New SEC rules on private offerings

October 2014

by Michael J. Hagan,
Fox Horan & Camerini LLP
(www.foxhorancamerini.com)

A major overhaul of the legal regime governing private securities offering was launched with the enactment of by the Jumpstart Our Business Startups Act (JOBS Act) in 2012 and the regulations that followed in 2013 and are anticipated in 2014.[1] The JOBS Act mandated the Securities and Exchange Commission (SEC) to promulgate amendments to the regulations on private offerings (often made under Regulation D) in order to, among others, allow companies to use "general solicitation" and "general advertisement" to solicit investors in certain kinds of private placements of securities[2].

The JOBS Act also introduced, for the first time, the concept of capital formation through "crowdfunding" ventures – a new method of raising capital through the Internet, usually by obtaining small subscriptions from a large number of investors. The JOBS Act established the basis for a regulatory structure that permits small businesses and startups to raise capital through crowdfunding, and directed the SEC to adopt rules in connection with this method of raising capital through the Internet.

On July 10, 2013, the SEC adopted rule changes to comply with the JOBS Act, including the amendment to Rule 506 to permit general solicitation and general advertising in private securities offerings made in reliance on that rule. As a result, offers and sales exempt under Rule 506, as revised to permit general solicitation, will not be considered public offerings under federal securities laws[3]. In addition, on October 23, 2013, the SEC published the proposed rules to address the questions associated with "crowdfunding" by smaller issuers that seek to access capital by tapping investors via website postings. The period for comments to the proposed rules addressing crowdfunding ended on February 3, 2014. So far, the SEC has not yet issued final rules on

[1] This note does not constitute formal legal advice, and the reader may not rely on the discussion in this note as the legal basis for any offerings or solicitations, or other actions. You should consult with legal counsel before undertaking any of the actions referred to in this note.

[2] The terms "general solicitation" and "general advertisement" are not defined in Reg D, but Rule 502(c) provides examples of what constitutes them, including, but not limited to, advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars where attendees have been invited by such means. The SEC has also confirmed that the use of unrestricted websites also constitutes general solicitation and general advertising.

[3] Reg D consists of Rules 501 through 506, inclusive.

crowdfunding and, at present, issuers seeking to raise funds via the internet must fit their offering within one of the existing paradigms available under Reg D, often relying on Rule 504 governing offerings that do not exceed one million dollars.

This note provides a brief overview of the changes to the Rule 506 and other relevant changes to rules in connection with Rule 506 offerings, and some of the anticipated changes to market practices that may accompany the final crowdfunding rules.

Regulation D

Since it was first promulgated in 1982, Regulation D (Reg D) has been a leading basis for issuers seeking to raise capital via private placements, by providing for exemptions from registration requirements for securities issuers, subject to compliance with the terms of Reg D (Rules 504, 505 and 506)[4]. In addition to encouraging issuers to restrict offerings to a class of sophisticated investors known as "accredited investors"[5], a key aspect of Rule 506 was the prohibition on general advertising and general solicitation.

On July 10, 2013, the SEC adopted amendments to Reg D, which, among other things, eliminated the general advertising and general solicitation prohibition as long as all of the purchasers are accredited investors and the issuer takes "reasonable steps" to verify that those purchasers are accredited investors at the time of the sale. The rule permitting general solicitation became effective on September 23, 2013 and is codified as Rule 506(c).

Crowdfunding

As mentioned above, the JOBS Act introduced the concept of raising capital through crowdfunding and directed the SEC to issue rules on the subject. On October 23, 2013, the SEC released the proposed rules on crowdfunding, providing an exemption from the registration requirements for certain crowdfunding transactions. The period for comments on the proposed rules ended on February 3, 2014 and, so far, the SEC has

[4] Rule 506 permits sales to an unlimited number of accredited investors and up to 35 unaccredited investors.

