

“Angel” Investors: Using the Internet in the Private Offering of Securities

By Brian C. Bonner and Laura H. Huggins

In the jargon-filled world of financial markets, “angels” are wealthy individuals who provide equity capital to start-up companies. Recent projections estimate that angels inject more than \$50 billion into young companies each year—more than twice what venture capital firms contribute. Emory Thomas Jr., *Bands of “Angels” Get Organized* (visited February 1, 2000) www.msnbc.com/news/304203.asp?cp1=1.

While angel investing has been a vital source of capital in this country over the last century, the Internet is making access much more readily available. For instance, companies such as Garage.com, DirectStockMarket (www.DSM.com), Nvst.com and IPOnet (www.e-IPOnet.com or www.Rule506.com) are operating Web sites that enable potential investors to connect with entrepreneurs. In essence, these sites provide a financial market dating service in cyberspace.

This expansion of angel investing through the Internet raises two issues. First, how can this method of raising equity capital benefit South Carolina businesses? Second, how can businesses lawfully take advantage of the Internet to raise equity capital?

THE CHALLENGE OF THE SEED CAPITALIZATION

Because capital is the lifeblood of any business, whether a start-up company or a more fully developed enterprise, access to capital is critical. Capital acquisition is almost always undertaken in specific stages over the

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life of the enterprise. The most common sequence of these stages is based on the ease of the start-up company’s access to the capital source.

A start-up company typically begins obtaining funds through the entrepreneur’s personal funds, then seeks funding from the entrepreneur’s friends and family. As the need for additional funding arises, entrepreneurs look to wealthy and sophisticated strangers, or “angel” investors, but this avenue will only be lucrative if the enterprise is able to attract angels’ interest. If unable to attract angels, the start-up company will often pursue traditional venture capital sources or possibly a joint venture with a more fully capitalized partner. Alternatively, if the entity is especially fortunate, it may have enough market promise to vault over the venture capital stage and proceed directly to an initial public offering.

As the investor audiences at each of these successive stages become further and further removed from a connection with the enterprise and its founders, being able to adequately demonstrate and communicate a compelling investment opportunity becomes ever more critical for the enterprise. However,

demonstrating such an opportunity can be difficult to accomplish without a record of performance that is traditionally only developed and realized over time—usually several years. For this reason, a start-up enterprise is rarely able to skip more than one of these stages in its capital evolution.

Public Offerings. Regardless of the zeal exhibited by many entrepreneurs conceiving of an initial public offering, a public offering is almost always impractical for a start-up company. Because a public offering involves the offer of securities to a very large number of investors without regard to their individual levels of sophistication, the success of the offering invariably depends on the ability of third party selling agents (typically one or more investment bankers) to sell the company’s securities, either on a “firm commitment” or “best efforts” basis.

The selling agent’s success, in turn, depends on whether the company’s investment potential is attractive enough to make investors part with their money. As noted above, the absence of any track record makes communication of the compelling investment opportunity very difficult for the start-up enterprise. Public



Photo by George Fulton

offerings are also very expensive and time consuming, requiring the services of accountants, attorneys and selling agents in preparing registration and disclosure documents that must pass a rigorous review by the U.S. Securities and Exchange Commission (SEC), typically involving the filing of several amendments over the course of several months. Consequently, start-up companies are limited in their ability to

successfully pursue this avenue of equity capital until much later in their capital evolution.

Friends and Family. Although family members are often the first individuals that entrepreneurs contact for capital, the pool of friends and family is frequently quite limited and offers insufficient funding to meet the ongoing needs of many start-up companies. Furthermore, embroiling friends

and family in a risky, fledgling company can often aggravate the already stressful operating atmosphere of the enterprise.

Traditional Venture Capitalists. The start-up enterprise that has either abandoned or exhausted its capital opportunities from friends and family, but still finds itself not quite ripe enough for an initial public offering, is basically left with the choice between

pursuing traditional venture capital sources or wealthy and sophisticated "angels."

In most cases, these alternatives can present a very unattractive choice or no choice at all because traditional venture equity capital is often not readily available for start-up companies. This lack of access is due, in part, to the venture capital firms' minimum annual revenue requirements for the start-up enterprise and the gravitation of these firms to offerings larger than the typical \$500,000 to \$1 million seed capitalizations of start-up companies. In addition, although venture capital firms provide a network of contacts for entrepreneurs, many start-up companies are not willing to relinquish the managerial control or substantial ownership of the company that venture capital firms almost always require.

"Angels." The "capital gap" between friends and family and the traditional venture capitalist (or the initial public offering) is littered with the remnants of many, if not most, start-up companies. Applying the term "angel" to the group of investors willing to help bridge this gap is consequently apropos.

