

## Keynote Address at the 2014 Angel Capital Association Summit

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Thank you for that introduction. It is a pleasure to be here today at what I understand to be the world's largest gathering of angel investors. As Marianne can hopefully attest, we have always welcomed the views of the angel investor community – even the harsh, critical ones – and I welcome this opportunity to share some of my own thoughts with those who will be most directly affected by what we are doing over at the SEC. Before proceeding, however, I need to provide the standard disclaimer that the views that I express today are my own and do not represent the views of the Commission or its staff.<sup>[1]</sup>

The importance of small businesses in America is unquestionable – they are the foundation of today's economy and are responsible for many of the new jobs created each year in the United States. And angel investors play a vital role in the development of small businesses by nurturing them at their earliest, most vulnerable stages when they may have little more than the next great idea. For early stage entrepreneurs, angels often are the only ones willing to listen to their business pitch, provide advice, and put in that crucial infusion of capital that is needed to transform an idea into a thriving new business. Yahoo, Google, Facebook, Home Depot – these are just some of the titans of today's corporate America that, at an earlier stage of their development, were first backed by angel investors. <sup>[2]</sup> Equally impressive are some of the statistics about the impact of angel investing – by one estimate, in the first half of 2013 alone, angels invested approximately \$9.7 billion in over 28,000 ventures, with over 111,000 new jobs created as a result of these investments.<sup>[3]</sup>

From the perspective of the federal securities laws, angels have historically made their investments by purchasing in private offerings conducted under Section 4(a)(2) of the Securities Act or the safe harbor under Regulation D, which exempt these types of offerings from Securities Act registration. As a result of the JOBS Act, however, the regulatory landscape for angel investing is changing dramatically. Enacted in 2012, the JOBS Act is intended, among other things, to expand access to the capital that entrepreneurs need to grow their businesses. To that end, the Act directs the Commission to engage in a number of rulemakings that, when completed, will provide small businesses with new avenues for raising funds through securities offerings. The Commission and the staff have been focused on these rulemakings since then, with Chair White indicating recently that the completion of all of the mandated capital formation rulemakings in 2014 is an important priority for her.<sup>[4]</sup>

For angel investors, the changes resulting from these rulemakings present both new opportunities and new obligations. In the interest of time, I would like to focus today on three items on the Commission's recent agenda that are of particular importance to angels: the elimination of the prohibition against general solicitation and general advertising in Rule 506 offerings, the review of the accredited investor definition mandated by the Dodd-Frank Act, and the changes to the existing Regulation A exemption to permit offerings of up to \$50 million.

### **Elimination of the General Solicitation Prohibition in Rule 506 Offerings**



I will start with the change that is already in place today – the ability to conduct Rule 506 offerings by means of a general solicitation. As many of you know, the prohibition against general solicitation in private offerings has been a cardinal principle of the federal securities laws since the early days of the Securities Act of 1933.<sup>[5]</sup> So, the Congressional mandate that this prohibition be eliminated for Rule 506 offerings was a watershed moment for longtime practitioners and for companies that have long sought the ability to communicate more freely and broadly about their “private” offerings of securities.

In July 2013, the Commission completed this mandated rulemaking by creating a new exemption, Rule 506(c), that permits the use of general solicitation to offer securities as long as two conditions are met: the securities can be sold only to accredited investors and the issuer must take “reasonable steps to verify” the purchaser’s accredited investor status. <sup>[6]</sup>

The exemption became available in September 2013. Since then, we have seen almost 900 new offerings conducted in reliance on the exemption, raising more than \$10 billion in new capital as of the end of last week. While impressive, the use of this new exemption still pales in comparison to the use of the old “private” Rule 506 exemption (now called Rule 506(b)) which, during the same time period, was relied upon in over 9,200 new offerings that resulted in the sale of over \$233 billion in securities.

Looking at these figures, one wonders why the new Rule 506(c) exemption has not caught on more widely with issuers who have long clamored for the general solicitation ban to be lifted. And sure enough, there has been a fair amount of commentary written about the reasons for this somewhat surprising turn of events. I would like to spend a few moments talking about three of the most commonly-heard explanations and share some of my thoughts on each one of them.

