With General Solicitation Now Permitted, Has New Day Dawned for Private Placements?

Yes, but Beware of Traps for the Unwary!

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Companies seeking investments in the United States must comply with the Securities Act of 1933 (the "Securities Act") and related laws in all 50 states, a regulatory framework that requires either registration of any offer or sale of securities[1] with the United States Securities and Exchange Commission (the "SEC") or compliance with one of the exemptions made available by the Securities Act. Registration[2] is a complicated and expensive process which has prompted capital-seeking companies[3] to bend over backwards in an effort to avail themselves of exemptions from registration. For the past 30 years[4], issuers raising investment by means of a private placement have most often relied upon the "safe harbor" exemption provided by Rule 506 of Regulation D, which notably has no limitation on the dollar amount that an issuer may raise from investors. Rule 506 does, however, place two important limitations on issuers in their capital raising efforts: securities may as a practical matter[5] only be sold to "accredited investors", and securities may not be sold through any form of public advertising or general solicitation.

This exemption was significantly changed by the April 2012 enactment of the Jumpstart Our Business Startups Act (the "JOBS Act"), Section 201(a) of which eliminated the prohibition under Rule 506 against using general solicitation to market securities being offered for investment where all purchasers of the securities are accredited investors. At its July 10, 2013 open meeting, the SEC adopted final rules allowing general solicitation, and on September 23, 2013, those rules went into effect.[6]

Under newly created Rule 506(c), issuers can offer securities through means of general solicitation[7], provided that:

- all purchasers in the offering are, or are reasonably believed by the issuer to be, accredited investors[8],
- the issuer takes reasonable steps to verify their accredited investor status, and
- certain other conditions in Regulation D are satisfied.

General solicitation, however, has never been affirmatively defined in the Securities Act or the rules and regulations adopted under it. Rule 502(c) defines it only by way of non-exclusive examples, including "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising." (Although the Internet did not exist when the rule was written, it has been interpreted to include publicly available websites and mass email campaigns.) In general, this has been held to mean that there must be a substantial pre-existing relationship with those to whom an issuer makes an offer of securities under Rule 506, and there is a substantial amount of precedent interpreting what qualifies as a substantial pre-existing relationship.

With general solicitation now permitted, what potential problems should concern issuers? A fair number, it turns out.

Potential deterrence of investors

Under the old Rule 506, issuers could rely — at least in good faith — on self-certification by prospective investors that they were accredited investors. Issuers taking advantage of the new availability of general solicitation under Rule 506(c) must either request highly personal and private financial information from prospective investors or take other reasonable steps to verify that the investors are accredited. Requesting such information or taking other steps to verify may deter potential investors. Indeed, the Angel Capital Association has stated in a press release that angel investors will be unwilling to provide this kind of information to an issuer and that as a result startups will have far less access to capital.[9]

Amended Rule 506 does not define general solicitation

The SEC did not provide a definition of general solicitation under the amended Rule 506. In 2013, where extensive use is now made of social media, tweets, Facebook messages, websites and financing portals (and it is not unlikely that yet newer forms of media will appear that are not known today) to raise money, the uncertainty of what exactly constitutes a general solicitation that triggers compliance with the requirements of Rule 506(c) may have serious consequences for issuers that are raising funds, even for those that are not intentionally raising funds in reliance on Rule 506(c). Among other things, angel meetings where issuers pitch to high net worth individuals, and demo day events at which companies present new technologies and products to a broad audience of attendees, including potential investors, could be found to be general solicitation. In the face of this uncertainty, many early stage companies may decide to incur additional costs by taking a conservative approach to compliance when offering securities.

Unintentional or unknowing general solicitation

The old Rule 506 (which survives as Rule 506(b)), continues to be available; however, once general solicitation is used, an issuer is precluded from relying on Rule 506(b) for the same offering. There is emerging concern that, as a result of the new focus on general solicitation, longstanding practices in the startup community that developed when general solicitation was completely banned (see Amended Rule 506 does not define general solicitation, above) may be reassessed under the new Rule and may be subjected to closer regulatory scrutiny.[10]

As a result, various types of communications around the time of a Rule 506 offering should be reexamined in light of existing guidance regarding what constitutes a general solicitation. Among other communications, the following may have the hallmarks of an offer of securities and therefore be regarded as general solicitations:

- mentions of the issuer's offering on its website, in print, online, in broadcast media, or in social media;
- product advertising and business announcements;
- presentations at demo day events; and
- presentations at pitch events.

Whether such communications will be deemed to be consistent with the ban on general solicitation will likely depend on the facts and circumstances surrounding them.

Rule 506(c) may force compliance with data privacy laws

If an issuer satisfies its obligation to take "reasonable steps" to verify the accredited investor status of potential investors by obtaining sensitive financial documents such as tax returns, W-2

statements, bank statements and consumer credit reports, it will become subject to legal obligations regarding the use and retention of personal information, both in the United States and abroad. If an issuer fails to take reasonable steps to ensure the privacy and security of such information, it could face federal or state regulatory penalties, legal actions by investors, or a damaged reputation among prospective investors.

