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“Stealth Mode” Venture Capital Financings and the Pending Jobs Act Regulations

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Emerging technology companies frequently prefer to withhold information about recent financing events for a variety of reasons. They may feel that it would be best not to tip off competitors about their newfound war chest. Or they may simply decide that it is best to wait and combine the press release of an announcement of the financing with additional news of interest to the industry, such as the arrival of a new senior executive or the release of a new product. This desire to maintain confidentiality with respect to a financing event sometimes creates a conflict between the preferred timing of the company’s press release on the one hand, and full compliance with applicable securities laws on the other—in particular, the filing of Form D as required under Rule 506 of Regulation D (“Regulation D”) promulgated under Section 4(2) (“Section 4(2)”) of the Securities Act of 1933 (the “Securities Act”). As a result of certain pending regulations, the late filing of a Form D may soon have more serious implications for issuers, and any company selling securities needs to factor in these implications when weighing the benefits of remaining in stealth mode against the costs of non-compliance.

Regulation D provides certain safe harbor rules which allow issuers to conclude with relative certainty that stock sales meeting the criteria of Regulation D are exempt from registration under the Securities Act. This is critically important because in the absence of an exemption, the stock would need to be registered, and registration is an expensive and time consuming process. As a result, these safe harbor rules are heavily relied upon by issuers to ensure compliance under the Securities Act. When a company has issued stock in a venture financing in reliance on one of the safe harbor exemptions found in Regulation D, the company has an obligation to file a Form D disclosing the financing within 15 days of the closing. These Form D filings immediately become a matter of public record. The media monitors these public records and the information the media is able to extract from these filings is often used as the basis of articles that are published in various media within days of the filing of the Form D. This is typically done without the company’s participation or knowledge. In doing this, the media frustrates the company’s desire to remain in stealth mode. While it is always advisable to fully comply, in order to prevent the media from reporting the financing ahead of the company’s communication plan, companies often choose to file Form D’s later than 15 days after the closing and contemporaneous with their own press release. Even though the filing is late, under current Rule 506 the late filing does not preclude reliance on the Rule 506 exemption.

Under a pending set of sweeping changes to Regulation D being promulgated under the Jumpstart Our Business Startups Act (the “JOBS Act”), the practice of late Form D filings could have much more severe implications for a company by impairing the company’s access to capital in the future. One of the goals of the Securities and Exchange Commission (the “Commission”) that is evident in these pending rule changes is the Commission’s desire to create incentives that promote compliance with Form D filing requirements. Toward this end, the new rules include an amendment to Rule 507 of Regulation D that would disqualify a company automatically from relying on Rule 506 for one year for any future financings if the issuer (or a predecessor or affiliate) failed to comply during the last five years with Form D filing requirements in any Rule

506 offering. This means that the failure to file a Form D in a timely manner would render Rule 506 unavailable for that issuer for one year. In certain scenarios, the inability to rely on Rule 506 for one year could make it difficult for the company to lawfully raise capital during that one year period. This could significantly impact the company's ability to execute its business plan.

While the new regulations are pending at the current time, companies should begin to plan for the possibility that they may be operating under this new regime in the near future. With this in mind, companies and their counsel should consider all of their options. The simplest and safest approach would be to better plan the company's communications strategy so that a press announcement can be released by the company during the 15 day notice period required for the filing of the Form D. This way the company can comply with Regulation D by making a timely filing and not jeopardize access to Rule 506 in the ensuing year. Another alternative is to look at other available exemptions that might be applicable and that would eliminate the need to file the Form D in the first instance. The more general exemption under Rule 4(2) of the Securities Act is the most obvious alternative, and in many situations legal counsel should likely be able to conclude that the 4(2) exemption is sufficient. A third option would be to rely on 506 and make a late filing as necessary, realizing that under the proposed rules this will preclude access to certain sources of capital for the next year.

For more information on this topic, please contact **Jonathan D. Gworek**.