**Reasonable Steps to Verify.** Some believe that the reluctance of issuers to use the new Rule 506(c) exemption is because the rule requires that the issuer take “reasonable steps to verify” the accredited investor status of a purchaser. The legislative history of the JOBS Act made it clear that self-certification – without something more – was not enough if the ban was to be lifted.<sup>[7]</sup> Some believe that the “reasonable steps” requirement drives away potential purchasers who are interested in making an investment but wary of turning over financially sensitive information, such as tax returns or brokerage statements, to the issuer for verification.

Given the amount of public attention that this view has received, one could almost be under the impression that the rule requires that an accredited investor produce his or her tax returns or brokerage statements in all circumstances. Of course, this is not true. It is important to recognize that, in fact, there are actually two paths for complying with the rule’s verification requirement. Issuers can rely on one of the four non-exclusive verification methods for a natural person that, if used, would be deemed to satisfy the verification requirement. To be sure, for some of these methods a prospective purchaser must provide written documentation of his or her annual income or net worth. The other method, however, is the principles-based verification method in which the issuer would look at the particular facts and circumstances to determine the steps that would be reasonable to verify that someone is indeed an accredited investor. Although the verification method must be objectively reasonable, the principles-based method is intended to provide issuers with significant flexibility in deciding the steps needed to verify a person’s accredited investor status and to avoid a “one size fits all” approach.

Under this principles-based approach, the documentation that a person must provide, if any, will depend on the answers to questions such as:

- How much information about the prospective purchaser does the issuer already have? The more information the issuer has indicating that the person is an accredited investor, the fewer verification steps that it may have to take to comply with the rule’s requirement. A person’s



investments in previous Rule 506 offerings or membership in an established angel group is also information about the person that may affect the likelihood of the person being an accredited investor and therefore may be useful in determining the steps that would be reasonable for an issuer to verify the person's accredited investor status. The issuer would, of course, still need to consider any other relevant facts in making its final determination about the person's accredited investor status.

- How did the issuer find the prospective investor? A person that the issuer located through publicly-accessible and widely-disseminated means of solicitation may need to undergo a greater level of verification scrutiny than a person who may have been pre-screened as an accredited investor by a reasonably reliable third party.
- Are the terms of the offering such that only a person who is truly an accredited investor could participate? The ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors, using their own cash, could reasonably be expected to meet it is relevant in deciding what other steps are needed to verify accredited investor status.

Lastly, the Commission envisioned a role for third parties that may wish to enter into the business of verifying the accredited investor status of prospective investors on behalf of issuers and allowed for such third party verification under the principles-based approach as long as the issuer has a reasonable basis to rely on such third party.<sup>[8]</sup>

These are all part of a deliberate effort by the Commission to provide issuers with an alternative to the clear but highly prescriptive list of verification methods included in the rule. In fact, it is ironic that this list of verification methods is being viewed by some as the primary way to verify a purchaser's accredited investor status when, in fact, the Commission originally proposed the principles-based approach as the way issuers would comply with the rule's verification requirement and added the list of specific verification methods only in response to address the concerns of commenters who wanted more certainty.

On that note, we have had recent inquiries asking whether the staff would provide guidance – presumably on a case-by-case basis – confirming that a specified principles-based verification method constitutes “reasonable steps” for purposes of the rule's requirement. The notion of the staff reviewing and approving specific verification methods seems somewhat contrary to the very purpose of a principles-based rule and I am not yet convinced of the need for this type of staff involvement. Rather, this is an area where issuers and other market participants have the flexibility to think about innovative approaches for complying with the verification requirement of the rule and use the methods that best suit their needs. While the staff may not be in a position at this point to provide guidance on what constitutes “reasonable steps” under particular circumstances, I also believe the staff will not be quick to second guess decisions that issuers and their advisers make in good faith that appear to be reasonable under the circumstances.

