

SEC Lifts Ban On General Solicitation Giving Start-Ups Increased Access To Capital Investment

On July 10, 2013, the U.S. Securities and Exchange Commission ("SEC") lifted an 80-year-old ban on general solicitation and general advertising in fundraising, fundamentally altering the way in which capital may be raised by start-ups, operating ventures, and investment funds.

In particular, the SEC approved a final amendment to Rule 506 of Regulation D permitting issuers to engage in general solicitation or general advertising in offering and selling private securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuers take reasonable steps to verify that such purchasers are accredited investors.

The elimination of the prohibition against general solicitation for a subset of Rule 506 offerings will finally enable issuers to solicit potential investors directly, whether via mailings, newspaper advertisements and television commercials, or via email, the Internet, and social media.

Background

On August 29, 2012, the SEC proposed a rule amendment to implement Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"), enacted April 5, 2012. Section 201(a)(1) of the JOBS

Act directs the Commission, not later than 90 days after the date of enactment, to amend Rule 506 of Regulation D under the Securities Act of 1933 to permit general solicitation or general advertising in offerings made under Rule 506, provided that all purchasers of the securities are accredited investors.

The JOBS Act also stipulates that the amended Rule must "require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."

Under existing Rule 506, an issuer may sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors" (including corporations having assets in excess of \$5 million and individuals meeting specified net worth or income tests), and to no more than 35 non-accredited investors who meet certain "sophistication" requirements.

A natural person qualifies as an accredited investor if he or she has either:

- an individual net worth or joint net worth with a spouse that exceeds \$1 million at the time of the purchase, excluding the

value (and any related indebtedness) of a primary residence (the “Net Worth Test”); or

- an individual annual income that exceeded \$200,000 in each of the two most recent years or a joint annual income with a spouse exceeding \$300,000 for those years, and a reasonable expectation of the same income level in the current year (the “Income Test”).

The availability of the Rule 506 safe harbor is subject to a number of conditions, including, most notably, the requirement that the issuer (or any person acting on its behalf) not offer or sell securities through any form of “general solicitation or general advertising.” This condition barred start-ups, venture capitalists, and hedge funds alike from openly advertising that they were raising money, and instead relegated them to closed-door meetings with their existing network of established contacts, word of mouth solicitations, and other forms of private communications.

Eliminating the Prohibition Against General Solicitation

Under new Rule 506(c), which is expected to go into effect in September, 2013, issuers can offer securities through means of general solicitation, provided that (i) all purchasers of the securities are accredited investors; and (ii) the

issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors.

Whether the steps taken are “reasonable” will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction.

Among the factors that issuers should consider under this facts and circumstances analysis are:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be (e.g., a natural person, registered broker or dealer, investment company);
- the amount and type of information that the issuer has about the purchaser;
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering; and
- the terms of the offering, such as a minimum investment amount.

In other words, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status, and vice versa. For example, if the terms of an offering require a high minimum investment amount and a purchaser is able to meet those terms, then it is

likely that the purchaser qualifies as an accredited investor, such that, absent any facts to the contrary, it may be reasonable for the issuer to take fewer steps to verify accredited investor status. Likewise, an issuer that solicits new investors through a website accessible to the general public, through a widely disseminated email or social media solicitation, or through print media, such as a newspaper, will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party.

Rule 506(c) also provides a non-exclusive list of methods that issuers may employ to verify accredited investor status for natural persons that, if used, shall be deemed to automatically satisfy Rule 506(c)'s verification requirement:

- As it relates to the Income Test, by reviewing copies of any IRS form that reports income, such as Form W-2, Form 1099, Schedule K-1 of Form 1065, and a copy of a filed Form 1040, for the two most recent years, along with obtaining a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year. (In the case of a

person who qualifies as an accredited investor based on joint income with that person's spouse, an issuer would be deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of these forms for the two most recent years in regard to, and obtaining written representations from, both the person and the spouse.)

- As it relates to the Net Worth Test, by reviewing one or more of the following types of documentation, dated within the prior three months, and by obtaining a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed: for assets, bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties are deemed to be satisfactory; and for liabilities, a consumer/credit report from at least one of the nationwide consumer reporting agencies is required. (Again, in the case of a person who qualifies as an accredited investor based on joint net worth with that person's spouse, documentation and representations from both

the person and the spouse is required.)

- By obtaining a written confirmation from registered broker-dealers, investment advisers, licensed attorneys, or CPAs that such persons have taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor.
- By obtaining a “bring down certification” from existing holders of an issuer’s securities who, as accredited investors, purchased such securities in the same issuer’s Rule 506(b) offering prior to the effective date of Rule 506(c).

Conclusion

The elimination of the prohibition against general solicitation is generally expected to facilitate capital formation by allowing businesses, particularly early-stage companies, to advertise their fundraising activities, resulting in wider access to potential investors. Similarly, accredited investors who previously encountered difficulties in finding suitable investment opportunities in Rule 506 offerings may be able to identify and potentially invest in a larger and more diverse pool of potential investment opportunities, likely resulting in a more efficient allocation of investments by accredited investors.

It should be emphasized that issuers may continue to rely on the current version of Rule 506, to be restyled as a Rule 506(b) offering. Under Rule 506(b), general solicitation will still be prohibited, but non-accredited investors may be included in the offering, and the new requirement that issuers take reasonable steps to verify that the purchasers of the securities are accredited investors will not apply.

Of special note, on the same day as amended Rule 506 was passed, the SEC approved a proposal which would require 506(c) issuers to file a notice of sale (Form D) 15 days *before* and at the conclusion of an offering. Under the proposal, an issuer will be disqualified for a one-year period from using the Rule 506(c) exemption in any new offering if the issuer or its affiliates do not comply with the Form D filing requirements in a Rule 506(c) offering. Like the proverbial rose and thorn, this proposed added regulatory burden would (if adopted) likely dampen entrepreneurs’ enthusiasm as they otherwise begin racing to Twitter, Facebook and other media outlets to raise funds.

If you have any questions about this article, please contact:

Robert McHale, Esq.
R | McHale Law
9 West Broadway, Suite 422
Boston, MA 02127
Tel. 617.306.2183
Email: robert.mchale@rmchale.com



DISCLAIMER: The contents of this publication are not intended, and cannot be considered, as legal advice or opinion. The contents are intended for general informational purposes only, and you are urged to consult an attorney concerning your situation and any specific legal questions you may have.