[5] "The definition of accredited investors applicable to Rule 506 is set forth in Rule 501(a) of Regulation D and includes any person who comes within one of the definition's enumerated categories of persons, or whom the issuer "reasonably believes" comes within any of the enumerated categories, at the time of the sale of the securities to that person. For natural persons, Rule 502(a) defines an accredited investor as a person: (1) whose principal net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence ("the net worth test"); or (2) who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has reasonable expectation of reaching the same income level in the current year (the "income test")."

not yet announced whether it will adopt those rules as proposed or amend them.

To qualify as a crowdfunding transaction exempted from registration requirements, under the proposed rules, a company may raise a maximum aggregate amount of $ 1 million through crowdfunding offerings during a 12-month period. Non-US companies, SEC reporting companies, and certain investment companies among others are ineligible to raise funds through this new method.

Over a 12-month period, investors (who do not have to be accredited investors) would be permitted to invest up to (1) $2,000 or 5% of their annual income or net worth, whichever is greater, if their annual income and net worth are less than $100,000; or (2) 10% of their annual income or net worth, whichever is greater, if their annual income or net worth is equal to or more than $100,000, in which case, during a 12-month period, those investors may not purchase more than $100,000 of securities through crowdfunding. Securities purchased in a crowdfunding transaction may not be resold for a period of one year.

The proposed rules also require companies conducting a crowdfunding offering to file certain information with the SEC, including, but not limited to, information about officers and directors as well as owners of 20% or more of the company; a description of the financial condition of the company; financial statements of the company that, in the event the amount raised during a 12-month period is greater than $500,000, would have to be audited; and an annual report.

In addition, crowdfunding transactions must be conducted through an SEC registered intermediary (a broker or a funding portal, a new type pf SEC registrant) to help ensure that the offering is accessible to the public and that investing individuals can share information. The proposed rules also require intermediaries to deliver educational material to investors as the SEC determines appropriate. General advertising is not permitted in crowdfunding offerings and marketing efforts by the issuer must be limited to directing investors to web portals for the offering.

A wide range of comments to the new rules on crowdfunding were targeted to the burdensome disclosure requirements and the high costs of a crowdfunding offering vis-à-vis the limited amount of capital that such an offering could raise (that is, not greater than $ 1 million for a 12-month period).

Rule 506(c)

Rule 506(c) does not define “reasonable steps” but lists, on a non-exhaustive basis, principles-based methods an issuer may use to verify the accredited investor status of a natural person which are deemed to be “reasonable”. In determining the accredited investor status of the purchaser, issuers should consider (1) the nature of the purchaser and the type of accredited investor the purchaser claims to be; (2) the amount and type of information that the issuer has about the purchaser; and (3) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

It is important to mention that regardless of the steps taken, the burden of demonstrating that the accredited investor status of the purchaser has been verified rests with the issuer, and the issuer and its verification service providers are expected to retain detailed records of those steps.

On January 23, 2014, the SEC published new Compliance and Disclosure Interpretations on Rule 506(c) clarifying that in the event an issuer commenced a Rule 506(b) offering in reliance on Rule 506 before September 23, 2013, and decided after that date to continue such offering as a Rule 506(c) offering, that issuer will not be required to take “reasonable steps to verify” the accredited investor status of investors who purchased securities in the offering before the issuer determined to rely on Rule 506(c). Instead, the issuer should take reasonable steps to verify the accredited investor status of those investors who purchase securities in the offering after the issuer determined to rely on Rule 506(c). In addition, the SEC clarified that the issuer must amend any previously-filed Form D to indicate its reliance on the Rule 506(c) exemption for its offering.

In summary, issuers can offer securities through means of general solicitation, provided that (1) all purchasers of securities are accredited investors; (2) the issuer take reasonable steps to verify that the purchasers of the securities are accredited investors; and (3) other conditions specified in the rules for traditional Reg D offerings are met.

Issuers will continue to have the ability under Rule 506(b) to conduct Rule 506 offerings subject to the prohibition against general solicitation.

