

New SEC Rules on General Solicitation: What Entrepreneurs and Startup Supporters Must Know

October 3, 2013

Agenda and Presenters

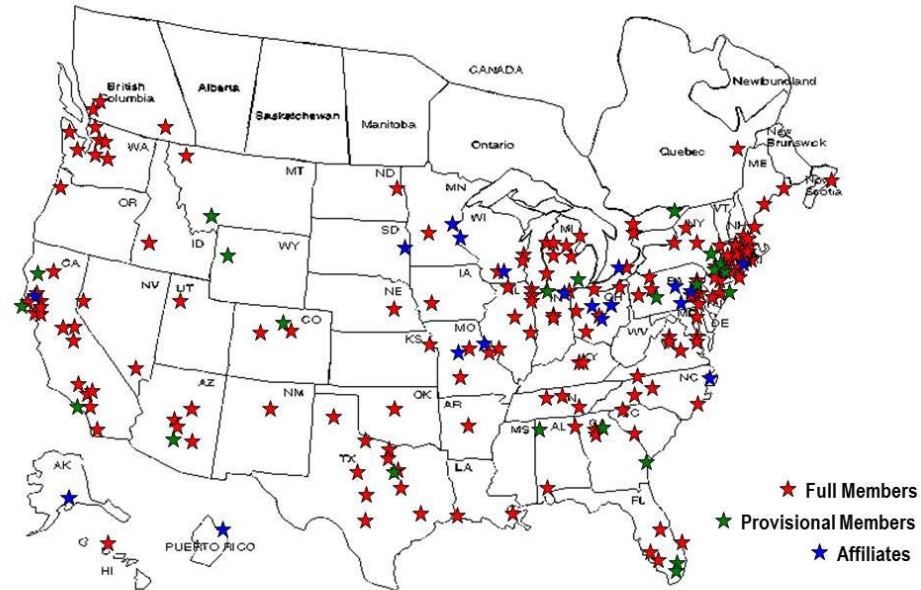
- **Welcome and Moderators**
 - *David Verrill, ACA Chair*
 - *Patrick Riley, Global Accelerator Network*
- **Overview of Rules**
 - *Jean Peters, ACA Board*
 - *Sara Hanks, CrowdCheck*
- **Global Accelerator Network's Insights**
 - *Jason Mendelson, Foundry Group*
- **Questions to Ask Your Attorney**
 - *Peggy Wallace, Golden Seeds*
- **Lend Your Voice**
- **Audience Q&A**

Technical Stuff

- Everyone is muted during the presentation
- Feel free to text chat at any point – see bottom right of your screen
 - Use text chat forum for live Q&A portion of the program
 - Enter a question any time
- This program is being recorded and will be archived for viewing

Angel Capital Association

- Mission: Fuel the success of angel groups and private investors who actively invest in early-stage companies
- Largest trade group for angels:
 - 200+ member angel groups
 - 10,000 accredited investors
 - Individuals, accredited portals, family offices
- 50 states/ 5 Canadian provinces
- Charitable partner:



Global Accelerator Network

- Invitation-only organization of over 50 accelerators in 63 cities on 6 continents around the globe
- All members follow a similar model & meet a list of criteria to become members:
 - Short-term cohorts
 - Mentorship-driven
 - Terms favorable to entrepreneurs
 - Proven record of helping companies



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Differing Perspectives on SEC Rules

- You may see varying interpretations of SEC rules
 - Particularly in regard to definition of “General Solicitation”
 - Verification of “Accredited Investor” practices will evolve
- It will take time to get full clarity on how rules will be apply in different circumstances and by different market participants
 - State and other regulators (FINRA, etc.)
 - SEC interpretations and potential enforcement
 - Development of general industry practices
 - Entrepreneurs and other issuers
 - Investors
- This Webinar is to provide ACA’s perspective, based on our counsel and meetings/discussions with regulators
 - How ACA angel groups and investors are addressing the rules

