# Living with the New Reg D and its impact on Demo Days and Pitch Events

## Best Practices for Incubators, Angel Groups and Pitch Events

A White Paper

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# I. Introduction / Background

With the passage of the JOBS Act, the regulation governing most private securities offerings is undergoing a dramatic makeover. Congress tasked the Securities and Exchange Commission (SEC) with developing new rules allowing companies to generally solicit funds, subject to restrictions as determined by the SEC. In July 2013, the SEC issued final rules on this topic and also proposed additional rules that are not yet final. Managers of incubators, accelerators, angel groups and others involved in startup capital raising have expressed great concern about how the revised regulations will affect them, particularly with respect to their public-facing events.

Whether presenting at a demo day event, angel group meetings or business plan competitions constitutes "general solicitation" is a question that has caused great concern among many angel groups, incubators and other event organizers around the country. This white paper is designed to provide practical tips to event organizers on how to structure their demo day, pitch event or angel group meeting event in light of new federal rules and the current regulatory landscape.

Starting today, September 23, 2013, the final rules published by the SEC in July go into effect and companies can use general solicitation (or advertising) in connection their securities offerings under the new Rule 506(c) of Regulation D of the Securities Act of 1933, adopted under Title II of the JOBS Act. However, the companies that choose to take advantage of general solicitation under the new rules will have to take steps they did not need to take in the past, including additional verification of accredited investor status. If the proposed rules go into effect, there are a further steps that would be imposed on companies choosing to generally solicit, including making advance filings of a Form D, filing with SEC the materials used in the general solicitation and including specific language (referred to as "legends") in written solicitation materials.

There has been concern about whether the implementation of the new final rules will have serious negative consequences for angel investing. Most notably, some worry that existing events such as demo days, business plan competitions and pitching to angel groups could be swept into the category of general solicitation requiring compliance with the Rule 506(c) restrictions. However, companies can still raise funds in the same ways as they have in the past by complying with Rule 506 of Regulation D (with the former Rule 506 now revised to Rule 506(b)) that always prohibited making general solicitations. Participation in angel group "pitch" events typically was not viewed as general solicitation in part because companies and guests were curated such that attendees were accredited investors with some pre-existing relationship between the attendees and the angel organization.

However, as a result of the SEC's implementation of Title II of the JOBS Act and its new rules that allow general solicitation under Rule 506(c) (provided the other requirements of Rule 506(c) are met), "general solicitation" will be allowed and significant attention is being paid to what that means. Additionally, the proposed rules would require companies using general solicitation to provide the SEC with their solicitation materials, something that many private companies and their investors do not want due to confidentiality concerns as well as concerns about inadvertent non-compliance.

With the new rules, there will be special challenges for demo days or other pitch events if presenting companies are simultaneously engaged in fundraising activities. Some of the presenting companies may choose to generally solicit using the new Rule 506(c), while others may actively avoid general solicitation and rely upon the old approach using Rule 506(b).

Event organizers are left with the dilemma of navigating these new rules and sorting out if they need to change things as a result. Many are receiving conflicting advice about what the rules mean for them and are concerned about how they should structure their events. Questions such groups are asking include:

- What is general solicitation?
- What are the new rules?
- Can I ignore the new rules and do what I've always done?
- Is my event a demo day or a pitch event?
- If my event is a demo day, how can I structure my invitation and event to avoid general solicitation?
- If my event is a pitch event, can some companies use general solicitation under Rule 506(c) while others avoid it and rely on Rule 506(b) all at the same event?

# II. Key Securities Law Concepts

### *A. Securities Registration and Exemptions*

As background, federal law requires all sales of securities to either be registered with the SEC or qualify for an exemption from registration. Publicly traded stocks such as Apple or Google are registered with the SEC. Most startup financing transactions have been done relying Rule 506 under Regulation D for their securities exemption. Historically, under Rule 506, startups could raise an unlimited amount of money from certain high net worth investors so long as the company did not engage in general solicitation as defined in Rule 502(c) of Regulation D.

### *B. What is general solicitation?*

Rule 502(c) of Regulation D provides that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

> (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.

In general, this means that there will need to be a substantial pre-existing relationship with those to whom an issuing company makes an offer of securities under Rule 506 (now 506(b)).