General solicitation could jeopardize intellectual property rights

Issuers using general solicitation will need to disclose sufficient information to persuade prospective investors to invest and to protect the issuer from lawsuits for failure to disclose material information. Although proprietary information such as trade secrets about the issuer's technology can be protected to some extent by non-disclosure agreements, such disclosure to a possibly much larger — and more anonymous — group creates the risk that the issuer may inadvertently make public disclosures of an invention or that some of the recipients may make disclosures prohibited by the NDA, either of which would render patent protection in most jurisdictions outside the United States unavailable and trigger the one-year filing deadline under US patent law.

As mentioned above, in the Regulation D Proposing Release, the SEC proposed new and amended rules that would:[11]

- require the filing of a Form D for 506(c) offerings before the issuer engages in general solicitation;
- require the filing of a closing amendment to Form D for any 506 offering after the termination of the offering;
- require Form D to include additional information about Regulation D offerings.
- require written general solicitation materials used in Rule 506(c) offerings to include certain legends and other disclosures;
- require filing of general solicitation materials with the SEC for two years following adoption of the proposed rules; and
- disqualify an issuer from relying on Rule 506 for future offerings for one year if the issuer failed to comply within the last five years with Form D filing requirements.

Judging by widespread and emphatic negative reaction to the proposed rules, adoption in their present form is not likely soon, so the potential drawbacks and risks of offering an investment by general solicitation discussed in this note are only those that exist due to today's unsettled status of general solicitation under the new Rule 506(c), without even attempting to address the further potential traps that could arise from the eventual adoption of some version of the proposed rules.

In light of the new focus on what communications may constitute a general solicitation, best practices for issuers should include the following:

- As soon as a company begins thinking about seeking investment, discuss with legal counsel the advantages and disadvantages of using general solicitation under Rule 506(c) or instead doing the older "quiet" 506 offering still available under Rule 506(b).

If the decision is made not to use general solicitation,

- Develop a clear understanding of what communications and circumstances may constitute general solicitation.

- Seek legal review of all public communications around the time of an offering.
- Be careful not to refer to the offering in oral speech or otherwise in public settings.

If the decision is made to use general solicitation,

- Seek legal review of all general solicitation materials.
- Maintain good record-keeping of the reasonable steps used to verify accredited investor status.
- Use bad-actor questionnaires and keep them updated.[12]

For more information on solicitation of securities being offered for investment and Rule 506, please contact Peter Barnes-Brown.

Footnotes.

1. Broadly speaking, all stock, most debt, and some other types of investment and participation should be assumed to be "securities" within the meaning of the securities laws.

2. A registered offering is often called a "public offering" or "IPO".

3. "Issuers", in the language of the securities laws, because they "issue" stock or debt instruments.

4. Since the promulgation of Rule 506 as part of Regulation D by the SEC in 1982.

5. Literally Rule 506 (before and after the amendments) permits up to 35 non-accredited investors to participate in the offering, but many securities lawyers believe that the amount of disclosure required to non-accredited investors makes their inclusion a non-starter.

6. At the same July meeting, the SEC also adopted final rules to prohibit certain "felons and other 'bad actors'" from participating in offerings under Rule 506, which were required by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and issued a proposing release (the "Regulation D Proposing Release") that proposed new and amended rules (1) relating to the content, timing and consequences of failing to file Form D; (2) requiring that written general solicitation materials be submitted to the Commission; and (3) providing guidance relating to when information in sales literature by private funds could be fraudulent or misleading under the federal securities laws. The Regulation D Proposing Release also requested comment on other matters, including potential changes to the definition of "accredited investor" under Regulation D. The proposed amendments are intended to enhance the Commission's ability to evaluate changes in the private offering market and to address the development of practices in Rule 506 offerings.

7. Note that Rule 506(c) offerings are not crowdfunding offerings under the JOBS Act. The repeal of the ban on general solicitation in all-accredited-investor Rule 506 offerings appears in Title II of the JOBS Act. Crowdfunding, embodied in Title III of the JOBS Act, will allow sales of securities to both accredited and non-accredited investors in small amounts, and is not yet legal.

8. An "accredited investor" includes a natural person who: earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence). An "accredited investor" may also be an entity such as a bank, partnership, corporation, nonprofit or trust, when the entity satisfies certain criteria.

9. The available evidence so far indicates limited use of Rule 506(c) and instead continued reliance on Rule 506(b) (the old Rule 506), which continues to allow self-certification of accredited investors.

10. Note, however, that at the SEC's 2013 Government-Business Forum on Small Business Capital Formation, held at the SEC headquarters in Washington, D.C., SEC Director of Corporate Finance Keith Higgins observed that it was "pretty clear" that the Commission did not want to shut down the longstanding practice of demo days. In the view of this writer, this should not be understood to mean that the Commission will not issue guidance changing how demo days may be conducted and participated in, nor that the SEC might not take enforcement action against a demo day sponsor or participant that had crossed the line into general solicitation. It may also be meaningful that Director Higgins referred only to demo days and not to pitch events.

11. (in addition to several amendments not relevant to offerings by startups).