Because the ability to reach these angel investors in many cases means the difference between the success or failure of the enterprise, managements are compelled to devote tremendous time and energy to the angel investor search. This search usually involves spending days and weeks away from the enterprise holding meetings with and giving presentations to potential investors—most often with disheartening results.

This drain on management and its already limited resources always occurs to the detriment of the very entity whose need for management participation is as great as its need for capital. With the advent of the Internet, however, the start-up entrepreneur may finally have a less painful means to seek out and seize the angel investor, helping to bridge the "capital gap."

THE BENEFITS OF INTERNET PRIVATE PLACEMENTS

Because the Internet has become ubiquitous, it can provide the start-up

company with a relatively simple vehicle to access a large number of potential investors seeking to invest in start-up companies. To assist these companies in their search for angel capital, companies like Direct Stock Market and Nvst.com have emerged to operate Internet sites that pool angel investors nationwide and worldwide.

Because these sites are visited by investors who have expressed a specific desire to invest in start-up companies, they reduce a company's dependence on traditional venture capital firms and bring together entrepreneurs with individuals actively seeking investment opportunities. Furthermore, while a traditional venture capital or investment banking firm may assist in raising capital, very often the contacts of the venture capitalist or investment banker are regionally concentrated, limiting the pool of potential investors.

If the venture capitalist or investment banker does have contacts with a national network of potential investors, the cost could likely be prohibitive for the majority of South Carolina seed capitalizations. Thus, the Internet allows start-up companies the option to undertake a private offering of securities, on a national or international scale, without the loss of the managerial independence often associated with utilizing a traditional venture capital firm and usually at a much more attractive price.

The Internet can also increase the speed of an offering to angel investors. Offering materials can be downloaded or viewed online, placing the materials almost instantly in the hands of qualified, potential investors. With the competition among start-up enterprises for seed capital growing, this speed could prove critical for companies desiring to commit investors to fund their operations.

This electronic transmission of materials reduces the traditional expenses of printing, binding and mailing the offering materials. Using the Internet may also facilitate the execution of subscription materials and offer the potential of electronically routing subscription funds directly to escrow accounts. Michael D. Stovsky, *Private Securities Offerings on the Internet* (visited March 17, 2000) www.cyberlaw.com/

privoff.html. These technological advances should decrease the costs of ministerial offering tasks and increase the speed with which such tasks can be accomplished.

However, one would be wise to advise clients upfront that besides the potential cost savings in ministerial offering tasks, the Internet most likely will not reduce the legal fees implicit in offerings to angel investors. Using the Internet to disseminate materials does not reduce or eliminate in any way the need for counsel to conduct thorough due diligence and to draft precise, comprehensive and accurate disclosure and subscription documents.

Regardless of the medium used, any disclosure to investors is still subject to compliance with Rule 10b-5, § 12(a)(2) and § 17 of the Securities Act of 1933 ('33 Act), which impose liability for untrue statements of material fact, omissions of material fact and other deceptive and fraudulent activities. In addition, certain favorable exemptions from the registration requirements require specified types of disclosure documents. Consequently, the disclosure and subscription documents and legal due diligence still require substantial time and effort.

POTENTIAL EXEMPTIONS FROM REGISTRATION

In all but the public offering stage, the harvesting of investment capital is accomplished through what are commonly referred to as "private offerings" or "private placements." These offerings, whether to friends, family, angels or venture capitalists, are tailored to take advantage of various exemptions from the public offering registration requirements.

As discussed below, a number of methods for conducting a private placement exist, each possessing advantages and disadvantages, especially in the context of Internet use, that must be weighed by client and counsel. Possible exemptions from the registration requirements of the '33 Act include: Regulation A (Reg A); § 4(2) of the '33 Act; and Regulation D (Reg D), which encompasses Rules 504, 505 and 506.

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Regulation A. Section 3(b) of the '33 Act authorizes the SEC to create exemptions involving offerings where the amount of the offering does not exceed \$5,000,000. The SEC created such an exemption by promulgating Reg A, which exempts from registration public offerings that do not exceed \$5,000,000 (including no more than \$1,500,000 offered by all selling security holders) in any 12 month period. 17 C.F.R. § 230.251(b). Pursuant to Rule 254(a) of Reg A, issuers may solicit potential investors for indications of interest via written documents and television and radio broadcasts. 17 C.F.R. § 230.254(b).

