Written by Greag Beattie, Esq.
Veritas Corporate Law

Public Advertising of Private Placements Is Now Legal – But Proceed With Caution

Many of our clients have asked how to take advantage of the Jumpstart Our Business Startups Act (JOBS Act), a groundbreaking piece of legislation that eases the restrictions of the federal securities laws governing the private placement of securities.

The JOBS Act received wide bipartisan support despite protests from state and federal securities regulators. One of the most fundamental changes was a narrow exception to the long-standing ban on solicitation of and advertising to the general public regarding private placements of securities — the issuance of stock that is not registered with the Securities and Exchange Commission and therefore not publicly traded.

The SEC was vocal in its concerns about the legislation and has been predictably slow to enact regulations to implement it. Finally on July 10, 2013, the SEC adopted the requisite regulatory amendments, which will be effective on September 23, 2013. The SEC also proposed rules that would create additional notice obligations and disclosure requirements for publicly promoted offerings. Although the new and proposed rules permit public advertising, they also impose new responsibilities on those issuers who wish to do so, which make this approach more difficult, expensive, and risky than offerings without public advertising.

The JOBS Act directs the SEC to remove the prohibition on general solicitation or general advertising for securities offerings relying on the most commonly used safe-harbor exemption from federal registration — Rule 506 of Regulation D — so long as the issuer of the securities takes “reasonable steps” to verify that all purchasers are accredited investors. In other words, there is no restriction on whom an issuer can tell about this type of securities offering, but the issuer must try to limit the purchasers of the securities to accredited investors only, and comply with the other requirements of Rule 506.

What is an Accredited Investor?

The term “accredited investor” is defined in Regulation D to include (i) a variety of specifically defined entities which by their regulated status or their high net worth are deemed to be able to fend for themselves, and (ii) any individual with either:

- A net worth or joint net worth with a spouse that exceeds $1 million at the time of the purchase, excluding the value of a primary residence; 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.

What are “Reasonable Steps”?

The new Rule 506(c) does not list or define the “reasonable steps” that must be taken to determine accredited investor status, but the SEC has published a non-exclusive list of examples, including:

- Confirming the potential purchaser’s income by reviewing copies of any IRS form that reports such income for the two most recent tax years, and obtaining the purchaser’s written representation that he or she will likely continue to earn the necessary income in the current year.
- Receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney or certified public accountant that such entity or person has taken reasonable steps to verify the purchaser’s accredited status.
- Obtaining a written statement from the purchaser verifying accredited investor status, supported by bank, brokerage and other account statements and credit agency reports to confirm asset and liability levels.

These examples strongly suggest that traditional methods of verification — such as having investors complete offeree questionnaires or a check-box certification of their accredited status without providing supporting documentation — are inadequate. The time and effort it will take issuers to take these additional steps, and the likelihood of investor resistance to this level of disclosure, should not be underestimated.

Making matters more challenging is the SEC’s statement that the appropriateness of a particular method of verification will depend on the following factors:

- The facts and circumstances of the specific transaction, including how broadly the offering is publicized (for example, whether it’s targeted to pre-screened investors or persons affiliated with the issuer, offered via indiscriminate advertising to the general public, or something in between);
- The nature and terms of the offering (such as whether or not there is a substantial minimum investment requirement, tending to screen out unaccredited investors); and
- The specific information the issuer possesses about the purchaser’s income, net worth, and level of sophistication.

Until there is some track record from which to gauge the SEC’s application of these vague guidelines to specific scenarios, there will be unavoidable risk in public solicitation.

More Rigorous Reporting Standards Proposed for Publicly Promoted Offerings.

As noted above, issuers relying on Rule 506 have always been required to file a notice (Form D) of the transaction with the SEC. Form D has been amended as part of the new rules to require issuers to indicate whether or not the offering involves general solicitation. In offerings not involving public solicitation, the Form D will continue to be due 15 days after the offering. But for offerings using public solicitation, the SEC has proposed new rules that would provide:

- The Form D must be filed 15 days prior to the first general solicitation;
- A copy of written general solicitation materials must be filed no later than the date of first use;
- The solicitation materials must contain certain additional specific disclosures and legends; and
- A final Form D must be filed within 30 days after completion of the offering.

The proposed rules would also provide that issuers who fail to timely make any of the necessary Form D filings in a Rule 506 offering could be disqualified from relying on Rule 506 for a full year from the date of the corrective filing. If these rules are enacted, they will obviously add another significant planning and disclosure element to offerings involving public solicitation.

Is Public Solicitation Worth It?

Each company raising capital must of course decide for itself if the opportunity to advertise publicly justifies the more rigorous responsibility for verifying each purchaser's accredited investor status. For some companies, unable or unwilling to raise capital through traditional angel and venture channels, or having a particularly strong appeal to the broader investing public, the new flexibility may provide a better conduit to previously unavailable funding sources. For others, the traditional private placement to known funding sources will continue to be less expensive and cumbersome — the SEC has made it clear that "issuers conducting Rule 506 offerings without the use of general solicitation or general advertising can continue to conduct securities offerings in the same manner and aren't subject to the new verification rule."

Practical Considerations.

To the entrepreneur in desperate need of funding, splashing the details of a stock offering across the Internet or promoting it in industry publications may look compellingly attractive, but the decision to promote publicly has many implications that should be weighed carefully. Aside from the additional purchaser-verification burden under the new SEC rules, issuers should also consider:

- The quality and quantity of investors likely to respond to a public solicitation or advertisement. Prudent issuers seek investors that are known to be cooperative, rational, and in the best cases, helpful to the success of the enterprise due to their experience, skills, or contacts, and able to provide more capital when necessary. Broad public solicitation of investors is less likely to find the most desirable sources of funds, and the noise soon to be created by many companies soliciting publicly will likely make it even more difficult to reach appropriate investors in the public arena. If one clearly unaccredited investor, or one accredited investor with unreasonable expectations and demands, slips through the filters, that can create real risks and disruption for any private company. Issuers will need to evaluate carefully which types of public solicitation are most likely to yield quality leads with the least amount of separating the wheat from the chaff. Online match-making sites may gain currency as a mechanism for putting the right kinds of companies and pre-qualified investors together.

- Exposure of the company's financial or strategic information to unknown recipients. The sale of securities is subject to antifraud laws that require disclosure of all information an investor would find material to a decision to invest. Issuers will need to think carefully about how much information they are willing to make public (and available to their competitors, suppliers and customers) in order to entice unknown investors to the point of expressing interest and making a confidentiality commitment before receiving deeper details.
- The cost of conducting the offering. Aside from the obvious costs of advertising, mailing lists, promotional events and the like, a public investment solicitation by a little-known private company will require the preparation and distribution of more elaborate and detailed offering materials than would an entirely private placement to sophisticated, high-net worth investors familiar with the company or its team. The less the issuer knows about its potential investors, and the less they know about the issuer, the more information it should be prepared to share with them to insure that they are fully informed. This can increase offering expenses significantly.

This Legal Update does not constitute legal advice and does not create an attorney-client relationship. For more information about the new rules, or to discuss how your company can raise funds through a private offering, contact Greg Beattie (Email - greg@veritascl.com: Phone - +1 510 550 8600) at Veritas Corporate Law, P.C.