### *C. What is an "accredited investor"?*

Under Rule 501(a) of Regulation D, an accredited investor is a person that meets certain qualifications and therefore is deemed able to protect themselves in making investment decisions without certain additional protections under the securities laws such as those obtained through the SEC registration process and the public disclosure of information about the company that is made through the process of becoming an SEC reporting company. There are several ways to qualify as an accredited investor with the most common being (1) an individual with at least $200,000 (or $300,000 jointly with a spouse) in annual income over the last 2 years or at least $1 million in net worth (excluding the value of a principal residence) or (2) an entity in which all of the equity owners are accredited investors or the entity has at least $5 million in net assets.

### *D. The Jumpstart Our Business Startups (JOBS) Act*

The JOBS Act was passed on April 5, 2012, based on significant public support and demand upon our President and Congress to help create jobs. The JOBS Act consisted of the following parts:

Title I – IPO On-Ramp
Title II – Lifts the Ban on General Solicitation
Title III – Crowdfunding
Title IV – Reg A+ Offerings
Title V – Shareholder Limit

In relevant part, Title II of the JOBS Act directed the SEC to promulgate rules to lift the ban on general solicitation in effect under Rule 506, as discussed above. Title V of the JOBS Act raised the limit on the number of shareholders a company may have before it triggers public reporting requirements from 500 to 2,000 accredited investors. The combination of these two changes could result in private companies utilizing new methods of marketing securities to investors other than a traditional securities offering registered with the SEC such as an initial public offering (IPO).

### *E. Rule 506(b) – The "Old Way" Preserved*

In implementing these rules, the SEC chose to preserve the past Rule 506 approach in the form of Rule 506(b) so as to not disrupt the way offerings are currently being done. If a company is not using general solicitation, they can continue to conduct offerings as they have done in the past in terms of verification of accredited investor status[1] and, presumably continue to use self-certification of accredited investor status (i.e., investors can continue with the check-the-box forms or sign representations indicating they are accredited investors). That said, there is some concern we will see heightened regulatory scrutiny on the issue of accredited status even for companies conducting Rule 506(b) offerings (i.e., not using general solicitation). This is in part due to the concern that many companies may generally solicit through some action taken in the

[1] The JOBS Act did effect one important change that applies to all Rule 506 offerings, including those relying on Rule 506(b): the "bad actor" rules set forth in new Rule 506(d). In order to rely on Rule 506, the new rules require that neither the company nor any "covered person" have committed certain securities-related violations. Note that "covered persons" includes officers, directors, general partners, managing members, 20% shareholders, investment managers, promoters and compensated solicitors, and companies will likely desire to obtain questionnaires from such covered persons. A sample of such a questionnaire is available at www.TheVentureAlley.com at http://www.theventurealley.com/vc-and-pe-funds/new-sec-rules-disqualifying-bad-actors-in-private-fundraising/.

process of the offering (perhaps not even realizing it until after the fact) and find themselves unable to rely on Rule 506(b); as a result they may try to fit within Rule 506(c) and need to meet the higher verification standards. As noted above, while the "old way" of conducting a Rule 506(b) offering was maintained, the new focus on accredited investor status has caused concern that the regulatory landscape could be changing even for those companies not using general solicitation for their offerings.

In addition, as discussed below, the SEC also has proposed further rules regarding Rule 506(c) offerings, including advance Form D filing requirements and general solicitation disclosure and documentation filing requirements that have not been finalized. We expect that practices may need to evolve as the SEC issues new final rules or additional commentary and its views become clearer.

### *F. Rule 506(c) – The "New" Way*

Under the new Rule 506(c), companies can generally solicit (or advertise) their securities offerings so long as all of the investors who actually purchase securities in the offering are accredited. This means that companies will be able to talk about their offerings in public seminars, send out email blasts, push offering information out on social media sites as well as run ads on television, radio and the Internet. Companies will generally be free to talk about their offering to whomever they want.

Using this rule, however, comes with certain additional compliance requirements. Companies who generally solicit under Rule 506(c) may only sell securities to accredited investors in the offering. Additionally, companies will have to take additional steps to verify that all purchasers actually are accredited. In its release issuing the new rules, the SEC explicitly said that it did not believe self-certification by the purchaser checking a box was as adequate (absent other information) to verify the accredited status for purposes of Rule 506(c).

The new Rule 506(c) includes several non-exclusive methods that will be deemed to satisfy the verification requirements (provided that the issuer does not have knowledge that the purchaser is non-accredited). The "safe harbors" (and they are safe harbors, not mandatory methods) the SEC has provided for verification of accredited investor status include:

(1) Income verification by checking federal tax forms, including W-2's and tax returns, and a statement by the investor that he or she expects enough income in the current year to remain accredited;

(2) Net worth verification by checking a recent credit report (within past 3 months) and bank or investment account statements, together with a written representation from the purchaser that he or she has disclosed all liabilities necessary to make a determination of net worth; and

(3) Certification of accredited investor status by a registered broker-dealer, SEC-registered investment adviser, licensed attorney or certified public accountant who has verified the purchaser's accredited investor status.