*Definition of “General Solicitation.”* Another commonly-heard criticism is that the definition of a “general solicitation” is too vague, creating so much uncertainty about whether a particular communication or activity is a form of general solicitation that issuers have adopted a very cautious mindset about the new Rule 506(c) exemption.

Perhaps this concern is the result of the highly-publicized nature of the Rule 506(c) rulemaking, which may have caused some to focus on the definition of general solicitation itself and wonder, perhaps for the first time, if a particular longstanding practice may in fact be a general solicitation. Some may even be under the erroneous impression that the Commission has broadened the definition so that activities



such as "venture fairs" and "demo days" are now prohibited. The truth of the matter is that the recent rulemaking has not changed any notions of what constitutes a general solicitation. The analysis for determining whether a specific communication or activity constitutes a general solicitation for an offer or sale of securities under Rule 506 remains the same as when the rule was first adopted in 1982, with the particular facts and circumstances surrounding the communication or activity determining the final answer. I hope that some of the concerns about the general solicitation definition will diminish as issuers and their advisers become increasingly familiar with what the Commission changed – and did not change – with the adoption of the Rule 506(c) exemption.

Of course, we do recognize that even though the definition of "general solicitation" may not have changed, issuers may have a greater need for additional guidance about what constitutes a general solicitation now that it is permitted in one type of Rule 506 offerings but not in the other. In a funny way, it was probably easier when general solicitation was simply impermissible in all instances. The staff has previously provided guidance through no-action letters on whether specific activities (such as certain venture fairs) constitute a general solicitation; perhaps the positions in these letters may warrant a fresh review and possible update.<sup>[9]</sup> Or perhaps there is now a need to think about whether specific types of communications should not be viewed as general solicitation, such as regularly released factual business information or communications that occur at times sufficiently distant from capital raising activities and do not refer to any offering so as to negate any inference that they are solicitations. These are just some of the many ideas that have been suggested to help issuers better adjust to the new dichotomy between a "private" Rule 506 offering and a "public" Rule 506 offering.

*"Overhang" of the 2013 Regulation D Proposal.* Before moving on to the accredited investor definition, I would like to say a few words about the so-called "overhang" effect of the Regulation D proposal that the Commission issued last summer in conjunction with the adoption of the final rules to eliminate the general solicitation ban.<sup>[10]</sup> As you can imagine, the ability of issuers to publicly solicit in what used to be private offerings will lead inevitably to changes in the Rule 506 market, including changes in the types of issuers using the exemption, the types of intermediaries participating in these offerings, and, of course, the manner in which investors are solicited. The proposed amendments to Regulation D and Form D are designed to enhance the Commission's ability to assess these changes and their effects on investor protection and capital formation. It is a proposal that has polarized commenters, with some characterizing it as a vital step for protecting investors and others viewing it as a burdensome impediment for small businesses. The staff is considering the concerns of both of these schools of thought as it formulates its recommendations to the Commission.

While I cannot predict what the Commission will ultimately do on the rule proposal, I can speak to a fear we have heard expressed that the proposed requirements and penalties might be applied retroactively to offerings conducted before the adoption of the proposal, which, in the view of some, creates an "overhang" effect over issuers' willingness to use the new exemption. I would like to note that Chair White has already stated publicly that issuers are not expected to comply with any aspect of the rule proposal until such time as the Commission approves a final rule and such rule becomes effective.<sup>[11]</sup> She also expressed her expectation that the Commission will consider the need for transitional guidance for ongoing offerings that commenced before the effective date of any final rules, as it did when it adopted Rule 506(c) last summer. It is my hope that the Chair's comments will give some comfort to those who want to conduct a Rule 506(c) offering but are concerned about the effect of the Regulation D proposal on their completed or ongoing offerings.

#### **Review of the Accredited Investor Definition**



With that, I would like to turn to the accredited investor definition. The newfound ability of issuers to publicly solicit in Rule 506 offerings provides what may be an opportune time for a thorough reexamination of this definition. After all, it was the condition that only accredited investors would be permitted to purchase the securities offered through a general solicitation that gave many members of Congress the comfort needed to support the elimination of the decades-old ban.

