



ANGEL CAPITAL ASSOCIATION

APPLYING THE PRINCIPLES-BASED VERIFICATION METHODOLOGY UNDER GENERAL SOLICITATION RULE 506(c): “ESTABLISHED ANGEL GROUP” AND OTHER METHODS

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The Securities and Exchange Commission (SEC) Rule 506(c) permits issuers seeking to raise capital from accredited investors to use general solicitation, and places additional responsibility on issuers to take reasonable steps to verify that all purchasers are accredited investors.¹

The new rule ends the 80-year ban on general solicitation of private offerings, and represents a significant change in securities law. The SEC addressed this fundamental change by providing a principles-based verification methodology, based on ascertaining facts and circumstances that meet the verification requirement. The SEC underscored the fundamental importance of this method to the effectiveness of Rule 506(c), which is expected to lead to the development of a broad range of reasoned and reliable approaches to issuer verification.

In furtherance of building industry practice around implementation of Rule 506(c), the Angel Capital Association (ACA) recently offered guidance on verifying membership in an Established Angel Group as an appropriate verification methodology under the principles-based approach.²

This paper further discusses methods and examples of factors relevant to 506(c) verification. Whether any particular set of facts and circumstances is sufficient for verification depends on each individual transaction. *Issuers should consult with legal counsel about how to apply the principles-based method of accredited investor verification in any transaction designed to rely on Rule 506(c).*

In its essence, the SEC’s principles-based methodology requires an objective determination that a purchaser is an accredited investor in the context of the facts and circumstances of each purchaser and transaction.³ A key objective of the Commission in designing the principles-based method was to “maintain the flexibility” of the verification process.⁴ As the Commission noted: “the 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.” In other words, the principles-based method provides a “sliding scale” of reasonableness in relation to the risk that a purchaser is not accredited.

There will be many cases in which observable traits of an individual purchaser may be deemed sufficient for an issuer to meet the verification requirement. For example, in addition to reliance on Established Angel Group membership as recommended by ACA, other categories which offer solid evidence of accredited status that may be sufficient to meet this standard include:

¹ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306, 313 (2012).

² See www.angelcapitalassociation.org/aca-public-policy-jobs-act/

³ SEC Release No. 33-9415 at 27.

⁴ SEC Release No. 33-9415 at 27.

- An individual accredited investor who joins ACA through referral from an existing member with a pre-existing relationship to the individual.
- An accredited investor who has made one or more investments in a private offering under any Regulation D exemption during the prior 12 months.

In cases where there are not sufficient principles-based factors, the SEC provided four non-mandatory, non-exclusive methods deemed to be conclusive. These methods require an issuer or approved third party to review detailed financial documents establishing income or net worth, or to have a pre-existing relationship with a purchaser who has bought securities in an issuer's prior offering. These methods present significant privacy, cost and procedural concerns for both issuers and investors.

In order for Rule 506(c) to successfully function, it is critical that the utility of the principles-based method be encouraged through the development of industry practice. Startups and other small business issuers have a compelling need for practical examples of how the principles-based method operates. Otherwise, small issuers employing 506(c) are likely to default to one of the four optional safe harbors. This would damage the Commission's objectives in the following ways:

- Reliance confined to the four safe harbors would controvert the SEC's objective of maintaining flexibility in meeting the verification requirements.
- Startups may incur significant costs and be required to create complex systems for maintaining confidential investor information, even if provided by a third party.
- Investor privacy will be eroded, likely causing some active investors to reduce, or possibly cease investment in startups, resulting in disruption of the Rule 506(c) market.
- If angel investing decreases, fewer startups will emerge and those that do will be less likely to receive essential advice and support from experienced professionals who make up the rosters of angel groups and networks nationwide.
- If angel investing decreases, it may harm federal, state and local economic development efforts that rely on experienced angels and groups to fund promising early-stage companies that create jobs in their communities. These economic development benefits are of particular importance in regions of the U.S. where venture capital or other equity funds typically do not invest, and where angel groups and individuals are the primary source of startup funding.

Maintaining a Flexible Verification Methodology

The SEC addressed its objective of maintaining flexibility of the verification requirement with a three-pronged approach:

- It provided a general requirement in Rule 506(c) that issuers take reasonable steps to verify that all purchasers are accredited investors using a principles-based method.
- It provided four non-mandatory, non-exclusive methods deemed to satisfy the requirement.
- It preserved the ability under Rule 506(b) for issuers to conduct private offerings subject to the prohibition against general solicitation; under which self-certification by accredited

individuals is permitted.