Solicitations for indications of interest via the Internet should also be permissible for Reg A offerings. See SEC Technology Report, at 15; Angel Capital, 1996 SEC No-Action Letter, LEXIS 812 (Oct. 25, 1996). However, such solicitations for indications of interest must state, among other required disclosures, that no money is being solicited or will be accepted until an offering circular qualified by the SEC has been delivered to the investor. 17 C.F.R. § 230.256(b)(2).

In addition to the potential disadvantage of limited offering amounts, Reg A imposes other conditions, including without limitation the requirement that issuers must file an offering circular with the SEC prior to making any offers. 17 C.F.R. § 230.253(a). The circular must contain substantially all of the narrative and financial information required by Form 1-A, a comprehensive form required for certain public offering registrations. Although the Reg A disclosure Form 1-A was intended to provide an abbreviated mode of registration, the detail required in its completion is extensive. The issuer must also file a Form 2-A summarizing the status of sales and use of proceeds every 6 months following the date of qualification until all sales are consummated and proceeds applied or until the offering is terminated. 17 C.F.R. § 230.257.

In summary, while Reg A provides an avenue for issuers to generally solicit potential investors without regard to their sophistication, which would prove beneficial for Internet private placements, the "shortened" form of registration and the periodic notice filings with the SEC on Forms 1-A and 2-A impose disclosure burdens that may be undesirable or cost prohibitive for many businesses.

Section 4(2). Prior to the adoption of Reg D, many issuers looked to § 4(2) of the '33 Act as their basis for exemptions from registration. See Larry D. Soderquist, *Understanding the Securities Laws* 130 (3d ed. 1998). Section 4(2) exempts from registration transactions by an issuer not involving any "public offering." "Public offering" is not defined in the '33 Act. Consequently, a myriad of court decisions and SEC releases have attempted over the years to outline more specifically the parameters of this exemption.

In *Securities Exch. Comm'n v. Ralston Purina*, the U.S. Supreme Court focused on whether offers and sales were made to sophisticated offerees and purchasers who have access to information similar to that information that would be contained in a registration statement. 346 U.S. 119, 123 (1953). If such access exists, then the offerees and purchasers are less in need of the protective disclosures required in a "public" offering. Consequently, such offers and sales may be exempt pursuant to § 4(2). However, even offering the securities to one individual who is later deemed to be unable to "fend" for himself or herself (because of lack of access to financial information, for example) destroys the § 4(2) exemption. *Id.* Because of the difficulty in limiting not just sales—but offers as well—to sophisticated potential investors, many issuers find relying solely on § 4(2) to be less than desirable. See Soderquist at 130.

Regulation D. Reg D, promulgated by the SEC under the statutory authority

of §§ 4(2) and 3(b) of the '33 Act, exempts three categories of offerings of securities by an issuer from registration. First, Rule 504, which is promulgated under the authority of § 3(b) of the '33 Act, exempts offerings by an issuer of up to \$1 million in securities. 17 C.F.R. § 230.504. Purchasers need not meet any sophistication or other suitability test, and no limit exists as to the number of purchasers. *Id.*

Additionally, as with Reg A, Rule 504 issuers may generally solicit and advertise their offerings if the offerings are (i) registered under state law requiring public filing and delivery of a disclosure document to investors before sale or (ii) exempted under state law permitting general solicitation and advertising so long as sales are made only to accredited investors. 17 C.F.R. § 230.504(b)(1). Despite this potential for general solicitation, which could prove quite beneficial in this Internet age, issuers must still comply with state blue sky laws by either registering with each state in which the issuer offers securities for sale or by finding a separate state exemption for the offering. These state compliance issues often severely restrict or eliminate many of the advantages of Rule 504.

Second, Rule 505, also promulgated under the statutory authority of § 3(b) of the '33 Act, exempts offerings by an issuer of up to \$5 million in securities to any number of "accredited investors" (hereinafter defined) and up to 35 non-accredited investors. 17 C.F.R. § 230.505. In general, to be deemed an "accredited investor," as such term is defined in Rule 501(a) of Reg D, for purposes of Rule 506, an investor is: (i) a natural person whose individual net worth (i.e., total assets in excess of total liabilities) or joint net worth with that person's spouse, at the time of the purchase exceeds \$1,000,000; (ii) a natural person who has an individual income in excess of \$200,000 in each of the two most recent years or joint income with the person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same level of income in the current year; or (iii) an entity having

total assets in excess of \$5,000,000 not formed for the specific purpose of acquiring the securities offered. 17 C.F.R. § 230.501(a).

