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ANGEL INVESTORS OBJECT TO SEC'S REQUIREMENT FOR VERIFICATION OF ACCREDITED INVESTORS

by Dan Lonkevich

Startup companies were supposed to be the main beneficiaries of the new market rule that will end the ban on general solicitation and advertising of common types of private securities offerings, but angel investors, who startups rely on, are in revolt.

The problem, angel investors say, is the rule includes a new requirement that companies issuing securities in private offerings certify that the buyers of those securities meet the Securities and Exchange Commission's definition of an "accredited" investor.

Proving their accredited status could in some cases require angel investors to provide personal financial documents such as W-2 tax forms, tax filings or brokerage statements.

"I don't know about you, but there is no way I am going to give an entrepreneur any of these documents," Marianne Hudson, an angel investor and executive director of the Angel Capital Association, said in a July 15 blog post on the association's website. "Every angel I've talked with about the rules feels the same way. It is a huge violation of our privacy, and how are startups going to have good control of these documents?"

Hudson argued that the rule could "kill angel investment" and that would be contrary to the intent of the very law that is ending the ban on general solicitation.

The SEC was required to lift the general solicitation ban under the Jumpstart Our Business Startups Act, a package of provisions signed into law in April 2012 that was meant to make it easier for small companies to raise capital.

The ban against general solicitation and advertising had applied to private offerings made under Rule 506 of Regulation D of the Securities Act. Securities sold in these offerings are not registered with the SEC. Investment in them is therefore limited to affluent accredited investors to make sure

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NEW SEC INITIATIVES MAY LEAD TO MORE ENFORCEMENT ON PENNY STOCKS, FINANCIAL REPORTING

by Bill Meagher

Three new enforcement initiatives recently announced by the Securities and Exchange Commission are likely to lead to more enforcement actions regarding penny stocks and financial reporting, according to industry observers.

The new Financial Reporting and Audit Task Force, the Microcap Fraud Task Force and the Center for Risk Quantitative Analytics were all announced in a July 2 press statement.

"These initiatives build on the division's unmatched record of achievement and signal our increasingly proactive approach to identifying fraud," Andrew Ceresney,

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the securities are only purchased by buyers who are better able to withstand risk.

The advertising ban that was previously in place was meant to assure that Rule 506 offerings were not marketed to unaccredited investors. So when the SEC voted on July 10 to repeal the ban, it also established the new accredited investor verification requirement to make sure that small investors remain protected. The new general solicitation rule is expected to take effect in September.

Aside from what some see as an invasion of privacy, the new disclosure requirements could put some angel investors at a disadvantage in negotiating the terms of their deals, said Jean Peters, an ACA board member and a Richmond, Va.-based managing director of angel investment group **Golden Seeds**.

Two angel investors — one worth $50 million and the other worth only $5 million — might be treated differently by a startup's management team, which might perceive that the wealthier angel is in a better position to provide more financing in the future, she said.

"The SEC isn't fully aware of the key role angel investors play in providing initial funding for the majority of startups," said David Verrill, chairman of the ACA and co-founder of **Hub Angels Investment Group LLC** in Boston. "While they're opening up the world to general solicitation and advertising, they're also inhibiting the angel investing ecosystem."

Verrill said, however, that after meeting with SEC staff members, he believed that the commission is receptive to angel investors' concerns about the rule.

"They didn't know how angel investing worked, or that membership in a reputable angel group is a good basis for ensuring an investor is indeed accredited" Verrill said. "They tacitly acknowledged they missed a few things, given their short timeline for delivering a ruling. We're optimistic that the SEC can provide sufficient guidance and direction to clarify the situation."

Providing tax documents or brokerage statements were only two of the ways that the SEC suggested that securities issuers could meet the requirement to verify their investors' accredited status.

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> *Hub Angels Investment Group LLC*

The commission also suggested that an issuer could rely on a third party such as a broker-dealer, an attorney, an accountant or a registered investment adviser to handle verification.

Some market observers view this as a potential new business opportunity for the brokerage industry.

Mitchell Littman, a partner with the law firm of **Littman Krooks LLP** in New York, notes that verifying investors' accredited status is already part of the core work that brokers currently do.

"And now they can generally solicit to thousands of potential investors," he said. "Even if they go through the process of qualifying an investor for a deal only to have him bail out at the last minute, they will still have a pre-approved accredited investor for future pitches."

The ACA's Hudson speculated in her blog post, however, that having a broker or other third party verify accredited status will be costly and that it may not be a service that they will want to provide.

She said that angel investors should be allowed to certify their own accredited status by filling out a questionnaire or through membership in a reputable angel investors' group such as the ACA.

Angel investors and the entrepreneurs whose companies they invest in have also expressed other concerns with how the SEC is dealing with the new allowance for general solicitation of private placements.

On the same day that it voted to lift the ban on general solicitation, the commission also proposed a new rule that would require private placement securities issuers to file the written materials they use in their general solicitations with the SEC.

The requirement could prove legally perilous, especially for startup companies whose managers have little experience with regulatory compliance and who may not be able to afford regular legal advice.

"In our world, this is just silly," said Kevin Laws, chief operating officer of **AngelList**, a San Francisco-based website that connects startups and angel investors. "Twenty-two-year-olds don't know anything about securities laws. It's just not going to happen. It creates a potential minefield for tech startups."

The proposal may be particularly ill-suited to companies that use newer forms of media to solicit prospective investors.

"This is written for an issuer that uses a [private placement memorandum] and other official documents," Laws said. "In our world, people raise money off their AngelList profile. Most of our stuff is a comment in an e-mail."

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