SEC Rule 506(c): Radical Change in 80-Year Old Law

- Securities Act of 1933 established rules for registered offerings and created categories for offerings exempt from registration
 - Exemptions have evolved over years
 - Regulation D Rule 506 was added in 1982
 - Permitted private companies to raise unlimited capital without registration
 - Purchasers must be Accredited Investors
 - Issuer must “reasonably believe” investor is accredited, based on some fact set (e.g., prior business relationship, etc.)
 - Advertising or “General Solicitation” of private deals was prohibited
- In 2012, Congress passed the JOBS Act, requiring SEC to lift the ban on general solicitation
 - SEC final rules were approved July 2013; became effective September 23

New and Final Rules

- Rule 506(c) Lifts the Ban on General Solicitation
- www.sec.gov/rules/final/2013/33-9415.pdf
- Rule 506(b) Allows Startups to Raise “Quietly,” No General Solicitation
- Difference between (c) and (b) is how startups must verify investors are accredited
- Bad Actor Rules Bans Use of Private Placement Exemption
- www.sec.gov/rules/final/2013/33-9414.pdf
 - People convicted of securities fraud or other disqualifying event are prohibited from participating in private placements
 - Rule required by Dodd-Frank Financial Reform

Proposed Rules: Regulation D and Form D

- Extensive changes in reporting requirements for startups
- www.sec.gov/rules/proposed/2013/33-9416.pdf

Non-Generally Solicited 506(b) “Quiet Deals”

- Self-certification by written representation is allowed
 - No additional verification requirements
 - Issuer still must have a “reasonable belief” investor is accredited
- The Concern with “Quiet Deals”
 - Some common startup activities and practices may fall under 506(c)
 - Demo days, pitch competitions, blogs, websites, etc.
 - Inadvertent general solicitation puts 506(b) offering into 506(c) arena
 - “Reasonable steps to verify” requirement applies

SEC “Definition” of General Solicitation is Broad

- SEC Rules State that General Solicitation includes:
 - Any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast
 - Any seminar or meeting whose attendees have been invited by general solicitation
- Gray Area: Are common angel deal flow sources “general solicitation”?
 - Demo Days and Pitch/ Business Plan Competitions/Speed Rounds
 - Often sponsored by
 - Accelerators/ Incubators
 - Colleges/Universities
 - Econ Development Orgs (non-profit and government)
 - Law firms
- Startups MUST Seek Counsel on these Issues

Generally Solicited Offerings Require

- All purchasers must be accredited investors
 - Old rule allowing up to 35 non-accredited investors does not apply
 - May preclude “Friends and Family” from 506(c) offering
 - Definition of Accredited investor
 - Person with income of \$200,000 per year; or spouses with \$300,000; or
 - Person with net worth of \$1 million or more, excluding value of home
- The issuer must take “reasonable steps to verify” that all purchasers are accredited.
 - “Check the box” self-certification is not acceptable for verification
 - Issuer must document steps taken with each purchaser
- Issuers must file Form D and specify reliance on 506(b) or 506(c)
- Issuer can change offering from 506(b) to 506(c) – but can’t reverse

SEC Prescribed Principles-Based Verification Method

- Verification standard requires issuer to establish “reasonable belief” that purchaser is accredited
 - “Absolute proof” is not the standard
- The Principles-Based Method (PBM) is intended to give issuers flexibility to develop verification practices
- PBM requires issuer to assess specific facts and circumstances
 - nature of purchaser and type of accredited investor he/she claims to be;
 - amount and type of information the issuer has about the purchaser
 - nature of the offering
 - manner in which purchaser was solicited
 - offering terms, such as minimum investment amount.

