// By Jon Uretsky, Esq.

VAST CHANGES TO MICROCAP FINANCING PART II

THE SEC STRIKES BACK

In Q1's Legal Corner, we said that vast changes would be coming to the structure of microcap financing – get ready because they're here.

In my last article, I highlighted a string of enforcement actions the SEC had begun pursuing in 2019 against various lenders who all earned money in a similar way: sending funds to a microcap company in exchange for shares based on convertible debt, and then after a six-month waiting period, selling the suddenly unrestricted shares on the open market. This financing structure existed because, when it worked out, it was mutually beneficial for both the lender and the microcap company. Lenders saw large profits while these companies got financing they couldn't get elsewhere. Sometimes, disputes, and thus litigation, was involved, and we have been on both sides of those disputes. More often than not, settlements were reached, and the company and lender worked together afterwards. This financing structure is hardly ideal, but it was "the done thing" in the microcap industry for decades. Critically, this financing structure, where lenders are seen as "traders," instead of "dealers," had been deemed legal for decades. That's changing.

We defended lenders against the SEC by arguing that the SEC should not be permitted to regulate by enforcement – arguing that the SEC can make rules if it wants to. Well, the SEC just did. As I discussed at the Planet Microcap Showcase, the SEC Commissioners just unanimously proposed rules that would change the letter of the law to further define a "dealer" and dealer activity. The SEC's purported focus here was to "reflect Congress' statutory intent" that firms who engage in important "liquidity-providing roles" in the securities markets should be registered.

Prior to this rule, a dealer was someone "who engaged in the business of buying and selling securities for his own account." An individual who bought and sold for his or her own account, but not as part of a regular business, fell under the trader exception and thus was not required to register and file with the SEC – which can often be an expensive process. Now, a dealer will be considered anyone who engages "in a routine pattern of buying and selling securities that has the effect of providing liquidity to other market participants." How many funds does that include? All of them, perhaps?

WHAT DOES THE SEC'S NEW DEFINITION MEAN, EXACTLY?

According to the SEC, the new definition of dealer sweeps in investors who, for example:

- Routinely make roughly comparable purchases and sales of the same or substantially similar securities in a day; or
- Routinely express trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that make them accessible to other market participants; or
- Earn revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquid-supplying interests.

Keep in mind that though the SEC provides these standards, it warns that no presumption should be made that certain persons are not dealers solely because those persons do not meet the standards of the rule. In other words, there is no safe harbor.

There could be some light at the end of this tunnel, as the SEC included a provision for excluded persons against whom the new rules would not apply: persons who have or control total assets of less than $50 million. The SEC believes that individuals who are not part of a business, but are buying and selling securities with less than $50 million controlled, are less likely to pose the type of risk to the market – and other market participants – that the SEC is trying to address.

WHAT NOW?

The net that the SEC's new dealer definition casts is wide indeed, and as I've mentioned before, this will change how the microcap industry is financed. Here is what I see happening to this industry:

- Larger microcap lenders and issuers with deeper pockets might start looking at international exchanges instead of ones in the United States that are regulated by the SEC. Issuers can choose to list microcap securities internationally in, for example, the United Kingdom. The Financial Conduct Authority ("FCA") regulates markets in the UK with less stringent listing requirements, where debt securities can be sold on an alternative market to qualified investors. And when microcap securities are listed internationally – what's to stop the larger lenders from moving their money internationally as well?
- Smaller lenders could structure their funds differently to qualify as an "excluded person," avoiding registration. However, the SEC may have anticipated this and as a result, clarified the definition of "own account" to now include "parallel account structure" which the SEC defines as "a structure in which one or more private funds (each a 'parallel fund'), accounts, or other pools of assets (each a 'parallel managed account') managed by the same investment adviser pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account." In short, the SEC may come after lenders who have "parallel account structure," but what's to stop these smaller lenders from structuring their operation to be owned by different individuals?
- As for the microcap companies themselves, this new definition could cause publicly listed microcap companies to go back to being private companies. Without the benefit of being a public company – *i.e.,* being able to raise funds – what is the purpose of going through onerous public filing requirements? Other microcap companies may cease to exist at all without the necessary funding, causing lost jobs and generally stagnating microcap market activity.

In the end, this rule may have the opposite effect the SEC intended, as those in the microcap industry with more funds may find alternatives and ways around the rule, while the smaller microcap companies – the very ones the SEC is seeking to protect with the new rules by "levelling the playing field" – will likely be hurt. With that said, experienced counsel can help navigate the process so you don't end up one of those hurt by the SEC's new rule. The SEC is providing a one-year compliance period from the effective date of any final rules adopted by the SEC, which will likely be sometime this summer.

So you'll have a year to figure it out. Retaining experienced microcap counsel like PULLP can help. We invite you to contact uretsky@pullp.com or call 212.571.1164 for a complimentary analysis.

PULLP, "The Microcap Litigators" is one of the only law firms specializing in microcap litigation. Jon Uretsky is the founding and managing partner of PULLP. Mr. Uretsky has a broad multidisciplinary practice that includes extensive experience in litigation and dispute resolution, regulatory investigations (including FINRA and SEC matters like those described above). In addition, he counsels corporate boards, board committees (including special committees) as well as being a personal adviser to many entrepreneurs, business leaders and corporate executives. He has counseled clients on significant litigation, regulatory and transactional matters across multiple industry sectors. Additionally, the PULLP team has extensive experience negotiated mergers and acquisitions (including reverse mergers); domestic and cross-border investments/joint ventures; the representation of private equity; venture capital and other private investment funds; securities offerings; and private and public financings.

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Notes:
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