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SMALL CAP FINANCING REBOUNDS IN FOURTH QUARTER AS INVESTORS SEEK MORE RISK

by Dan Lonkevich

The small cap and microcap equity capital financing market rebounded in the fourth quarter as unregistered PIPEs, registered directs, confidentially marketed public offerings, initial public and follow-on offerings all rose sharply compared with the year-earlier period's historic lows.

The number of reverse mergers declined 26% and special purpose acquisition company activity was limited to four IPOs and another four that filed to go public.

The latest quarter's results were buoyed by increased investor appetite for small cap and microcap equities, as well as a strengthening U.S. economy, lower unemployment and less uncertainty about tax and fiscal policy after the presidential election. The moribund fourth quarter of 2011 in contrast, was hampered by festering concerns about the European sovereign debt crisis and how it might migrate across the Atlantic.

"The year until the fourth quarter was a tough one for small cap and microcap companies and they were giving money away to larger companies," said G. Christopher Andersen, founder and partner of investment bank **G.C. Andersen Partners** in New York.

G.C. Andersen had one small cap client looking for a PIPE all year finally get it done in the fourth quarter, Andersen said. "It wasn't that the rate had changed. Investors came along and moved a little outside of the risk spectrum. There's money flowing in again. We were kind of encouraged in the fourth quarter. If investors are coming along, 2013 could be a pretty good year."

Andersen was not alone in his assessment of investor's increased tolerance for risk in the fourth quarter and what it may mean for 2013.

"The fourth quarter was much better than last year's fourth quarter, in particular in December, with a real increase in risk appetite for small cap and microcap equities and new issues," said David Bohn, head of

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INVESTOR VERIFICATION STANDARDS LAX AT MANY FINANCING WEBSITES

by Joshua Sisco

A staff member of *The DealFlow Report* gained access to the financing websites **SecondMarket**, **FundersClub**, **CircleUp** and **EarlyShares** as an accredited investor, despite not meeting the proper qualifications.

These and other sites that offer opportunities to invest in unregistered securities are only allowed to sell them to accredited investors. All of the sites granted access, however, with requirements no more stringent than checking a box.

As it stands now, that may not technically be breaking the law.

Currently, under Regulation D of the 1933 Securities Act, a securities issuer

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only needs to have a reasonable belief that an investor is accredited, and for the investor to verify that they have a net worth of at least $1 million or an annual salary of $200,000.

Broker-dealers, meanwhile, are subject to "know your customer" and suitability requirements, meaning that they have a responsibility to match their clients with appropriate investments.

The requirements for both issuers and brokers can be subjective, but under existing standards, self-verification by investors is all that's required, representatives of most of the sites mentioned said.

That could change as the SEC works to relax the rules around marketing of private placements.

The Jumpstart Our Business Startups Act, which Congress passed and President Obama signed last year, will end the ban on "general solicitation" or advertisement to the general public of unregistered securities. The measure is one of several in the JOBS Act meant to give growth-stage companies easier access to capital. It will also allow small investors to buy stock in private companies through so-called crowdfunding over the Internet.

General solicitation of private placement financing hasn't been allowed in the past, out of concern that it would target unsophisticated investors who wouldn't be able to gauge the risks involved in the offerings.

Under the JOBS Act, actual sales of unregistered securities will still mostly be limited to accredited investors, although issuers will be able to advertise their offerings to anyone.

However, the new law requires the Securities and Exchange Commission to make rules to govern general solicitation. The investment portals and other players in the small company financing market are waiting to see how that will play out.

The SEC issued proposed rules for general solicitation last August, for public comment. The proposal was widely criticized for not providing specific enough guidance for how securities issuers should verify that investors are accredited.

The commission hasn't scheduled a vote to approve the controversial proposal and its fate is uncertain. The politics of the SEC are currently in flux, with former chairman Mary Schapiro having stepped down last month and numerous other senior staff members resigning. The commission is now split between two Democrats and two Republicans. President Obama hasn't yet nominated a fifth commissioner to replace Schapiro.