Principles-Based Method (PBM)

- Based on “likelihood of purchaser being accredited in relation to the risk he is not”
 - “[T]he more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status and vice versa.”
- PBM is expected to lead to development of a broad based range of practical and reliable industry practices
- Issuers should always consult with legal counsel about how to apply PBM to accredited investor verification in any transaction

SEC Also Added Four Non-Mandatory “Safe Harbors”

- Issuer *may* use any one of four non-exclusive, non-mandatory methods of verifying a natural person is an accredited investor.
 - Will be deemed to have taken reasonable steps to verify, provided issuer does not otherwise know the purchaser is not accredited.
- These safe harbor methods are not required – and they are problematic for angel investors and issuers
 - Use of Safe Harbors raises privacy, cost and complexity concerns for issuers and investors
 - Have to ask investor for financial documentation
 - Engage (and pay for) third party
 - Maintain careful records of verification process used with each purchaser
 - Added only after extensive public comment when rule was proposed
 - SEC emphasizes objective of maintaining “flexibility” in the rule under the principles-based approach

Optional Safe Harbor	Steps Required for Issue to Verify Accredited Investor
(A) Income Test	<ul style="list-style-type: none"> • Review of documents including: <ul style="list-style-type: none"> ○ IRS Form W-2, 1099, 1040, Schedule K-1, etc. • Written representation from purchaser that he has a reasonable expectation of reaching the income level necessary to qualify in the current year.
(B) Net Worth Test	<ul style="list-style-type: none"> • Review of one or more documents that is current within prior 3 months, including: <ul style="list-style-type: none"> ○ Assets: bank statements, statements of securities holdings, tax assessments, third party appraisals, certificates of deposit, etc. ○ Liabilities: consumer credit report from national reporting agency • Written representation from purchaser that all liabilities have been disclosed.
(C) Third-Party Verification	<ul style="list-style-type: none"> • Written confirmation from permitted third party that purchaser is an accredited investor • Issuer must take “reasonable steps to verify” that the third party has taken “reasonable steps to verify” the purchaser is accredited. • Permitted 3rd parties: CPA, attorney, registered broker-dealer or investment advisor. • Certification must be within three months’ prior to purchase
(D) Previous Purchaser	<ul style="list-style-type: none"> • Written representation from purchaser that she is an accredited investor at time of sale

ACA Guidance on Principles-Based Method

- ACA Believes Established Angel Group (EAG) Membership Meets PBM
 - All EAG members are accredited investors; Many have done prior 506 deals
 - EAG membership is by invitation or referral from current member
 - Membership application requires self-certification and details on professional background
 - EAG's employ strong investment practices; members make own investment choices; no transaction-based compensation
- Principles-based methodology is robust – ***don't get stuck in safe harbors***
- PBM may be appropriate for other active angels
 - Active individual angels, accredited crowdfunding platforms, family offices
- Issuers MUST check with legal counsel

ACA Guidance, White Paper and Example Memo

- ACA Guidance on Principles-Based Methodology
 - www.angelcapitalassociation.org/data/Documents/Public%20Policy/GuidanceonEAG09_03_13.pdf
- White Paper on Principles-Based Methodology
 - www.angelcapitalassociation.org/data/Documents/Public%20Policy/ACAGeneralSolicitationWhitePaper09-20-13.pdf
- EAG Memo (Example) to Entrepreneur Applicants
 - www.angelcapitalassociation.org/data/Documents/Public%20Policy/EAGMemoforEntrepreneurs09-20-13.pdf

Bad Actor Rule Disqualifies Certain Issuers

- Rule: www.sec.gov/news/press/2013/2013-124-item2.htm
- Multiple “disqualifying events”
 - Securities-related criminal convictions, injunctions, disciplinary orders, etc.
- No grandfather period (effective 09/23)
 - Issuers in the middle of an offering should start start compliance now
- Issuer must certify there are no bad actors in offering (on Form D)
- Required bad actor diligence may be difficult and cumbersome
 - Issuer must determine who are covered persons
 - Issuer must interview or investigate covered persons, or use other reasonable methods to confirm they are not bad actors
 - Questionnaires, with contractual representations etc., may be a method

