Published on *The National Law Review* https://natlawreview.com

Setting The Record Straight On The New General Solicitation Rules

Article By:

John R. Hempill

John D. Tishler

On September 23, 2013, the final rules eliminating the prohibition on general solicitation and advertising for certain offerings under Rule 506 went into effect. While this development was anticipated with much excitement by the angel and venture capital communities, the final rules have created some uncertainty. In this blog post, we address some of the speculations about how to do private placements in this new day and age that are floating around the angel and venture capital communities.

The definition of what is general advertising or a general solicitation has changed.

False. The SEC did not adopt a new definition for what constitutes general advertising or a general solicitation in connection with the adoption of these new rules. If you are engaging in a "classic" Rule 506 offering not using general advertising or solicitation, then you should conduct yourself as you would have before the adoption of the new rules. If you are taking advantage of new Rule 506(c) and using general advertising and solicitation, then please see our blog post here about the additional steps you must take to qualify for the Rule 506(c) exemption.

If you do a Rule 506 offering, you have to take actions you did not have to take before the adoption of the new rules.

This is partially true. For all Rule 506 offerings, issuers need to check to make sure that they are not running afoul of the new "bad actor" provisions. For more information on what these provisions are and what is required, please see our blog post here.

If you are doing a "classic" Rule 506 offering, then this would be the only additional change you have to be concerned about currently. Be aware that there are additional proposed rules that would affect "classic" Rule 506 offerings as well as Rule 506(c) offerings. These rules have not yet been adopted. We will update you on the status of these rules as the SEC takes action with respect to them.

With the adoption of the final rules regarding general solicitation and advertising, the SEC has implemented "Crowdfunding" required by the JOBS Act.

False. The SEC has not yet adopted the final rules for Title III of the JOBS Act, or "Crowdfunding". The SEC issued proposed rules to implement Title III on October 23. For more information on these proposed rules, please see our blog post here. The SEC has also not yet proposed rules for Title IV of the JOBS Act, which relates to also another exemption, commonly known as "Regulation A+", that would permit companies to raise up to $50 million from an unlimited number of investors using general solicitation.

The restrictions in the new rules permitting general solicitation and advertising will change how "Demo Days" are conducted.

Maybe, but there is much misinformation on this topic. The applicability of the prohibition on general solicitation to "demo days" has long been uncertain. Many companies and legal practitioners have become comfortable with issuers participating in "demo days" so long as the presentations are limited to a description of the company and do not directly solicit investment or discuss proposed investment terms.

As noted above, the new rules implementing Rule 506(c) do not address the definition of general solicitation and they therefore do not address permissible or non-permissible communications at "demo days". We believe companies should approach "demo days" with the same degree of care and analysis as to what information is communicated as they did before these new rules went into effect. We see no need for any change in practices — unless of course the company intends to rely on Rule 506(c), in which case it needs to take all of the steps required by that rule.

Any third party can act as an intermediary to verify that a potential investor is accredited.

False. The final rules provide that an issuer can verify that an investor is accredited by obtaining certification from a registered broker-dealer, an SEC-registered investment advisor, a licensed attorney or a certified public accountant. That certification must state that such professional has taken reasonable steps within the prior three months to verify that such investor is accredited. In a footnote, the SEC stated that an attorney so relied upon must be "in good standing" where he or she is admitted to practice law and an accountant so relied upon must be "in good standing" under the laws of the place of his or her residence or principal office.

The final rules do not preclude reliance on someone who does not practice one of the listed professions to perform the verification, but whether or not such verification is sufficient will be based on the "objective" standards discussed in our prior article here. The "objective" standards are not well-defined, and an issuer that relies on someone who is not in the professional safe harbor group will bear the burden of proof that such reliance was reasonable.

Companies now have more latitude to pay success of professional's fees to "finders".

False. The SEC has indicated that the following actions determine whether a party needs to register

as a broker-dealer: involvement in negotiations, discussing details regarding the transaction or making a recommendation, receiving transaction-based compensation and previous involvement in the sale of securities. The SEC Staff generally takes the position that that transaction-based compensation (what they call a “salesman’s stake”) would on its own require broker-dealer registration even if the other factors are absent. The SEC has recently stepped up enforcement activity against unlicensed “finders” and the companies that employ them. See, for example, the enforcement action brought against Ranieri Partners.

Title II of the JOBS Act creates a limited exemption from broker-dealer registration requirements for persons who maintain a platform or mechanism that facilitates offers and sales of securities, including those using general solicitation. This exemption requires that such persons receive no compensation in connection with the purchase or sale of a security offered through such portal. The SEC has indicated in guidance that it will read this requirement very strictly. “Finders” thus cannot rely on this exemption if they receive transaction-based compensation.

The SEC does recognize a limited exception from broker-dealer registration for parties that co-invest or receive a “carried” interest. The SEC recently issued no-action letters to two web services (FundersClub and AngelList) that list private investments and form private funds to pool investors for purposes of investing in the listed private investments. Affiliates of the web services manage the funds and receive a “carried interest”, or a percentage of the profits earned by investors in the funds. Subject to a number of conditions, the SEC indicated that it would not recommend enforcement actions against these websites or their affiliates for failure to register as broker-dealers. As one of the conditions is that no transaction-based compensation is paid, “finders” receiving such remuneration cannot rely on these no-action letters.

In short, while the JOBS Act and Rule 506(c) may make it easier for issuers or “finders” to locate potential investors, it offers no relief from broker-dealer registration obligations for those persons who receive transaction-based compensation or who otherwise fall under the broker-dealer registration requirements.

National Law Review, Volume III, Number 313