



***Forum on
Small Business Capital Formation:
Evolving Documentation and Diligence
Practices in a New World of Regulation D***

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Wilson Sonsini Goodrich & Rosati is the premier provider of legal services to technology, life sciences, and growth enterprises worldwide, as well as the public and private capital markets that finance them. The firm's broad array of services and practice areas is focused on addressing the principal challenges faced by the management, boards of directors, shareholders, and in-house counsel of our clients. We represent companies at every stage of development, from entrepreneurial start-ups to multibillion-dollar global corporations. Our distinguished international roster of clients are leaders in a wide variety of industries, including information technology, life sciences, energy and clean technology, communications, retail, and financial services.



TROY FOSTER

Partner

Troy Foster is a partner in Wilson Sonsini Goodrich & Rosati's corporate and securities group. His practice touches a wide range of corporate and entrepreneurial clients, including emerging growth companies, venture capital firms, public companies, and investment banks.

Troy's venture practice is primarily focused in the life sciences and clean energy areas, where his clients include Angelica Pharmaceuticals, ArmaGen Technologies, Clean Power Finance, Free Space Solar, Hydra DX, Sutro BioPharma, and Xenon Pharmaceuticals. In addition, Troy has represented several venture firms in connection with their investments in the life sciences sector, including ALTA Partners, Frazier Healthcare Ventures, GBS Venture Partners, Venrock Associates, and Versant Ventures.

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Prior to joining the firm, Troy clerked for the Honorable Alex Kozinski of the U.S. Court of Appeals for the Ninth Circuit from 1999 to 2000.

SELECT TRANSACTIONS:

Represented the following companies in mergers or acquisitions:

- Calibra Medical in its merger with a subsidiary of Johnson & Johnson
- Intradigm in its merger with Silence Therapeutics
- Encenquate in its merger with IBM
- MadVision in its acquisition of the Soul Train assets from Don Cornelius Productions
- Setagon in its merger with Medtronic Vascular
- Intervideo in its merger with Corel
- ParAllele in its merger with Affymetrix
- InterVideo in its acquisition of Ulead
- yellowpages.com in its merger with a subsidiary of BellSouth and SBC
- Hewlett-Packard in its acquisition of Novadigm
- Crystal Decisions in its merger with Business Objects
- Documentum in its merger with EMC
- Synopsys in its acquisition of inSilicon
- E-Stamp in its merger with Learn2.com
- Silicon Valley Group in its merger with ASML
- Viant in its merger with divine

EDUCATION:

- J.D., Columbia University Law School, 1999
Harlan Fiske Stone Scholar; Senior Editor and Staff Member, Columbia Law Review; Contributing Editor, National Black Law Journal
- B.A., English, University of California, Los Angeles, 1993

ADMISSIONS:

- State Bar of California

Key Points

- Regulations and economic conditions have created an environment where it is easier for companies to remain private longer
- SEC's recent general solicitation and "bad actor" rulemakings are helpful, and we welcome additional practical guidance to help guide compliance efforts
- Our presentation focuses on smaller issuers and trading platforms
- Rulemaking has focused largely on primary issuers, but regulators should also consider role of private secondary markets

Rule 506(c) General Solicitation

- Unlike 506(b), Rule 506(c) general solicitation requires issuers to take “***reasonable steps to verify***” that all purchasers are accredited, with reasonableness determined by the facts and circumstances
- Four non-exclusive verification method safe harbors for natural persons
 1. Income Test
 - ▶ Review IRS forms that report income for past two years
 2. Net Worth Test
 - ▶ Review documents of assets and liabilities dated within prior three months
 3. Approved Third Party Certification
 - ▶ Written confirmation from a third party that *they* took reasonable steps to verify status within prior three months)
 4. Pre-Rule Investors

Rule 506(c) Diligence and Documentation Topics

- Representations in purchase agreement and investor suitability questionnaires were arguably sufficient under 506(b), but unlikely to be sufficient under 506(c)
- Safe harbor verification methods, however, require purchasers to disclose sensitive information (e.g., tax returns, brokerage statements) or issuers to rely on third-party certifications that are not yet widely available
- Smaller issuers seek a middle ground: a method more substantive than “check the box,” but less disruptive than obtaining tax returns or a third-party certification

