help such privately held companies raise more money without incurring the increased reporting and other requirements of becoming a public company.

According to the letter and people familiar with the matter, the likely changes would include raising from 499 the number of shareholders private companies can have without being required to open their books, and also making it easier for such companies to publicize share offerings.



Bloomberg News

SEC Chairman Mary Schapiro testified at a hearing in February.

Such a shift would upend the normal path for fledgling companies to raise funds, in which venture capitalists provide rounds of private funding, leading ultimately to an initial public offering of stock to the public, where large and small investors can participate. Instead, companies could remain private and raise money by selling shares to a wider number of investors.

The move could potentially delay or derail IPOs by tech companies that want to grow but would rather avoid having to disclose vast amounts of information. It could also shut out many ordinary investors from one of the fastest-growing market sectors, since shares in private companies are generally available only to investors whose individual net worth is at least $1 million. And at a time when investors are seeking more market transparency, it would lessen the amount of publicly available data about those companies.

An SEC spokesman declined to comment.

The possible changes come amid concerns about a dearth of U.S. stock listings, which politicians on both sides of the aisle worry could hurt American competitiveness with the rest of the world. The number of U.S. IPOs has plunged to an annual average of about 130 since 2001 from an average of 503 during the 1990s, according to Dealogic, a research firm.

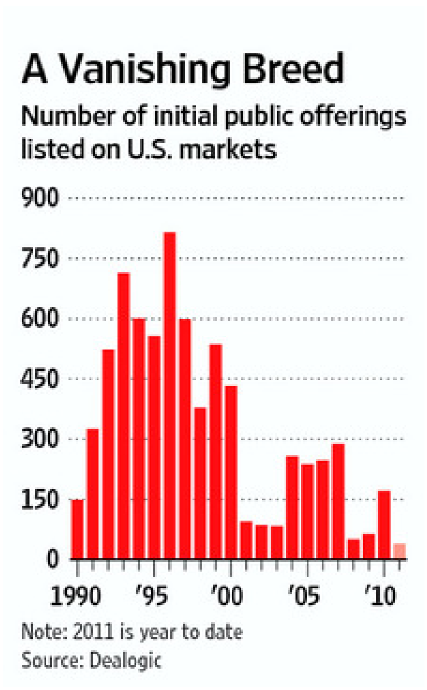
In the meantime, the value of transactions in private-company shares has grown, almost doubling in 2010 to $4.6 billion, from $2.4 billion last year, according to NYPPEX, a research firm and broker-dealer. It forecasts the value will reach $6.9 billion for 2011.

Proponents of a rule change say the SEC should respond to growing demand for such shares by modernizing rules, rather than keeping roadblocks to private fund raising in place. The current rules discourage private companies from issuing shares, "resulting in less investment and fewer jobs," says Rep. Darrell Issa (R., Calif.), House Oversight Committee Chairman.

Mary Schapiro, the SEC's chairman, sent the letter to Mr. Issa on Wednesday, saying she had ordered a review of all the rules that affect share issues by privately held companies. "The staff is taking a fresh look at our rules to develop ideas for the Commission about ways to reduce the regulatory burdens on small business capital formation," she wrote.

Currently, companies can issue shares privately without incurring onerous reporting obligations if they have fewer than 500 shareholders. The SEC is considering raising that limit, though it's unclear by how much. The rule was designed to protect investors who owned shares in companies that were growing but not required to disclose their inner financial workings. Some investors say the SEC should stop companies from getting around the rule, which they say remains an essential safeguard. Lawrence J. Goldstein, founder of institutional investor Santa Monica Partners L.P., said he would "absolutely be concerned" if the limit was raised.

The review comes as the SEC investigates whether there are abuses in the electronic market for shares in companies such as Facebook. The concern is that technology-company insiders could be trading in the private market using information unavailable to outside investors. The SEC has sent subpoenas to a number of tech companies seeking information on how their shares are traded, people familiar with the matter say.



On the rule front, the agency has a responsibility to encourage companies to raise capital as well as to protect investors. It is under increasing pressure from lawmakers and businesses to update rules governing share issues by private companies that date back to 1964—20 years before Facebook founder Mark Zuckerberg was born.

Critics say the rule creates an arbitrary and unnecessary barrier to private company growth. The American Bankers Association has lobbied for an increase in the limit to 2,000. The shareholder limit was notably a factor in Google Inc.'s decision to go public in 2004, when the Internet-search giant exceeded 499 shareholders.

The SEC can increase the limit without approval from Congress, according to Ms. Schapiro's letter.

The review also will examine issues raised by the growing use of "special purpose vehicles" that allow a pool of investors to buy a stake in a company, while counting as only one shareholder for the purposes of the SEC rules. Critics say the strategy is designed primarily to circumvent the shareholder limit.

The SEC also is considering relaxing a strict ban on private companies publicizing share issues, known as the "general solicitation" ban. The intent of the rule is to keep companies that need cash from targeting potentially vulnerable investors.

But critics say high-growth companies have gotten around the rule by raising money from investors overseas, denying U.S. citizens a chance to buy stakes.

Goldman Sachs Group Inc. withdrew an offer of shares in Facebook from its U.S. clients in January, stating that "the level of media attention" about the deal might have violated the solicitation ban.

But Ms. Schapiro suggested that Goldman's about-face was likely unnecessary. "At no point in time did the staff advise or instruct Facebook or Goldman Sachs that the offering could not be conducted in the United States," she wrote in Wednesday's letter. A spokesman for Goldman declined to comment.

—Liz Rappaport and Geoffrey Fowler contributed to this article.