The SEC also included a form of "grandfather" provision in the new Rule 506(c), which provides that for existing investors who were accredited investors in a Rule 506(b) offering prior to September 23, 2013, a self-certification of accreditation status by such investor at the time of sale

in a new offering by the same issuer under Rule 506(c) will be deemed to satisfy the verification requirement in Rule 506(c), although the company may not rely on this exemption if it has actual knowledge that the investor is not accredited.

# III. Structuring Your Event

### *A. Step 1: Determine if your event is a "demo day" or a "pitch event"*

We refer to a "*demo day*" event as one in which companies present their new products or services. A good example of this is New York Tech Meetup, where it's all about the product and they frown upon any discussion of business model and presenting companies do not mention their financing or capital raising.

By contrast, a "*pitch event*" is organized for the purpose of helping the presenting companies raise capital. Now, with the new Rule 506(c), pitching companies will need to decide if they are going to generally solicit funds under the new rule, or use the approach allowed under the old Rule 506(b).

These two types of events can be structured differently to address the different legal implications of demonstrating a new product versus trying to raise funds. Also, within the pitch events, there will be companies wanting to fundraise without general solicitation and those who decide to publicly try to raise funds. The differences among the types of presentations is where event organizers can help by paying attention to the general solicitation regulations and structuring events to provide appropriate environments.

*Demo Days*

For true demo days, where the presenting companies are not actively fundraising and the purpose is to demonstrate a company's products or services (rather than recruit investors), organizers can publicize the event freely and all may attend. The organizers should not mention fundraising in any promotional materials. Each company should be given specific instructions to AVOID mentioning their fundraising efforts and to AVOID presenting their business plans, financial projections, growth rates and other topics typically covered in a fundraising context.

### B. *Step 2: For pitch events, determine if your presenting companies are using Rules 506(b) or 506(c*)

If you are not doing a "demo day" as described above, your event probably falls into the "pitch event" category. For these events, it is important to ask each of your presenting companies whether they are going to be relying on Rule 506(b) (without general solicitation) or Rule 506(c) (with general solicitation). You should also consider getting written confirmation from each presenting company on this point, and encourage them to speak to experienced counsel about it, as many companies at an early stage may not be actively consulting counsel on securities regulations in advance of commencing pitch activities. Attached as Exhibit A is a form of confirmation that can be sent to each company in advance. For pitch events, questions about this

should be included in your application process. For accelerators, companies will need to decide which route they intend to go prior to pitch day.

*Company Application Process*

- Ask each Company to confirm they are familiar with the rules and restrictions regarding soliciting funds. You do not want to be giving them legal advice, but you can suggest they read up on the topic and consult experienced legal counsel.
- Ask whether they will be Rule 506(b) or (c), or whether they plan to use any general solicitation of any sort in their fundraising process (now or later).
- Ask each Company if it has offered securities in the last 6 months and whether general solicitation was used for that offering.

*506(c) Only Events – General Solicitation Expected*

If the companies you plan to include intend to generally solicit (and therefore you expect they will be relying on Rule 506(c)), you can freely invite members of the public (both accredited and non-accredited).

As discussed above, since companies using Rule 506(c) will only be able to sell to accredited investors who have verified their accreditation status, potential buyers may be surprised when asked to do so. You may want to explain that for any planned purchases by the attendees, they should expect to be asked for verification which may include significant financial detail or certification from one of their financial or business advisors.

Have each company confirm it is aware of the consequences of generally soliciting.

If the proposed rules described below go into effect, ask each generally soliciting company to confirm it is making the appropriate regulatory filings and has included appropriate disclaimers and legends on the Company's presenting materials. *See* Exhibit A, discussed more below.

### *C. Step 3: Determine if your event is going to be an "open" or "closed" pitch event*

An "*open*" pitch event is one in which members of the public in general can attend, the event is promoted publicly and often requires payment of a registration fee. From a legal perspective, this is similar to a "demo day" discussed above.

A "*closed*" pitch event is typically only open to accredited investors with a pre-existing relationship to the event organizers, such as a meeting of an angel investor group.