Rule 505 imposes no other suitability qualifications on the 35 or fewer nonaccredited investors. However, unlike Rule 504, issuers are always prohibited from offering or selling the securities by any form of general solicitation or general advertising, including, but not limited to “any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio.” 17 C.F.R. § 230.502(c). Additionally and like Rule 504, issuers must still comply with state blue sky laws by either registering with each state in which the issuer offers securities for sale or by finding a separate state exemption.

Finally, Rule 506 exempts offerings of unlimited dollar amounts of securities to accredited investors and 35 nonaccredited investors. Unlike Rule 505, nonaccredited investors in a Rule 506 offering must be “sophisticated” or have a “sophisticated” purchaser representative. 17 C.F.R. § 230.506(b)(2)(ii). Sophistication generally means that the issuer reasonably believes that the individual or his or her representative “[h]as such knowledge and experience in financial and business matters that he is capable of evaluating . . . the merits and risks of the prospective investment.” 17 C.F.R. § 230.506(b)(2)(ii). Additionally, unlike Rule 504 and Reg A and like Rule 505, no general solicitation and advertising is permitted for offerings exempt based on Rule 506. 17 C.F.R. § 230.502(c).

However, unlike Rule 504, Rule 505 and Reg A, issuers relying on Rule 506 have less concern regarding complying with state blue sky regulators. This lack of concern is attributable to the National Securities Markets Improvement Act of 1996 (NSMIA), which states that “[e]xcept as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof . . . (2) [s]hall directly or indirectly prohibit, limit, or impose any conditions upon the use of (A) [w]ith respect to a covered security . . . , any offering document that is prepared by

or on behalf of the issuer” 15 U.S.C. § 77r(a) (1999).

The definition of a covered security includes a security “with respect to a transaction that is exempt from registration . . . pursuant to Commission rules or regulations issued under Section 4(2)” § 77r(b)(4)(D). Consequently, no state can impose any conditions on the offering document for securities offered for sale in a Rule 506 exempt transaction because Rule 506 was promulgated under the authority of § 4(2). No similar preemption is available for SEC rules promulgated under the authority of § 3(b), as are Rules 504 and 505.

PRIVATE PLACEMENTS USING RULE 506

Because of NSMIA’s obviation of some duplicate regulation by the SEC and state regulators and because an unlimited dollar volume can be raised from an unlimited number of accredited investors, Rule 506 of Reg D is an exemption from registration frequently relied on by lawyers and businesses.

As discussed above, the Internet offers an avenue for issuers to be more efficiently connected with wealthy angel investors who would qualify as “accredited investors.” Instead of being limited to wealthy individuals in South Carolina or the Southeast who qualify as accredited investors (and therefore control the prospects for equity capital through private placements in South Carolina), start-up companies now can connect with potential accredited investors nation and world wide.

The benefits of the Internet coupled with the unlimited dollar amount and federal pre-emption characteristics of Rule 506 seemingly open the door to a myriad of possibilities for South Carolina businesses desiring to offer securities to investors without the time and expense of completing a federal registration statement.

However, while the qualities of Rule 506 make it generally attractive for issuers wishing to qualify for exemption from registration, the ban on “general solicitation” or “general advertising” of the offering makes Rule 506 private placements over the Internet problematic. The SEC, through a series of no-action letters, has outlined a specific

procedure for allowing the private placement of securities over the Internet without violating the ban on general solicitation or general advertising. Failure to follow the framework approved by the SEC will destroy the Rule 506 exemption and trigger the SEC registration process.

STRUCTURING THE RULE 506 INTERNET PRIVATE PLACEMENT

Strict adherence to the two no-action letters outlined below is critical because the SEC has previously held that the placement of private offering materials on the Internet that are publicly accessible does indeed constitute general solicitation and general advertising, thus eliminating the availability of an exemption from registration based on Rule 506. Securities Act Release No. 7233, Fed. Sec. L. Rep. (CCH) ¶ 3200, at 3131-7 (Oct. 6, 1995). Thus, in order to conduct a Rule 506 offering utilizing the Internet, the issuer and the issuer’s lawyer should become intimately familiar with the following no-action letters.

IPOnet No-Action Letter. On July 26, 1996, the SEC issued a no-action letter to IPOnet, a company engaged in the facilitation of Internet-based public and private securities offerings on behalf of issuers. IPOnet, SEC No-Action Letter, [1996-97 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252, at 77,270 (July 26, 1996).

IPOnet established a home page and other link pages on the Web, with a section entitled “Accredited Investor.” A person could become registered as an accredited investor with IPOnet by completing an online questionnaire relating to that person’s status as an accredited investor within the meaning of Rule 501(a) of Reg D. Under the IPOnet framework, a registered broker-dealer then verified the reported information; and if deemed qualified as an accredited investor, that investor would be given a password that permitted the investor access to a password-protected page on IPOnet’s site. Accredited investors would then be permitted to participate in private offerings of securities of various issuers posted on IPOnet, but only in those offerings

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posted after the investor registered and was qualified. *Id.* at 77,272.