The proposed rule states that securities issuers should have to take "reasonable steps" to assure that only accredited investors buy unregistered securities offered through general solicitation. It doesn't say what those reasonable steps should be.

Market players want a safe harbor, setting out a specific standard for investor verification that issuers could follow and be reasonably sure that they wouldn't be legally liable, even if they were misled by an unaccredited investor.

Checking a Box

But in the meantime, the notion of having a reasonable belief that investors are accredited has evolved into "checking a box," said Mitchell Littman, a securities attorney with the New York law firm of **Littman Krooks**.

However, "The SEC has also said that merely checking a box won't work in a very broad solicitation," Littman said.

SecondMarket spokesman Mark Murphy said that company's verification procedures are evolving but that "if someone is willing to lie all the way through," then it would be possible for an unaccredited person to make investments that they should be barred from.

"I think that it's pretty safe to say that there will be documentation required," Murphy said of the rules that the SEC will eventually enact

About two years ago, SecondMarket changed its investor questionnaire so that it no longer stated the minimum thresholds for accredited status, he said. The questionnaire now simply asks what a person's net worth and salary are.

"Check-the-box is fine for now, but it is pretty minimal at the same time," Murphy said.

Current verification practices are a "huge problem," said Tim Sullivan, President and Chief Executive Officer of Austin, Texas-based **MicroVentures**. "There is a responsibility to call investors who register and verify their information, risk tolerance, time horizons and other investment interests," which he said MicroVentures does.

CircleUp Chief Operating Officer Rory Eakin said that his firm uses a third-party verification service as well as proprietary steps including periodic audits.

FINRA May Not be Pleased

That didn't stop *The DealFlow Report* from gaining access to the CircleUp site as an unaccredited investor.

"We take these issues very seriously and if someone misrepresented themselves to gain access to the site, it is regrettable," Eakin said.

Littman said that it's an aggressive interpretation of the current rules to simply rely on the attestations of an individual, with no follow-up.

In general, "FINRA is likely not pleased," said Sullivan, regarding the Financial Industry Regulatory Authority, which regulates broker-dealers.

FINRA officials couldn't immediately be reached for comment.

Sullivan suggested that the financing portals may be relatively casual about investor verification because some are headed by technology entrepreneurs rather than executives with backgrounds in finance.

"There is a dislocation between the founder, who may be a tech person,

and the broker-dealer they are working with," Sullivan said.

EarlyShares Head of Product Development Etienne Maugain said in an emailed statement that its procedure for having investors themselves attest that they are accredited serves only "as a flagging function."

EarlyShares will contact the investors, if necessary, "upon issuance of the final rules from the SEC," he said. "Reasonable steps will need to be taken to verify that the investor is accredited."

EarlyShares, which bills itself as an equity crowdfunding service, is waiting for equity crowdfunding rules to be enacted by the SEC before it allows investments through its website.

Jack Hogoboom, a securities attorney with the **Lowenstein Sandler** law firm, said he would never advise a broker or company client to rely solely on the representations of an investor.

Even though the websites operate as broker-dealers, they "don't have the same type of client relationships that other brokers have," Hogoboom said. They "may not be obligated to follow the suitability rules in the way that a traditional brokerage would be."

FundersClub CEO Alex Mittal said in an emailed statement that the company "manually" verifies self-reported income and net worth.

However, *The DealFlow Report* only had to fill out an online questionnaire to be approved as an accredited investor for the FundersClub site. When this was brought to FundersClub's attention, spokeswoman Christina Chang said the account was deleted.

In his statement, Mittal also said that "Offline VC industry standards presently call for a check-a-box check." FundersClub exceeds that standard, he said.

"Not only are members administered a multi-question questionnaire prior to registering as a member, each and every time they invest, their accreditation status is reviewed," Mittal said.

Unlike other funding portals, Funders Club isn't licensed as a broker-dealer. The company is exempt from the licensing requirement because it operates as a traditional venture capital investor, according to Mittal.

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