*Closed Pitch Events*

For a closed pitch event, managing the invitation and event promotion process is the key concern. Organizers should take extra care to ensure that the event is not a "meeting whose attendees have been invited by any general solicitation or general advertising." In practice, this means:

- Send invitations only people who are part of your existing network and are known to be accredited investors.
- Obtain a completed accredited investor questionnaire or certification on file for each person receiving an invitation. It is likely that most individuals will not be comfortable sharing the level of data with individual startups or event organizers that would be needed to meet one of the safe harbor verification standards for accredited investor status, so many expect that broker and CPA certifications will become the norm (since they have the investors' financial data already). There are also likely to emerge l third party services consisting of broker-dealers, lawyers, online platforms or others that will specialize in verifying accredited investor status for a fee. Getting out in front of the issue should help streamline future events.
- At registration for the event, organizers should confirm they have a completed accredited investor questionnaire or certification on file prior to admitting the attendee.
- Do not include the event posting on public event listings or otherwise send out invitations to any public forum (i.e., do not list the event on startup digest, Gary's guide, twitter, Facebook, LinkedIn, etc.).
- Do not invite or admit press. All attendees and presenting companies should be informed to not disclose information about fundraising publicly. (i.e., companies should not appear in TechCrunch noting that "they are raising $1 million").

If the event meets these criteria, companies should be able to talk openly about their company, including specifics about the securities offerings, without their participation becoming a general solicitation.

### *D. Step 4: If you are hosting an "open" pitch event, determine if the presenting companies are planning to use Rule 506(b) or (c) and structure your event accordingly*

1. Events for companies relying solely upon Rule 506(b) (i.e., *not* using general solicitation):

These events should be carefully structured to avoid any discussion by companies of their fundraising activities and plans. This means that during the presentation portion of the event:

- The company should not mention anything about their fundraising plans and the following should not be included in a pitch deck or pitch:
    - Any mention that the company is fundraising
    - Discussion of financial projections or results

    - Terms of offering (i.e. convertible note, Series A, valuation, etc.)
- Event organizers should make clear that such material is not allowed and consider reviewing any written presentation material in advance to ensure compliance
- Carefully moderate any open Q&A. Any questions touching on fundraising issues should be handled by the company saying "we are not here to discuss fundraising at this time, but I would be happy to speak to accredited investors offline."

All conversations about financing should happen privately in one-on-one conversations with known accredited investors (and not through publicized opportunities to meet with investors or companies seeking funds) or in a separately-held closed event conforming with the procedures outlined above for closed pitch events. This could include holding a separate dinner or networking portion with a pre-qualified group of accredited investors. If potential investors approach a company, the company can explain it is only selling to accredited investors and screen an investor at that time.

2. Events for companies relying upon Rule 506(c) (i.e., using general solicitation)

If all of the presenting companies turn out be using 506(c) with general solicitation (or you screen them in this way), then you will not need to worry about general solicitation and can freely invite members of the public (both accredited and non-accredited) and the companies will be allowed to pitch, talk about their securities offering and talk about the specifics of their financial model and terms of offering. Companies could even direct investors to invest in real time during the event through an online platform. However, all of the accredited status verification issues discussed above must be addressed because companies may only sell to accredited investors in a Rule 506(c) offering and must meet the accredited status verification standard.

You should ask each company to confirm that it is familiar with the requirements of Rule 506(c), has consulted experienced legal counsel about participation in the event or similar events, and if the proposed rules discussed below are adopted, has included appropriate disclaimers and legends on the Company's presenting materials and has made (or is making) appropriate and timely regulatory filings. *See* Exhibit A for sample language.

*Proposed SEC Rules*

The SEC has proposed additional regulatory requirements on companies using general solicitation under Rule 506(c), including:

- Make an advance Form D filing 15 days before any general solicitation. This means that the company needs to make a filing at least 15 days BEFORE the event. If this requirement comes into effect, event organizers should request a copy of this filing be delivered 15 days prior to the event.
- Attach prescribed legends to the pitch deck or any other written material (this would include any recording of the pitch).
- File any written materials with the SEC on or prior to the date of the event (this generally

means that the pitch deck would need to be pre-filed with the SEC).

As of September 23, 2013, these proposed rules are currently in a comment period and not final. They might never be enacted or could change substantially before they are. Event organizers should be in contact with each company and ask them to consult with counsel before any event to confirm compliance with the latest rules and regulations.