IPOnet relied on a previous, “pre-Internet” no-action letter, *H. B. Shaine & Co.*, to support its request. There, the SEC stated that it would not recommend an enforcement action where Shaine planned to circulate offering materials to prospective accredited investors after such investors were deemed accredited. Shaine determined accredited status by having potential investors complete questionnaires designed to evaluate each potential investor’s sophistication and financial resources.

The SEC reasoned that the circulation of such offering materials would not equal a general solicitation or general advertisement for purposes of Rule 502(c) of Reg D because the questionnaire established a prior business relationship between Shaine and the potential investors. *H.B. Shaine & Co.*, SEC No-Action Letter, 1987 WL 107907, at *2 (May 1, 1987).

Because IPOnet’s proposed procedure was arguably indistinguishable from the *Shaine* scenario except that its distribution of the questionnaire and subsequent distribution of private offering materials would be by electronic rather than paper means, the SEC granted IPOnet’s request for a no-action letter. The SEC reasoned that the qualification of accredited investors and the posting of private offering materials in a password-protected page on the Internet accessible only to IPOnet members who have qualified as accredited investors would not involve any form of general solicitation or general advertising. Key to the SEC’s position were the facts that: both the invitation to complete a purchaser questionnaire used to determine whether an investor was accredited and the questionnaire itself were “generic” in nature and did not reference any specific transactions posted or to be posted on the password-protected page; the password-protected page was available to a particular investor only

after a determination was made that the particular investor was accredited; and a potential investor could purchase securities only in transactions that were posted on the password-protected page after that investor qualified as an accredited investor with IPOnet.

Lamp Technologies (Lamp I) No-Action Letter. The SEC took a similar position in *Lamp Technologies, Inc.* SEC No-Action Letter, [1997 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 77,359, at 77,804 (May 29, 1997). The practice being utilized in *Lamp* was the posting of information by hedge fund managers on a Web site administered by Lamp Technologies. Lamp Technologies did not provide investment advisory services to any of the funds listed on its site and did not act as an agent for any of the funds or of the subscribers to the site. In short, like IPOnet, Lamp Technologies was a clearinghouse entity entirely separate from the issuers offering securities utilizing its site.

The procedure Lamp Technologies used for soliciting subscribers paralleled that procedure used in IPOnet: subscribers would be pre-qualified as accredited investors and given a password necessary to access the site. However, unlike the IPOnet scenario, Lamp Technologies imposed a 30-day waiting period after qualification before an investor could purchase securities of a posted hedge fund. Once the waiting period was satisfied, the accredited investor could invest in hedge fund offerings posted before or after the investor was screened and approved.

As in the IPOnet No-Action Letter, the SEC responded that “the qualifications of accredited investors in the manner described and the posting of a notice concerning a private fund on a Web site that is password-protected and accessible only to subscribers who are pre-determined by Lamp Technologies to be Accredited Investors would not involve a ‘general solicitation’ or ‘general advertising’ within the meaning of rule 502(c) of Securities Act Regulation D.” *Id.* at 77,809.

CONCLUSION

The private placement of securities over the Internet offers an exciting opportunity for businesses to bridge the often lethal “capital gap” by quickly accessing angel investors from across the globe without relinquishing managerial control through an affiliation with a venture capital firm. However, this independence and greater access requires careful planning and tailoring to ensure that private placements do not run afoul of federal and state securities laws.

For instance, although Rule 506 appears to be the most favorable exemption for Internet private placements due largely to the pre-emption of state blue sky laws contained in NSMIA, the ban on “general solicitation” and “general advertising” poses certain obstacles that must be overcome before Internet utilization in Rule 506 transactions comports with the law. While the *IPOnet* and *Lamp I* No-Action Letters offer guidance for issuers considering utilizing Rule 506 and the Internet, these No-Action Letters protect only those entities or individuals requesting the letters—the SEC reserves the right to reach different conclusions based on different facts.

Additionally, businesses and their counsel must note that the SEC has not taken a position on the placement of private offering materials on the Web site of an issuer. The *IPOnet* and *Lamp I* No-Action Letters both addressed the scenario in which a firm independent from the issuer acted as a clearinghouse, or dating service, to facilitate the meeting of issuer and investor. Consequently, the most advisable course of action under current law is to use a commercial Web site operator, independent from the issuer, to facilitate Rule 506 private placements over the Internet.

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