SEC Lifts Ban on General Solicitation

01.10.2014

ATTORNEYS

Daniel M. McMahon

PRACTICE AREAS

Mergers & Acquisitions

Private Equity

Securities

Under federal law, companies that wish to raise capital by issuing securities must either register the securities offering with the Securities and Exchange Commission ("SEC"), or rely on an exemption from registration. The cost and complexity of a registered offering can be prohibitive; thus, the vast majority of capital raises are done in a private manner in reliance on an exemption. The most widely used exemption is the safe harbor provided in Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act"), which allows a company to raise an unlimited amount of capital from accredited investors (and up to 35 non-accredited investors).

New Rule 506(c) Offerings

Historically, issuers relying on the Rule 506 exemption were barred from using general solicitation or general advertisement to raise capital. So, for example, a company that advertised its capital raise on its website or mentioned the capital raise in a newspaper article would no longer be eligible to rely on Rule 506 and may have been forced to register its offering. Instead, issuers could raise capital only from those investors in the issuer's private network or with whom the issuer otherwise had a pre-existing relationship. In an effort to ease capital raising in the private market, the Jumpstart Our Business Startups Act ("JOBS Act") was passed by Congress and signed by President Obama in April of 2012. The JOBS Act directed the SEC to adopt amendments to Rule 506 to permit general solicitation and general advertising. On July 10, 2013, the SEC adopted final amendments that created a new exemption under paragraph (c) of Rule 506, allowing the use of general solicitation and advertising in private, unregistered capital raises. The amendments went into effect on September 23,

2013. To be clear, Rule 506(c) is a new exemption that is in addition to the current Regulation D safe harbors, including the original Rule 506, which is now embodied in Rule 506(b). Issuers can choose to refrain from general solicitation and advertising and continue to operate under and rely on the "old way" of raising capital.

This is a seismic shift in the way companies can raise capital. A startup company raising seed capital in reliance on Rule 506(c) can, for example, tweet about its offering to its customers and followers. A rural manufacturing company looking for growth capital can take out an ad in state-wide newspapers to reach potential investors that otherwise would not have known of the offering. The new rules come with new regulation, however, as issuers relying on Rule 506(c) must:

• Take reasonable steps to verify that all investors are "accredited investors" (as defined in the Securities Act);

• Sell only to accredited investors (or those that the issuer reasonably believes are accredited investors after reasonable verification); and

• Meet all other conditions of Regulation D (a discussion of which is beyond the scope of this article).

Investor Verification

The heightened investor verification requirements have received the most scrutiny from commentators and criticism from investors. Historically, investors typically only had to tell the issuer that they were accredited investors. The SEC has made clear, however, that this "check the box" approach is not sufficient verification for issuers relying on Rule 506(c). The SEC has provided a non-exclusive list of approved verification methods to determine whether an individual investor is accredited, including:

• Review of Internal Revenue Service forms (such as a W-2, Form 1099, or Schedule K-1), that report the income of the investor along with a written representation that the investor is reasonably certain to earn the necessary income in the current year;

• Review of statements, such as bank statements and credit reports, giving sufficient evidence of net worth, along with a written representation that all liabilities necessary to make the net worth determination were disclosed; and

• Receipt of written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that such person or entity has taken steps to verify the accredited status of the investor.

Proposed Amendments

In addition to the new amendments now in effect, the SEC has proposed additional amendments to Regulation D to address investor protection concerns relating to lifting the ban on general solicitation and advertising, and to enhance the SEC's understanding of market practices in Rule 506 offerings. The proposed amendments would require issuers to:

• File a Form D in Rule 506(c) offerings *before* engaging in general solicitation (currently the filing is due 15 days *after* the first sale);

• File a closing amendment to Form D after the termination of any Rule 506 offering (currently not required);

• Place legends and disclosures on written general solicitation materials (currently no specific requirements);

• Submit written general solicitation materials to the SEC *prior* to publication (currently not required); and

• Include additional information about offerings conducted in reliance on Regulation D (currently not required).

Issuers that fail to comply with certain of the proposed amendments would be disqualified from relying on Rule 506 for one year. This is a very significant penalty given that Rule 506 is the only applicable exemption for many private offerings, and during any period of disqualification the company would be required to either abandon fundraising efforts or incur the time and cost of a registered offering.

The proposed amendments have received tremendous interest from practitioners, investors, and companies alike, and at the time of this article remain in the SEC's public comment period. We will continue to closely monitor the proposed rules as it appears that, if enacted, they will place significant additional regulatory requirements on issuers using the new Rule 506(c), and may dissuade some issuers from using general solicitation in Rule 506 offerings.

Practical Implications

The new general solicitation exemption could potentially allow smaller companies issuing securities to reach and attract a wider pool of investors through advertising. It remains to be seen whether the new exemption will be widely utilized, but platforms such as *AngelList* are aggressively promoting general solicitation and are positioning themselves for wider audiences. It also remains to be seen how the venture capital and angel investor communities will react to the heightened investor verification process required for a general solicitation exemption. Finally, the new proposed rules add additional uncertainty to the use of general solicitation, as

companies do not know how these proposed rules will affect them in the future if they are adopted. Given the newness of the amendments, and the increased regulation and the uncertainties outlined above, we have seen most companies avoid general solicitation unless it becomes absolutely necessary in order to complete their offering. If a company does intend to generally solicit its offering, it should proceed with caution as this is a new and evolving area of practice. For more information, please call any of the attorneys in our Mergers & Acquisitions/ Securities Law Practice Group.

by Daniel M. McMahon