Rule 506(b) preserves the ability for issuers to conduct offerings without the use of general solicitation, therefore eliminating the need for issuers to take further steps to verify accredited status of purchasers. However, given the broad scope of what has been identified as general solicitation,⁵ it is likely that many issuers will find themselves employing Rule 506(c), even though they intend to raise funds primarily from an angel group or experienced individual angels. Thousands of startups today participate in publicly advertised pitch contests and demo days held by incubators or accelerators, and present their funding needs at economic development conferences and other events. Many of these activities could fall under the rubric of general solicitation, leading participating companies to seek exemption under Rule 506(c).⁶

The four non-mandatory, non-exclusive verification methods provided in Rule 506(c)(2)(ii) are:

- Income test: Review of IRS forms that report income for the most recent two years, and written representation from the purchaser that he/she has a reasonable expectation of reaching an income level necessary to qualify as an accredited investor for the current year.
- Net worth test: Review of documentation dated within the prior three months detailing assets, report from a national credit reporting agency, and written representation from the purchaser that all liabilities necessary to make a net worth determination are disclosed.
- Third-party verification: Written confirmation from a qualified third party that has taken reasonable steps to verify within the prior three months that the purchaser is an accredited investor. Allowed third parties include: registered broker-dealer, registered investment advisor, licensed attorney, or certified public accountant.
- Previous purchaser: In regard to a purchaser who has previously purchased an issuer's securities in a Rule 506(b) offering prior to the effective date of Rule 506(c), the issuer must obtain a certification from the purchaser of the same issuer's 506(c) offering that he or she qualifies as an accredited investor.⁷

These four methods, as the Commission acknowledged, are not perfect. The first three provide point-in-time documentation of the financial standing of a potential purchaser who is a natural person. However, with respect to maintaining a similar income level in the current year, this method ultimately involves self-certification. Verification of net worth is also fraught with uncertainty. The purchaser must self-certify that all liabilities are disclosed and often must resort to estimating the value of illiquid assets. The fourth method relies on self-certification and a pre-existing relationship between issuer and purchaser.

Investor Protection, Cost-Efficiency and Privacy

The table below compares the four safe harbors with the methods endorsed by ACA. The criteria applied include: investor protection, cost, and privacy concerns (Table 1).

⁵ Rule 502 of Regulation D states, in pertinent part, that general solicitation or general advertising includes, but is not limited to, "(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising."

⁷ SEC Release No. 33-9415 at 36-39.

Table 1

| | | Investor Protection | Cost | Privacy Concerns |
|-----------------------------------|--|----------------------------|--|--|
| Non-Mandatory Safe Harbors | Income Test Safe Harbor (A) | Medium | Medium/High Multiple documents (IRS Forms, bank statements, pay stubs, etc.) | High |
| | Net Worth Test Safe Harbor (B) | Medium | Medium/High Multiple documents current w/in prior 3 months (bank statements, brokerage statements, CDs, tax assessments, appraisal reports, credit reports)) | High |
| | Third-Party Verification Safe Harbor (C) | Medium/High | Medium/High *Potential for multiple documents depending on verifying entity. | May be lower than (A) or (B) depending on third party |
| | Previous Purchaser Safe Harbor (D) | Medium | No additional cost to issuer or purchaser | Low, due to pre-existing relationship |
| PBM* | Established Angel Group or ACA Member, or Prior 506 Deals | High | No additional cost to issuer or purchaser | None |

*PBM = Principles-Based Method

The four non-exclusive methods raise concerns about investor protection, cost-efficiency and privacy. These may be lessened by use of the principles-based method. As the Commission noted, “such flexibility could mitigate the cost to issuers of complying with Rule 506(c) because it would allow them to select the most cost-effective verification method for each offering.”⁸

“Transaction efficiency” is important to early-stage companies.⁹ This angel-supported sector is characterized by smaller deal sizes and a high volume of transactions. The Commission notes that the size of the median offering under Regulation D is approximately \$1.5 million.¹⁰ As the 2012 Halo Report notes, median angel group deal size at \$600,000 is less than half the Reg D median.¹¹ In practice, many angel groups finance seed-stage capital in amounts of \$250,000 or less. Deals funded by angel groups may be made up of a dozen or more individual angels investing \$10,000-\$50,000 apiece. Verification costs associated with multiple investors – estimated by some to range from \$75 to \$300¹² per individual -- could rapidly add up.

Privacy is also of great concern to most investors, who generally take care to protect the confidentiality of their financial position. Maintaining private financial information also presents a real burden for early-stage companies. Most of these companies do not have internal controls

⁸ SEC Release No. 33-9415 at 97.

⁹ “Angels are the only source of capital for most startups, and supply up to 90% of outside equity raised by seed-stage companies after they exhaust any resources from friend and family, according to Kauffman Foundation estimates.” Marianne Hudson, *Why Entrepreneurs Need Angels - and How Angels are Improving*, in Kauffman Thoughtbook (Kauffman Foundation 2005).

¹⁰ SEC Release No. 33-9415 at 68.

¹¹ The Halo Report at [www.angelresource.org/research/halo-report.aspx].

¹² Rough estimates provided by accredited portal representative at Milken Institute meeting on SEC Rule 506(c), September 6, 2013

to deal with gathering and retaining sensitive financial data. Also, many startups fail (statistically, the majority will cease operations within five years¹³) and there are no procedures required to ensure the confidentiality once a startup vacates its offices and leaves behind file cabinets or computers full of investor information. While privacy concerns may be lessened if an issuer relies on an authorized third party, purchasers may be asked to provide financial documents to an unfamiliar or online service (where privacy concerns would continue), or to incur the cost of engaging an attorney or accountant as often as every three months to review documentation.

