The Deal Pipeline

Regulation

New rules tip the balance

By **Andrew A. Hecht And Jon Morgan** Published Nov-22-2013 ET

In September, new offering rules went into effect permitting private companies to solicit sales of their securities using social media, press releases, live events and other widely distributed materials. There is of course a catch, which is that all purchasers in the offering must qualify as "accredited investors" — and the issuer must take affirmative steps to verify this status. But for many issuers seeking capital, this requirement is a small price to pay for the opportunity to reach a much larger audience of potential investors.

As any banker, lawyer or entrepreneur who has been involved in private placements of securities is aware, the ban on these general solicitation activities has been a bulwark of the federal securities laws for decades. This new ability to use the media and other communication channels to promote offerings has the potential to revolutionize the way private company securities offerings are negotiated and sold and, in some cases, upend the traditional intermediaries in the deal space. While the effects of the recent change in rules are yet to be fully appreciated, and further regulation could shape the ultimate contours, there are three trends that we can expect to see in the coming months.

DEAL TERMS will converge and become increasingly standardized. Private offering terms have long been a murky area, especially in seed-stage financings where terms can vary widely from deal to deal. As issuers go public with their offering plans, their deal terms can also be expected to become public information (whether authorized or not). Once reliable information on the terms of offerings becomes available, other entrepreneurs will watch closely which financings in their industry close successfully, and those deal terms will become the baseline for future deals.

Even before the lifting of the general solicitation ban, some lawyers and industry players (such as the incubator **Y Combinator**) had started to address the inefficiencies in early-stage financings by making available form term sheets and agreements. As deal terms go public, expect this trend toward standardization to continue and accelerate.

The increased transparency will also bring other changes in the private investment space. Private equity firms and activist investors that play in the public arena, where investment agreements often end up filed with regulators and are available to be combed through by their counterparties, have long been attuned to the risk that their past deal terms could be used against them. Repeat players in the private company financing world will need to become more sensitive to this risk as their own deal terms leak into the public realm. This is likely to be a new and unwelcome surprise for investors who are accustomed to the relative privacy of early-stage financings.

ISSUERS WILL SEEK smaller investors. A large group of small investors can be expected to settle for fewer rights than a small group of large investors. Practically speaking, the management and control expectations of a $25,000 investor should be markedly less than those of a $1,000,000 investor. If a company seeking capital can raise it from many small accredited investors without having to offer board representation, registration rights, price-based anti-dilution protection or other similar staples of the venture capitalist playbook, many entrepreneurs will value this "covenant-lite" financing more highly than any connections and technical expertise that large investors may promise. Already many entrepreneurs say they prefer angel investment to venture capital because of the generally more favorable deal terms available with smaller investment amounts. Again, expect this trend to continue and accelerate.

AND ISSUERS WILL WEIGH the costs and benefits of independently marketing their offering against the traditional model of hiring a placement agent. At the risk of oversimplifying, a placement agent is only as valuable as the network of pre-existing accredited investor relationships it can tap to sell an offering. With the lifting of the general solicitation ban for accredited investors, issuers now have the opportunity to bypass placement agents and use direct communications vehicles — public relations and marketing, most notably — to independently reach out to and develop a network of accredited investors to whom they can sell their securities. This network may well include customers of the issuer — who are already familiar with the company and its products/services — whom the issuer can reach easily, but who would be more of a challenge for traditional placement agents.

The best candidates for self-promotion of an offering will be those companies and brands that already enjoy a strong customer base and a well-known presence in the marketplace, but need an integrated public relations campaign to, in a phrase, "get the word out." This means use of traditional public relations tactics (such as press releases), but also controlled vehicles such as a targeted letter campaign and advertising. Of course, smaller and less-established issuers might also be considering similar brand-building campaigns to raise capital in support of their nascent business interests.

A final consideration from a communications perspective is that public relations and other communications resources are more of a traditional fee-for-services model, as opposed to a placement agent for whom payment is contingent upon placing the securities. As early-stage companies consider general solicitation options, this is an important upfront cost consideration.

THE OVERALL IMPACT of these trends is that the balance of negotiating power in private company financing transactions can be expected to shift toward issuers and entrepreneurs. And as a secondary effect, smaller investors can be expected to get access to more attractive deals in the cases where an issuer concludes that a diffuse and disorganized body of small investors makes for a more favorable shareholder group than a club of venture capitalists.

But this does not mean that everything will be easy for entrepreneurs who choose to pursue a general solicitation offering. There are plenty of legal potholes and uncertainties, many of which are just starting to emerge. And the practical difficulties for a small company to manage a large body of investors are not well understood — it would be a disaster to raise the money only to find that the CEO was spending all of her time on investor relations rather than growing the business. And on top of everything, the new rules do not make it any easier to close deals, an art where a skilled adviser can continue to add significant value.

Even as the playing field tilts toward issuers and smaller investors, all is not lost for venture capitalists and other large investors in early stage financings. Among other things, there is a real opportunity for them to use general solicitation offerings to their advantage. For instance, in the case of a portfolio company that needs expansion capital, options have traditionally been limited to putting in more of the investor's own capital, or bringing in new investors who would in turn extract their own pound of flesh. With the new general solicitation regulations, however, that portfolio company might instead think about reaching out to its customers, vendors and other business partners for investment. If the deal is structured in a way that limits the governance rights of the new investors, the new investors get an almost unprecedented opportunity to participate in the company's pre-initial public offering growth, the company can solve its capital problem, and the existing investors can preserve their control.

While "fortune favors the bold," we remain in the embryonic stages of these new securities laws and financing opportunities, and the regulators will be closely monitoring both the channels and messaging that issuers utilize to directly market for new capital. But for smaller issuers, the lifting of the general solicitation requires — at a minimum — being cognizant of this rapidly evolving landscape and what it means for raising and deploying capital.

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