Rule 506(c) Diligence and Documentation Topics

- Safe harbors are preferred—law firms will require for legal opinion purposes
- Costs to verify accredited investor status is a key factor for smaller issuers
- Additional guidance around existing safe harbors would be useful:
 - How much documentation will issuers be required to keep and for how long?
 - Will there be increased scrutiny by SEC on existing practices (*e.g.*, demo days)?
- Suggestion: More liberal safe harbors for smaller rounds (sub-\$1M)
- Provide for accreditation verification through trading platforms

Rule 506(c) Diligence and Documentation in Practice

- In practice, we have bolstered accredited investor representations in both 506(b) and 506(c) offerings
- We distribute accredited investor questionnaire with requests for safe harbor documentation
- Developing areas of practice:
 - May request backup certification from management regarding general solicitation or the lack thereof, for providing legal opinions
 - Creating record of accreditation investigation; what is sufficient?

Bad Actor Provisions in Rule 506(d)

- Presence of “bad actors” in an offering disqualifies use of **BOTH** Rule 506(b) and Rule 506(c) offerings
- Covered persons and disqualifying events are broadly defined
- In practice, these provisions are significant: 2,578 “bad actors” from 2007-2011 (in SEC-related matters)
- As a diligence matter, “bad actor” issues must be vetted in advance of financing
 - Evaluating covered persons
 - Hiring officers
 - Appointing directors
 - Soliciting investors

Rule 506(d) Diligence and Documentation Topics

- Are there procedures that an early-stage company can implement to satisfy the standard of reasonable care? How much factual inquiry will be considered sufficient?
- In practice, rule clarification will be needed to support legal opinions
 - How much involvement amounts to “participating in the offering”
 - Transitory or incidental involvement appears insufficient, but firms will be unlikely to opine in the absence of clarity
- Smaller issuers must be able to navigate “bad actor” rules efficiently to avoid impairing access to capital

Rule 506(d) Diligence and Documentation Topics

- Suggestions for additional safe harbor provisions:
 - Provide an exemption where an issuer has performed a background check which does not yield “bad actor” results
 - Permit platforms to perform the vetting process on behalf of issuers
- Additional Recommendation: Maintain an online database of “bad actors” to allow easy, efficient searching and access

Rule 506(d) Diligence and Documentation in Practice

- Bad actor questionnaires from financing participants
- In deal documents:
 - “No bad actors” representation from issuer and investors
 - Notice obligations if someone becomes a bad actor
 - Restrictions on transfer to bad actors
- Voting agreements limiting bad actor designees, and creating ability to remove bad actor directors and officers
- More controversial:
 - Removing rights from investors if they’re a bad actor, e.g., right of first refusal (prevent accumulation beyond 20%)
 - Creating right to buy back shares from bad actors to below 20% to reduce holdup risk

The JOBS Act Has Made It Easier and More Attractive for Companies to Remain Private

- Companies will be able to hire and incentivize more employees and have a greater number of investors, all while remaining private
- As the time from investment to IPO increases, there will be increased demand for private market liquidity

Secondary Market Discussion Topics

- Current rulemaking is focused on enhancing rules around primary issuances
- May be beneficial also to consider how to develop robust, well-regulated private secondary markets, which could serve as “on-ramp” to public markets
- Suggestions:
 - Consider Rule 144 amendments to make secondary trades easier, such as eliminating holding periods provided that the transferee is accredited, and covered security status for such trades

Conclusion

- Practitioners and issuers have moved quickly to integrate “bad actor” rules and accreditation verification requirements into their practices and business decisionmaking
- As rulemaking proceeds to protect an expanding pool of investors, we suggest that regulators remain mindful of (i) clear avenues to compliance, including safe harbors where appropriate; and (ii) the minimization of compliance costs for smaller issuers
- Regulators should also consider how private secondary markets fit into goal of increasing small business access to capital