Form D

In addition to amending Rule 506, the SEC has also amended Form D, which is a notice by an issuer claiming a Reg D exemption that is

required to be filed with the SEC. The amendment added a check box named “Rule 506(c)” to indicate whether an issuer is claiming an exemption under Rule 506(c). Form D was also amended to rename the previous box for “Rule 506” to “Rule 506(b)”, where general solicitation is still prohibited.

There is some ongoing uncertainty as to the required timing for a Form D filing. Prior to the rule changes, Rule 503 provided that an issuer offering or selling securities in reliance on Reg D must file with the SEC a Form D notice no later than 15 days after the first sale of securities in the offering. The SEC has amended Rule 503 to require issuers relying on Rule 506(c) and making a general solicitation to file a Form D at least 15 days prior to any general solicitation activities. Although the amendment was implemented by the SEC in an attempt to monitor market practices associated with Rule 506(c) offerings by gathering information in advance of the offering, the impact of that change and the premature disclosure of the possibility of capital-raising activities by an issuer could prove to be too burdensome, and may promote delays in the offering and limit the flexibility of an issuer in planning and conducting the offering.

The SEC received several substantial comments in connection with the new disclosure requirements and timing for filing a Form D in a Rule 506(c) offering during the comment period which ended November 4, 2013. So far, the rule has been kept unaltered as adopted.

Form D has also been modified to include additional disclosure items, some applicable only to Rule 506(c) offerings (such as disclosing the methods of general solicitation used and the methods to verify accredited investor status) and others to all Reg D offerings (such as disclosure of controlling persons of an issuer, issuer’s revenues; investor information and use of proceeds).

Bad Actor Disqualification

The SEC has expressed its concern to preserve the integrity of Rule 506(c) and to minimize the incidence of fraud in implementing those changes required by the JOBS Act. In an attempt to address that concern, the SEC adopted a disqualification of the “bad actor” for Rule 506 offerings mandated by the Dodd-Frank Act, by adding a paragraph “d” to Rule 506, which prohibits the use of Rule 506 by certain issuers if certain felons or other “bad actors” are participating in the offering.

Those covered by Rule 506(d) include the issuer and other covered persons, such as underwriters; placement agents; directors; executive officers of the

issuer or of any compensated solicitor[6], and other officers who participated in the offering; and security holders owning at least 20% of the issuer's outstanding voting securities as measured by voting power; and for issuers that are pooled investment funds, the rule covers the funds' investment managers and their principals.

Although the disqualifying rule applies only to covered persons whose disqualifying event occurs after the date of effectiveness of the new rules (that is, September 23, 2013), it is mandatory that any pre-effectiveness triggering events be disclosed by the issuer. The rules exempt an issuer from disqualification if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualifying condition existed. Issuers that discover disqualifying events during a Rule 506 offering may seek a waiver of disqualification from the SEC. The types of circumstances which will justify a waiver and how long it will take for the SEC to grant it remain unclear.

Conclusion

For the first time since the enactment of Reg D, issuers are now permitted in a private offering that is not registered with the SEC to engage in general advertising and general solicitation. This change will greatly expand the base of potential investors for companies looking to raise funds in the U.S. capital markets without going through the rigors of the registration process with the SEC.

With regard to a related subject, there has been considerable excitement in the financial community over the possibilities of capital raising via crowdfunding vehicles or platforms. While the proposed crowdfunding rules, in principle, provide greater reach in terms of potential investors because accredited investor status is not a requirement, the annual ceiling on capital raises, and limitations on investment, suggest that the crowdfunding platform, under current rules, will have limited impact on market practices for capital formation other than possibly in the case of a pure start-up venture.

For more information about the foregoing please contact Michael J. Hagan (mjhagan@foxlex.com) at Fox Horan & Camerini LLP (www.foxhorancamerini.com)

[6] A compensated solicitor is any person who has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers, regardless of whether he or she is, or is required to be, registered as a broker-dealer under Exchange Act Section 15(a)(1) or is associated person of registered broker-dealers.