New Rule Reg D / Form D Proposed

- Purpose: Enable SEC to monitor market developments re: general solicitation www.sec.gov/rules/proposed/2013/33-9416.pdf
- Requires 15-day advance filing before any general solicitation begins
- Missed deadline must be cured within 30 days; can only do this once
- If missed filing isn't cured, issuer can't reuse any 506 exemption for a year
- All written solicitation material must be furnished to SEC prior to public use
- Legends must be placed on all written general solicitation material
 - Lengthy – longer than a “tweet”
- Extensive additional disclosure required on Form D filing
- Must file terminating Form D within 30 days of the closing of the offering

Proposed Rules Are Problematic for Startups

- Highly complex and difficult for startups – probably unworkable
- If startup relies on 506(c)
 - Must file Advance Form D 15 days prior to the event
 - File materials by day of use and include legends on materials
 - If company fails to file, it is out of compliance
 - Many will not realize they are out of compliance
- Can only cure once, and must occur within 30 days
- If not cured, company may not again use Rule 506 for one year

Proposed rules would put many startups out of business

New and Proposed Rules are Not in Sync

- General Solicitation and Bad Actor rules effective 09/23
- Proposed Reg D/Form D rules are not effective yet
 - Implementation, if it occurs, will be somewhat later – ***Issuers are not required to submit forms and materials currently!***
 - Commission has reopened the comment period
 - Issuers may choose to avoid using 506(c), due to uncertainty
 - Issuers that have participated in a public event that is deemed general solicitation, or similar communication, would need to rely on 506(c)
- Some legal counsel may advise issuers to follow proposed rules before they are implemented in order to use 506(c)
 - SEC Chair White has indicated this is NOT necessary

Questions Entrepreneurs Should Ask Attorney

Is My Offering General Solicitation or Not?

- Pitch events or Demo days? – Under what circumstances are they general solicitation or not?
 - E.g., if deal terms aren't discussed, could my deal fit “quiet” rules?
- How does “conditioning the market” apply, if I’m seeking funds, but don’t mention it at a pitch event?
- Pitch events – Do you agree with event host on their reasoning that the event is not general solicitation?
- Quiet deals – How do we ensure my offering doesn’t fall into 506(c) rules for general solicitation?

Questions Entrepreneurs Should Ask Attorney

How Do I Work with the General Solicitation Rules?

- Investor verification – What are principles-based methods that are appropriate for me to use in verifying my investors are accredited investors?
 - Is membership in an Established Angel Group reasonable for my facts and circumstances?
 - For other investors, what methods may apply?
 - When is use of a “non-mandatory” approach appropriate?
- Form Ds – Must I file advance Form D and materials to the SEC related to the proposed rules?
- Friends and Family – How do I deal with F&F investments if my offering relies on 506(c) general solicitation?

Your Comments Are Needed!

- SEC comment period on Proposed Rule Form D
 - Comments may be posted: buff.ly/12YAlaN
- SEC reviews all comments and will base final rules on views of market participants
 - Regulators
 - Legislators
 - Investors
 - Issuers
 - Startup support community: accelerators; econ development organizations, etc.
 - Consumers and consumer protection groups
- **Your comments are important!**
 - Hundreds of comments already received by SEC – most requesting proposed rules be withdrawn
 - Startups and other issuers view rules as unworkable

ACA's View on Proposed Rules:

- Withdraw rules as currently proposed
- If rules are redeveloped and re-proposed
 - Remove harsh penalties for non-compliance
 - No advance Form D
 - Allow parts of Form D to be confidential (e.g. financing amount)
 - Require legends/disclosures only when terms are communicated
 - Form working groups from advisory bodies to monitor and report, rather than requiring all advertising materials be submitted



ANGEL CAPITAL ASSOCIATION



Q & A

Your Questions

VERRILL/ RILEY

Call to Action

- Comment on the proposed rules to the SEC!
 - ACA has template messages on JOBS Act Resource Website page
 - www.angelcapitalassociation.org/aca-public-policy-jobs-act/
- This impacts:
 - Entrepreneurs
 - Investors
 - Startup support community
 - Accelerators
 - Incubators
 - Economic development groups
 - Universities
- Urge entrepreneurs and the startup support community to review the new and proposed rules, and comment to the SEC.