

# New US securities solicitation rules and crowdfunding

On 10 July, the US Securities and Exchange Commission (SEC) adopted rules that permit issuers to use general solicitation and public advertising to reach accredited investors who may wish to invest in certain private placements of securities under Rule 506(c) of the Securities Act of 1933. The removal of the ban on general solicitation has the potential to remake the US private placement market by allowing issuers to reach a larger number of potential investors than current fundraising techniques allow and accompanies action taken by the SEC to permit two crowdfunding platforms that offer securities to accredited investors, as Scott H. Kimpel, Partner at Hunton & Williams LLP, explains.

Since the US federal securities laws were first enacted in 1933, they have required issuers of securities in the US to choose between offering securities to the public in an offering registered with the Securities and Exchange Commission (SEC) or privately placing securities in a nonpublic transaction that is exempt from registration. The US courts and the SEC have taken the position that to qualify for most private placement exemptions, offerings may not be made by means of general solicitation or general advertising, which has historically acted as a bar against advertisements in newspapers, magazines, television and radio. In recent years, the bar on general solicitation has also been interpreted to extend to advertisements made online or through social media.

On 10 July 2013, pursuant to the Jumpstart Our Business Startups Act (JOBS Act), the SEC adopted rules that permit issuers to use general solicitation and public advertising to reach accredited investors who may wish to invest in certain private placements of securities under Rule 506(c) of the Securities Act of 1933. The newly adopted rules will take effect on 23 September 2013<sup>1</sup>.

New Rule 506(c) permits general solicitation for securities offerings so long as the only parties who actually purchase securities are 'accredited investors.' It also requires that issuers in Rule 506(c) offerings take 'reasonable steps to verify' that the purchasers of the securities are indeed accredited investors<sup>2</sup>. The definition of 'accredited investor' includes natural persons and entities that come within one of several enumerated categories at the time of the sale and presupposes a high net-worth and a high level of financial sophistication. For natural persons, accredited

investors include any individual (1) whose net worth, or joint net worth with that person's spouse, at the time of purchase exceeds \$1 million, exclusive of the value of the individual's primary residence; or (2) who had an income in excess of US\$200,000 in each of the two most recent years or joint income with that person's spouse in excess of US\$300,000 in each of those years with a reasonable expectation of reaching the same income level in the current year<sup>3</sup>.

The adoption of Rule 506(c) comes on the heels of action taken by the SEC staff to permit two operators of crowdfunding platforms that offer securities only to accredited investors to commence operations<sup>4</sup>. Although the FundersClub and AngelList platforms differ in several ways, their core business models are similar. Briefly, these companies identify promising start-up enterprises and form subsidiaries to invest in them. The investment subsidiaries are then marketed to accredited investors via an online crowdfunding platform. If there is sufficient interest, the platforms collect funds from investors and finalise their investments in the underlying start-up companies.

More broadly speaking, removal of the ban on general solicitation has the potential to remake the US private placement market by allowing issuers to reach a larger number of potential investors than current fundraising techniques generally allow. Various small businesses have announced their intentions to begin marketing private offerings of securities in print media, via billboards and on the radio, with others setting their sights on online and social media advertising. One entrepreneur has even suggested he will begin printing T-shirts advertising his securities. Several securities intermediaries have announced

plans to launch online platforms for advertising private placements or vetting potential purchasers. More 'accredited crowdfunding' platforms may proliferate in light of the adoption of Rule 506(c).

While the prospect of marketing an offering to a larger audience without the need to complete the SEC registration process will be tempting to many issuers, issuers should be cautious when accepting subscriptions from investors with whom they have no prior relationship. Potential later-stage investors may be discouraged from investing in an issuer with a capital structure that has been complicated by admitting large numbers of early-stage investors. Although the new rules will require issuers to verify the accredited investor status of all purchasers, issuers may wish to exercise additional due diligence over potential investors to be sure they are the right fit for the company and do not pose undue risk.

Issuers of securities under Rule 506(c) should bear in mind that all offerings will remain subject to the antifraud provisions of US state and federal securities laws. As with any securities offering, marketing materials should continue to present a balanced view of an issuer's business, providing appropriate risk disclosure and generally avoiding puffery or other aggressive statements about an issuer's future prospects. Capturing this balance may prove challenging in 30 seconds of airtime or 140 characters of text.

Although the new rules will at first be attractive to start-up and smaller businesses that do not have existing relationships with traditional funding sources, all issuers are eligible to offer securities under Rule 506(c). There is no limitation on the size of the issuer or the type of business it engages in, nor is there an upper

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limit on the amount of funds that may be raised. Capital-intensive businesses, such as those in the real estate, energy and biotech industries, may be among the first to make use of Rule 506(c) offerings to obtain growth capital. On the other hand, considerable media attention has focused on the ability of hedge funds, private equity funds and other private funds to market their securities through general solicitations. Given the significant minimum investment levels these funds typically require, coupled with other regulatory restraints on their ability to admit investors, it remains to be seen whether they will rely heavily on the new rules to source investors.

Curiously, the adoption of Rule 506(c) and the expansion of the accredited crowdfunding business model comes at a time when the SEC is still yet to enact more general crowdfunding rules under the JOBS Act. That statute is intended, among other things, to permit the use of crowdfunding by small businesses to raise up to \$1 million in any 12-month period through the sale of a limited amount of securities to each investor, without regard to whether the investors are accredited. But the JOBS Act also requires a host of disclosures and other investor protection procedures that may hamstring the entire crowdfunding process when non-accredited investors are involved. With the potential for start-up and emerging businesses to offer unlimited amounts of securities directly to the public under Rule 506(c), or to avail themselves of the accredited crowdfunding alternative, the broader crowdfunding rules, should they ever arrive, may see limited use.

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1. The full text of the adopting release is available at <http://www.sec.gov/rules/final/2013/33-9415.pdf>
2. The SEC has provided a nonexclusive list of verification methods for natural persons including reviewing an investor's income tax forms, bank or brokerage statements; obtaining written confirmations from a registered broker-dealer, investment adviser, licensed attorney or accountant that the purchaser is an accredited investor; and for an existing investor who was accredited before the effective date of Rule 506(c), by obtaining a self-certification at the time of a subsequent sale that he or she is an accredited investor.
3. These dollar amounts have not been changed since 1982 and the SEC continues to study whether they should be increased to adjust for inflation.
4. See FundersClub Inc. and FundersClub Management LLC (avail. 26 March 2013) and Angellist LLC and Angellist Advisors LLC (avail. 28 March 2013).