Currently, a natural person is an accredited investor if he or she has a net worth, either individually or jointly with a spouse, of more than \$1 million, excluding the value of the person's primary residence. [12] Alternatively, a person can be an accredited investor if he or she has an individual income of greater than \$200,000 (or joint income with a spouse in excess of \$300,000) during each of the two most recent years and has a reasonable expectation of reaching the same income level during the current year. [13] Under the 2010 Dodd-Frank Act, the Commission is required to undertake a review of this part of the accredited investor definition four years after the enactment of the Act. The staff is currently conducting this review, which will help inform the Commission's consideration of whether or not to change the definition.

The goal is to determine whether the current net worth and income tests for a natural person still serve one of the key purposes of the accredited investor concept, which, as the Commission previously stated, is to identify persons who can bear the economic risk of an investment in securities sold outside of the Securities Act registration process and can afford a complete loss of such investment if necessary. [14] And while the net worth and income tests currently serve as the criteria for determining a natural person's accredited investor status, the review will look into whether other suggested criteria can serve either as an alternative or supplemental test for accredited investor status. These include criteria such as:

- possession of professional certifications or degrees, such as a CFA, CPA, or a securities license, which some believe may provide an individual with the knowledge and sophistication needed to be an accredited investor, presumably irrespective of the person's financial wherewithal;
- ownership of a specific amount of investment securities, which some believe provides a better measure of a person's ability to make informed decisions about whether or not to purchase securities; and
- reliance on intermediaries such as a registered broker or an investment adviser whose involvement could potentially enhance a person's ability to make an investment decision.

Of course, it is an important part of our review that we consider carefully the potential economic consequences of using any alternative or supplemental criteria, including whether the criteria will significantly expand or diminish the potential pool of accredited investors. I expect that any changes to the accredited investor definition will be made only after thoughtful evaluation of the impacts on investment opportunities and on the protection of potentially vulnerable investors. Any action that we ultimately take will strike a careful balance between the need to facilitate capital formation and the need to maintain a robust level of investor protection.

#### **Regulation A+**

Finally, I'll conclude with a few remarks about one other piece of the changing capital-raising landscape that could potentially affect angel investing – the proposed changes to Regulation A. Regulation A was originally adopted by the Commission to exempt smaller offerings of up to \$5 million from the Securities Act registration process. Yet, for a number of reasons, the exemption was rarely used, with only 19 qualified Regulation A offerings from 2009 to 2012 for a total offering amount of approximately

\$73 million.<sup>[15]</sup> By comparison, during the same time period, there were approximately 27,500 offerings of up to \$5 million (the cap for Regulation A offerings) that were conducted under one of the Regulation D exemptions, with a total offering amount of approximately \$25 billion.<sup>[16]</sup>

In an effort to make the exemption more useful to small companies trying to access capital, Congress mandated that the Commission build upon the existing Regulation A exemption to create a new exemption from registration under the Securities Act for offerings of up to \$50 million in a 12-month period. And last December, the Commission proposed the rules for this exemption, which is often called "Regulation A+."<sup>[17]</sup>

The proposal would update and expand the exemption by creating the following two tiers of Regulation A offerings:

- Tier 1, which would consist of those offerings already covered by Regulation A – namely, securities offerings of up to \$5 million in a 12-month period; and
- Tier 2, which would consist of securities offerings of up to \$50 million in a 12-month period.

For offerings up to \$5 million, the company could elect whether to proceed under Tier 1 or 2.

Under both tiers, companies would be subject to basic requirements, including ones addressing issuer eligibility and disclosure that are drawn from the existing provisions of Regulation A. The proposed rules would also:

- permit companies to submit draft offering statements for non-public review before filing;
- permit the use of "testing the waters" solicitation materials before the filing of the offering statement; and
- modernize the communication and offering process in Regulation A to reflect analogous provisions found in the Securities Act registration process, including electronic filing of offering statements.