3. Events with both 506(b) and 506(c) companies:

These events create special challenges to event organizers. First, you can run the entire event as if all companies were 506(b) companies and follow the instructions above. Alternatively, you could segregate the 506(b) and 506(c) companies via separate rooms or separate times (e.g., morning is 506(b) only and afternoon is 506(c)). In that case:

- The 506(b) room would only admit investors with a substantial pre-existing relationship with the group and with a completed accredited investor questionnaire on file, preferably received at least 30 days before the event;
- Any public advertisements for the event would not mention the 506(b) time, room or companies;
- The 506(b) invitation should be done in accordance with the instructions above; and
- The 506(c) room and companies may be broadcast publicly and should follow the relevant instructions above.

*Event Series – 506(c) event followed by 506(b)*

From an event organizer's perspective, a practical solution to this problem may be to hold two separate events, with the 506(c) event used to establish a pre-existing relationship with accredited investors, who can then be invited to a subsequent 506(b) event.

Event 1 – 506(c) Companies Only: Hold the first pitch event solely with 506(c) companies allowing for broad promotion. As part of the registration process for the 506(c) event, each accredited investor should complete an accredited investor questionnaire. During the event, the organizers should work to establish a relationship with each accredited investor in attendance.

Event 2 – 506(b) Companies Only: A second event could be held later, preferably at least 30 days after Event 1. The organizers will then be able to invite all of the accredited investors with which they established a pre-existing relationship in the previous 506(c) event. Companies that are relying on 506(b) could participate in this second event if it were run as described above in the section regarding 506(b) offerings.

**NOTE: any company that participates in a 506(c) event – or who generally solicits in any other manner - will be required to comply with the rules of 506(c) even if it later participates in a closed accredited-investor only 506(b) event. In other words, there is no going back to relying upon Rule 506(b) once a company has participated in an event that was structured as a Rule 506(c) event with the public invited, etc.**

*Disclaimer*

For any event, it is a good practice to make it clear that the organization in no way endorses, and has not verified the accuracy of, any of the statements made by the presenting companies. Attached as Exhibit B is a sample disclaimer, which can be included in event materials and/or read at the beginning of an event.

## IV. **Conclusion**

It remains to be seen how all of the final rules will shake out, but it is clear that companies and the groups that manage events where companies and potential investors can interact are going to have to be well prepared and vigilant about keeping current with the new rules and the possible enactment of additional proposed rules.

For further information, please feel free to contact us at kiran@seedinvest.com, trent.dykes@dlapiper or megan.muir@dlapiper.com.

**EXHIBIT A**

**SAMPLE REQUEST FOR ACKNOWLEDGEMENT**

**FOR PRESENTING COMPANIES**

*(Each company applying to present should confirm the following statement is true and check the appropriate boxes below by completing this and returning it to event organizers in advance.)*

By signing below and/or forwarding this email from my email account, I acknowledge and confirm that **[Company Name]** ("Company") and its officers, directors and executive management (including the Company's presenter(s) attending your event) are aware of the rules regarding general solicitation and the Company has been encouraged by you [**Angel Organization/Event Organizer Name**] to consult with experienced legal counsel about applicable securities regulations in advance of participating in your event.

I am the Company's [**Presenter's Title**] and I have consulted with experienced legal counsel about the implications of Rules 506(b) and 506(c).

1. For our current securities offering, the Company plans to rely on the following securities law exemption (check one):

_____ Rule 506(b) and will not be conducting any general solicitation or advertising;

OR

_____ Rule 506(c) and will be conducting general solicitation or advertising

OR

_____Other exemption (please specify here: _____).

2. The Company ____ has / _____ has not (check one) offered securities (debt or stock) in the previous 6 months.

If the Company has offered securities in the past 6 months, general solicitation

___was used / ____was not used / ____not applicable (check one).

[If proposed rules are adopted] On behalf of the Company, I confirm we have made, and will continue to make, the appropriate regulatory filings and have included appropriate disclaimers and legends on our presenting materials.

Signature: _____

Title: _____

Date: _____

## EXHIBIT B

## SAMPLE DISCLAIMER

The information presented here is the sole responsibility of the presenting company. **[Event Organizer]** has not taken any steps to verify the adequacy, accuracy or completeness of any information, materials or statements presented here. Neither **[Event Organizer]** nor any of its officers, directors, stakeholders, agents and employees makes any warranty, express or implied, of any kind whatsoever related to the adequacy, accuracy or completeness of any information presented here.

Each presenting company and investor is responsible for ensuring his/her/its compliance with applicable securities laws.

**[Event Organizer]** does not give investment advice, endorsement, analysis or recommendations with respect to any securities and is not a broker, venture fund or an investment advisor.