RESOURCES

"The Real Crowdfunding Exemption": Why the New General Solicitation Rules Will Revolutionize How Private Companies Raise Capital

In light of the substantial costs and burdens associated with the public sale of securities (e.g., expensive SEC registration process, extensive filing requirements, ongoing SEC reporting obligations, etc.), most companies seeking to attract capital look to qualify for exemption from registration by qualifying for one of the private offering "safe harbors" permitted under of Regulation D. However, prior to the SEC's recent adoption of the JOBS Act implementing regulations, companies seeking to raise capital were unable to reach a large pool of potentially interested investors due to the prohibition on general solicitation/advertising in private securities offerings.

As such, many financial market participants welcomed the passage of the JOBS Act in April of 2012, which was ostensibly designed to enhance the ability of entrepreneurs and private equity funds to raise capital by reducing barriers to investor solicitation. Among the new measures enacted to reduce such barriers included (1) lifting the prohibition against general solicitations of potential investors, (2) creating a new "crowdfunding" exemption to expand the pool of eligible investors in limited offerings, and (3) raising the holder-of-record threshold for registration under the Securities Act of 1934.

While popular media outlets seem to focus on the JOBS Act "crowdfunding" exemption as the new safe harbor likely to revolutionize private securities offerings, the substantial (and at times, draconian) burdens, limitations and costs associated with that safe harbor will undoubtedly minimize its impact on securities markets. Instead, two different features of the JOBS Act will likely combine to have the most immediate and widespread impact on the manner in which private offerings are conducted:

(1) the lift on the ban against general solicitation in Rule 506(c) offerings; and

(2) increasing the holder-of-record threshold with respect to the number of investors to whom securities can be sold without registration under the 1934 Act.

The SEC adopted the amendments necessary for implementation of these two provisions on July 23, 2013 and they became effective on September 23, 2013 – a historic date in the securities world that will likely bring monumental changes to the manner in which private placements are conducted. The combined effect of these two key provisions will likely generate a new wave of offerings under Rule 506 of Regulation D, sometimes referred to as "**publicly offered private offerings**."

However, in a divergence from the securities rules existing at the time, companies relying on Rule 506(c) can now reach a larger pool of potential investors by engaging in general solicitation and advertising communications that were previously prohibited as long as certain conditions are satisfied:

- (i) the issuer takes "reasonable steps" to verify each purchaser is an accredited investor;
- (ii) at the time of sale of the securities, all purchasers are in fact accredited investors or the issuer reasonably believes that they are accredited; and
- (iii) the requirements of Rule 501, Rule 502(a) and Rule 502(d) of Regulation D are satisfied.

The creation of a new exemption under Rule 506(c) obviously has many advantages for issuers who wish to

engage in general solicitations and advertising in order to attract investment capital from a larger pool of potential purchasers. Obviously, the ability to broaden the potential investment base by advertising to prospective investors whom otherwise would not have known about the issuer will be very attractive to issuers. In addition, private offerings made pursuant to new Rule 506(c) require only "notice filings" to SEC and the states – no requirement to file private placement memoranda and other offering materials with the SEC or the state.

Further, no specific disclosures from the issuer will be required if the offering is limited to "accredited investors" – a limitation required in any event when the issuer undertakes general solicitation efforts. This flexibility leaves the decision to the issuer's discretion as to what information to disclose in order to provide full disclosure and avoid anti-fraud liability.

The allowance of general solicitation of accredited investors will undoubtedly have a substantial impact on the securities markets. At a minimum, the new 506(c) rules will open up many securities offerings to expansive forms of solicitation and advertising, including: internet ads, cable network advertising, solicitations to a company's customer base, catalogue ads, Facebook and Twitter ads, offers to magazine subscribers or credit card account holders, and university alumni offers.

Significantly, securities offered under new Rule 506(c) of Regulation D qualify as "covered" securities and thus will generally avoid substantive federal and state regulation. Rule 506 offerings can be sold to an unlimited number of investors, subject to 1934 Act registration requirement for issuers with more than a certain number holders of record. Significantly, the JOBS Act raised the holder-of-record limit for purposes of 1934 Act registration from 500 to 2,000. **As a result, issuers can conduct a Rule 506(c) offering through general solicitation and widespread advertising, without registration under the Exchange Act of 1934, so long as: (i) all purchasers are "accredited investors" (or the issuer has reasonable belief they are); (ii) the issuer takes reasonable steps to verify accredited status of its investors; and (iii) the issuer has less than 2,000 holders of record following the offering.**

Consequently, the securities landscape is likely to experience a wave of "crowdfunding" placements, however not in the form contemplated by Congress when it created the "crowdfunding" exemption under Title III of the JOBS Act. Instead, the "real" crowdfunding exemption is likely to take the shape of an **"accredited investor crowdfunding"** mechanism, as private issuers will be inclined to attract investment capital through general solicitations and advertisements targeted at "accredited investors" so as to fall within the safe harbor of new Rule 506(c).

Part of the reason the markets are more likely to see a proliferation of "accredited investor crowdfunding" under Rule 506(c), as opposed to the new "crowdfunding" exemption created under Title III of the JOBS Act, is due to the significant expenses, burdens and limitations associated with undergoing a Title III "crowdfunding" offering. For example, the maximum aggregate offering in a Title III crowdfunding offering is limited to $1,000,000 and the potential capital an issuer can receive from an individual investor is capped at relatively low ceilings.

Another limiting attribute of the new "crowdfunding exemption" stems from the requirement that the offering must be conducted through a regulated intermediary. Intermediaries and issuers must comply with extensive reporting and disclosure requirements to participate in crowdfunding offerings, which will require substantial legal, accounting and intermediary fees for offerings limited to $1,000,000 in the aggregate. In addition, both issuers and intermediaries are subject to ongoing reporting obligations under Title III of the JOBS Act, which will further drive up the costs associated with such offerings.

In addition, even though the new "crowdfunding exemption" is not limited to accredited investors, or subject to the 2000 record holder limitations applicable to Rule 506 offerings, most issuers will likely limit securities sales to accredited investors in order to minimize disclosure requirements since accredited investors are assumed to be sophisticated and in less need of detailed disclosures.

In summary, issuers relying on new Rule 506(c) can raise an unlimited amount capital, from an unlimited number of accredited investors (subject to registration under the 1934 Act if there are more than 2,000 equity owners),

without incurring the additional expense likely to be assumed by crowdfunding issuers as a result of ongoing SEC reporting requirements, continuing dealings with funding portal intermediaries, heightened scrutiny with respect to disclosures to non-accredited investors, and the need to compensate professional advisors to ensure compliance with the cumbersome Title III crowdfunding rules. Accordingly, the marked relaxation of investor solicitation allowed under new Rule 506(c), coupled with the flexibility to have up to 2,000 investors, will arguably make 506(c) offerings the preferred vehicle for issuers planning to undertake a private offering of its securities.

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