Why Startups Are Stepping on the Brakes Despite SEC Giving Green Light to General Solicitation

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In September 2013, the SEC significantly relaxed restrictions that had been in place for over 80 years on companies' ability to advertise for investors. The old rule, generally referred to as the "ban on general solicitation," had been a central component of U.S. securities laws since the Great Depression. Before the ban went in place, it was not uncommon to see public advertisements to buy the next "can't miss" stock.

Increasingly in recent years, particularly with the startup boom, entrepreneurs felt as though their hands were tied with regard to raising money. If only they could advertise for investors, the vast pool of capital that was previously out-of-reach would come knocking at their doors. When the SEC announced it was considering eliminating the ban, the excitement in the business community was palpable. Yet today, more than six months after the ban was finally lifted, companies remain extremely skittish to test out the relaxed rules. To understand the hesitation, a little background on the new regulatory environment is needed.

New Rules

The SEC's new Rule 506(c) governs the conditions and requirements to engage in general solicitation. The rule allows companies to use general solicitation and advertising to raise unlimited amounts of capital from an unlimited number of investors so long as all of those investors are "accredited investors" (a legally defined term that generally means "financially sophisticated investors"). Under the new rule, however, the issuer must take "reasonable steps" to verify that each purchaser of securities meets the standard for an accredited investor. While there is some debate about what constitutes these "reasonable steps," suffice it to say that more than a cursory level of diligence is required – for instance, an issuer might want to review an investor's tax returns to satisfy the standard.

Why the Reluctance?

The requirement to take "reasonable steps" to verify investors' accredited status, and the significant consequence of falling short of satisfying the standard, is one of the key explanations for why companies are still sitting on the sidelines when it comes to general solicitation. Not satisfying the SEC's standard for "reasonable steps" can result in the issuer having to refund investors' money, together with interest and other damages, potentially at a time when the issuer can least afford to part with cash.

There's also the "no do overs" rule. An issuer that engages in general solicitation but fails to satisfy the standards of Rule 506(c) will not be able to fall back on some of the other most common securities law exemptions (i.e., the other exemptions under what's known as "Regulation D" covering private placements) that still prohibit general solicitation to satisfy their requirements. In essence, the issuer will be stuck waiting on the sidelines for at least six months (the period during which the SEC can determine that two offerings should be integrated and viewed as a single offering) before utilizing one of these other common exemptions.

Perhaps the most ironic reason there has been little use of the new rule, however, is that the principal intended beneficiaries of the new rule are the companies that lack the resources needed to comply with it. Rule 506(c) was not adopted to help those companies that already have significant revenues and resources. Those more established companies have typically had greater options available to them for accessing capital. Instead, Rule 506(c) was adopted to help the small guy who may need to cast a wider net when looking for capital. The small guy may lack the resources to engage in a fundraising advertising campaign. The small guy also may not have the resources to seek legal advice to make sure he is complying with the new law.

Another credible, but more speculative, reason many potential issuers have yet to test the waters with general solicitation is fear over the type of investors who are likely to respond to general solicitation. An issuer desperate for cash may not hesitate to take money from anyone willing to invest. Those who can be even mildly selective, however, prefer investors who are likely to be rational and business minded. But rational and business minded people generally are not the type to invest in a company after seeing a newspaper advertisement. Just because someone meets the financial standard to be an "accredited investor" does not mean they are a desirable investor.

Then there are the concerns over protecting proprietary information. Most companies take great strides to keep their confidential information confidential. However, when an issuer raises capital through the sale of stock or debt, it is selling a security, and therefore is subject to the antifraud laws that require disclosure of material information. A company considering engaging in general solicitation is faced with a dilemma: Disclose confidential information or run the risk that, if investors lose money, the information will be deemed material in hindsight in an investor lawsuit.

Finally, the SEC is likely to be particularly interested in the market's use of the new rules (as it is with all new rules). Those actively involved in the securities industry generally expect the SEC to scrutinize fairly closely the first batch of issuers to test the waters on general solicitation. Companies often hire lawyers to help keep them off the SEC's radar, so the prospect of waiving a flag in front of the SEC and saying "look at me" is fairly unappealing to issuers. Rather, most companies seem perfectly content to let the more adventuresome early adopters of general solicitation forge the way. To date, there seem to be relatively few volunteers for that pioneering role.

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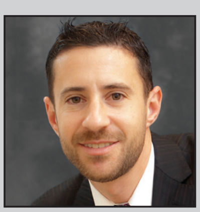

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