There are sectors of the Reg D market where additional facts and circumstances may be needed, and where additional steps and/or documentation may undoubtedly be appropriate. With the onset of general solicitation, the interest by accredited individuals with no prior experience in Reg D offerings of any type is likely to increase. According to the General Accounting Office, approximately 8.7 million households currently would qualify as accredited investors.¹⁴ Currently, approximately 16,000 accredited investors are members of angel groups, and approximately 250,000 accredited investors fund small issuers each year.

It may be helpful to think of the Reg D market as divided into three sub-categories:

- Institutional offerings introduced to investors by a registered intermediary.
- Private offerings of any type made using broad solicitation methods to accredited investors with no prior experience purchasing offerings issued under Reg D;
- Offerings by early-stage companies made to accredited investors who belong to an Established Angel Group, ACA, are members of accredited platforms, and/or who have done prior Reg D deals. These issuers will also often have support from economic development entities such as business accelerators, universities and government offices.

Congress intended the lifting of the ban on general solicitation to primarily benefit the startup economy. Much has been made on Wall Street of the potential benefits of Rule 506(c) for venture capital firms, hedge funds and other private equity managers that want to advertise to retail investors. However, these are large funds, which charge significant management and performance fees, and typically already have regulatory counsel and established verification mechanisms in place. These investment firms seldom cater to the startups, especially beyond the bounds of areas such as Silicon Valley.

Angel Group Importance to Early-Stage Sector of Reg D Market

Angel groups are essential to the viability of the start-up sector, and their increase in number and size is an important trend. As the U.S. innovation economy has experienced an explosion of growth in startups, more accredited investors than ever recognize the value of working in groups to pool knowledge, experience and capital in order to make larger investments, develop best practices and support the early-stage sector. Angel groups in number have grown from fewer than 100 ten years ago, to more than 375 today. Individual membership in groups has increased from a few hundred to more than 16,000 today.

¹³ Scott Shane, "Start Up Failure Rates: The Definitive Numbers", Small Biz Trends, December 17, 2012 (created from Longitudinal Business Database 1977-2010, Census Bureau and Business Employment Dynamics 1994-2010, Bureau of Labor Statistics).

¹⁴ U.S. Gov't Accountability Office, GAO-13-640, Report to Congressional Committees: Alternative Criteria for Qualifying As an Accredited Investor Should Be Considered (2013), available at www.gao.gov/assets/660/655963.pdf

Pre-existing relationships among members are the cornerstone of how angel groups ensure their members are accredited investors. These private organizations accept members by referral from a current member who is familiar with the candidate's professional history and financial status and believes the candidate to be an accredited investor. Multiple groups often participate in the syndication of a given deal, and guard their professional reputations to ensure they are viewed by both fellow angels and issuers as a reputable and reliable source of investment and funding opportunities.¹⁵

An important characteristic of angel groups is their economic bargaining power.¹⁶ These groups negotiate terms with issuers, including valuation, protective covenants, information rights and form of the security. In many if not most cases, it is the angel group that presents terms to an issuer.

An additional virtue of angel groups is that verification is effected outside of the context of an offering under Rule 506, and is instead an ongoing, continuous process. As long as an accredited investor is a member of an Established Angel Group, the meter gauging accreditation status is running.

Conclusion

The changes wrought by Rule 506(c) are significant and challenging for federal and state securities regulators and for market participants. In this time of transition from "quiet deals" to general solicitation, it is important that market participants have confidence that new rules will enhance the likelihood of success in this most important job-creating sector of the private capital markets.

ACA encourages issuers, accredited investors and other market participants and their legal counsel to develop multiple standards and practices to meet the verification standards of Rule 506(c). In addition, new practices will emerge and should be encouraged.

By having confidence that membership in an Established Angel Group, ACA and/or previous transactions under Rule 506 meet the principles-based test for verification, thousands of small businesses will be able to take full advantage of Rule 506(c), and thus amplify the mission of the Commission to streamline capital formation for small businesses while optimally protecting investors.

¹⁵(*Small Business Tax Reform – Making the Tax Code Work for Entrepreneurs and Startups: Small Business Tax Roundtable Before the S. Comm. on Small Bus. & Entrepreneurship*, (2013) (statement of Michael J. Eckert, Vice Chairman, Angel Capital Association); and Supplemental Information from the Angel Capital Association, July 17, 2013.) From 1980 to 2005, companies less than five years old accounted for all net job growth in the US, according to data from the Census Bureau and analysis by the Ewing Marion Kauffman Foundation. (John Haltiwanger, Ron Jarwin, & Javier Miranda, *Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States* (January 2009): www.kauffman.org/uploadedFiles/BDS_Jobs_Created_011209b.pdf.) Without these young companies, job growth would have been negative in many years of that period.

¹⁶ Robert Wiltbank, *Investment Practices and Outcomes of Informal Venture Investors*, 7 VENTURE CAPITAL 343, 2005