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New SEC Rule Helps Entrepreneurs Raise Capital

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Start-ups, small businesses, venture capi- talists and hedge funds can for the first time in 80 years begin openly advertising to raise money in private offerings. The change by the **Securities and Exchange Commission** is part of the JOBS Act requirement to amend Rule 506 of Regulation D to permit general solicitation. While opening the gates for general solicitation, the SEC has simultaneously tightened rules to protect investors.

Prior to the new rules that be- came effective Sept. 23, companies seeking to sell securities to raise capital had to either register the offerings or qualify for exemptions from registration. The costs and complexities of public offerings often were beyond the reach of many small businesses. The new public solicitation rules make it possible for startups, small businesses, venture capitalists and hedge funds to search for investors via the internet, newspaper and other ads, social media and other general solicitation methodologies — previously forbidden territory. At the same time, they avoid the challenges and costs that come with the full registration process.

The new rules are complex, and ensuring compliance will invariably require advice from securities lawyers and investment bankers who can help companies raise capital safely. This includes ensuring they qualify for the traditional exemption or are in the “safe harbor” of the new rule. While this involves cost and time commitments, the new avenues for fund raising are still less complex and ex- pensive than traditional registered offerings. For example, offerings under the original Rule 506 exemption (now retained as a Rule 506(b) offering) allowed companies to raise an un- limited amount of capital from an unlimited number of accredited investors, but not from more than 35 nonaccredited investors. The new alternative, Rule 506(c), allows companies to generally solicit potential investors, gaining access to wider au- diences through solicitation and advertising methods previously unavailable – good news for startups and small companies.

Other changes require issuers to provide ad- ditional information about the 506(c) offerings and require companies using the new rule to take “reasonable steps” to ensure every inves- tor is qualified. The definition of a “reasonable step” is not clear under the new rule. It will take time to fully understand what the SEC views as a “reasonable step.” Practitioners will want issu- ers to document in their files that the companies did more than just take the investors’ word that the investors are accredited. It is generally understood that tax returns, certifications from tax accountants, review of bank account statements or other independent confirming information about potential investors will suffice to meet the “reasonable steps” standard.

Another change imposed by the new rules: a “bad actor” disqualification. This means issuers and other market participants will be disquali- fied from relying on Rule 506 when felons or other bad actors participate in Rule 506 offerings. As part of the adoption of these new rules, the SEC also voted to issue new companion rules containing stronger investor protections. Theseinclude requiring entrepreneurs who take advantage of the new general solicitation rules to (i) provide additional information about their capital raising offerings, (ii) provide more information about the in- vestors who are participating in the offerings, and (iii) require companies to file Form D with the SEC at least 15 calendar days before engaging in general solicitation and within 30 days of completing the offerings to update the informa- tion contained in the Form D and indicate that the offerings have ended.

Although it remains to be seen whether these rules will make it easier for entrepreneurs to raise money, the new rule changes will certainly allow companies to reach more potential inves- tors in a more cost-effective manner. If handled properly, entrepreneurs should have a powerful new vehicle at their disposal to support the de- velopment and growth of their companies.

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