Companies conducting Tier 2 offerings would be subject to several additional requirements, such as:

- limitations on investors so that they can purchase no more than 10 percent of the greater of the investor's annual income or net worth (with income and net worth calculated as they would for purposes of the accredited investor definition);
- the need to include audited financial statements in the offering statement; and
- the filing of annual and semiannual ongoing reports and current event updates similar to those required under the Exchange Act.

Purchasers in a Tier 2 offering would be "qualified purchasers" and the offering would not be subject to state "blue sky" registrations.

The comment period for the rule proposal just ended this past Monday, although we will, of course, still look at comment letters submitted afterwards. And while the full impact of this exemption will depend in large part on the parameters of the final rules adopted by the Commission and the reactions of the marketplace to these rules, our goal is to make Regulation A+ an effective, workable path to raising capital for small businesses.



I hope that I will leave you today with a sense of the changes that will affect the angel investor community in the near future – changes that may affect how you find your next big investment, who your next investment partners may be, or the types of offerings that you may be considering. These changes may demand new ways of thinking on the part of issuers, angels, and the staff. And while there may be some differences in views, I believe that we all share the same common goal of helping businesses access the capital they need to grow while continuing to protect investors.

Thank you all for your attention and this wonderful opportunity to speak today.

[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

[2] See Angel Investors – Critical Initiators of Startups and Job Creation, Presentation by the Angel Capital Association to the SEC Advisory Committee on Small and Emerging Companies (Sept. 17, 2013), available at: <http://www.sec.gov/info/smallbus/acsec/acsec-091713-verrill-hudson-slides.pdf>.

[3] Center for Venture Research, The Angel Investor Market in Q1Q2 2013: A Sustainable Growth Continues, available at: [https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/Q1Q2\\_2013\\_Analysis\\_Report.pdf](https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/Q1Q2_2013_Analysis_Report.pdf).

[4] "The SEC in 2014," speech at the 41<sup>st</sup> Annual Securities Regulation Institute (Jan. 27, 2014), available at: <https://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540677500>.

[5] See Letter of General Counsel Discussing Factors to be Considered in Determining the Availability of the Exemption from Registration Provided by Second Clause of Section 4(1), Securities Act Release No. 285 (Jan. 24, 1935).

[6] See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415 (July 10, 2013) [78 FR 44771], available at: <http://www.sec.gov/rules/final/2013/33-9415.pdf>.

[7] See, e.g., Markup of H.R. 2940, Access to Capital for Job Creators Act, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Financial Services Committee, 112th Cong. (Oct. 5, 2011) (remarks of Rep. Waters, explaining that she is introducing the amendment that requires issuers to take reasonable steps to verify accredited investor status because "we must take steps to ensure that those folks are indeed sophisticated"); 157 Cong. Rec. H7291 (daily ed. Nov. 3, 2011) (remarks of Rep. Maloney (same)); 157 Cong. Rec. H7294 (daily ed. Nov. 3, 2011) (remarks of Rep. Lee (same)).

[8] Release No. 9415.

[9] See, e.g., Michigan Growth Capital Symposium (May 4, 1995).

[10] See Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Securities Act Release No. 9416 (July 10, 2013) [78 FR 44806], available at: <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>.

[11] Letter from Chair Mary Jo White, Securities and Exchange Commission, to Chairman Patrick T. McHenry, Subcommittee on Oversight and Investigations, House Committee on Financial Services (Aug. 8, 2013).

[12] See Securities Act Rule 501(a)(5).

[13] See Securities Act Rule 501(a)(6).

[14] See Net Worth Standard for Accredited Investors, Securities Act Release No. 9287 (Dec. 21, 2011) [76 FR 81793], available at: <http://www.sec.gov/rules/final/2011/33-9287.pdf>.

[15] Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, Securities Act Release No. 9497 (Dec. 18, 2013) [79 FR 3925], available at: <http://www.sec.gov/rules/proposed/2013/33-9497.pdf>.

[16] Id.

[17] Id.

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