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SEC Acts on JOBS Act

Title II Implementation and Potential Market Impact

Highlights

- ✔ Verification of accredited status to be required
- ✔ Senator Carl Levin said that the SEC's decision to adopt the final regulations will do little to jump start investment, and much to weaken investor protections
- ✔ Additional Form D filing requirements proposed
- ✔ Rule disqualifies bad actors

Inside

Section 201(a)(1) of the JOBS Act directs the SEC to remove the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506 provided that sales are limited to accredited investors and an issuer takes reasonable steps to verify that all purchasers of the securities are accredited. On July 10th, the SEC adopted regulations implementing Title II of the JOBS Act to end the ban on general solicitation and advertising under Rule 506 of Regulation D. Release No. 33-9415. The implementation of Title II evidences the SEC's efforts to balance its dual mission of promoting capital formation and investor protection.

The SEC also amended Securities Act Rule 144A to provide that securities may be offered to persons other than qualified institutional buyers (QIBs), provided the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Rule 144A is a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain restricted securities.

General Solicitation and General Advertising

The SEC regulations, which take effect 60 days after Federal Register publication, allow issuers to use general solicitation and general advertising to offer their securities provided they take reasonable steps to verify that the investors are accredited investors and all purchasers of the securities fall within one of the categories of persons who are accredited investors under Rule 501 of Regulation D, or the issuer reasonably believes that the investors fall within one of the categories at the time of the sale of the securities.

Form D. The final rule amends Form D, which is the notice that issuers must file with the SEC when they sell securities under Regulation D. The revised form adds a separate box for issuers to check if they are claiming the new Rule 506 exemption that would permit general solicitation or general advertising.

The existing provisions of Rule 506 as a separate exemption are not affected by the final regulations. Issuers conducting Rule 506 offerings without the use of general solicitation or general advertising can continue to conduct securities offerings in the same manner and aren't subject to the new verification rule.

Principles-Based Approach

According to SEC Chair Mary Jo White, the new SEC regulations provide a principles-based approach to satisfy the verification of accredited

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investors requirement, and, as urged by a number of commenters, provide a non-exclusive list of methods that issuers may use to satisfy the verification requirement as it applies to natural persons.

Under existing Rule 501, a person qualifies as an accredited investor if he or she has either an individual net worth or joint net worth with a spouse that exceeds $1 million at the time of the purchase, excluding the value of a primary residence or an individual annual income that exceeded $200,000 in each of the two most recent years or a joint annual income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year.

Methods of Verification. The determination of the reasonableness of the steps taken to verify an accredited investor is an objective assessment by an issuer. An issuer is required to consider the facts and circumstances of each purchaser and the transaction.

These methods include reviewing copies of any IRS form that reports the income of the purchaser and obtaining a written representation that the purchaser will likely continue to earn the necessary income in the current year and receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that such entity or person has taken reasonable steps to verify the purchaser's accredited status.

Purpose of Verification. Verification is a key concept of the lifting of the general solicitation ban. The SEC believes that the purpose of the verification mandate is to address concerns, and reduce the risk, that the use of general solicitation in Rule 506 offerings could result in sales of securities to investors who are not, in fact, accredited investors. The question of whether the steps taken are "reasonable" will be an objective determination by the issuer, or those acting on its behalf, in the context of the particular facts and circumstances of each purchaser and transaction.

Among the factors issuers should consider under this facts and circumstances analysis are the nature of the purchaser and the type of accredited investor that the purchaser claims to be; the amount and type of information that the issuer has about the purchaser; and 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.

The SEC believes that these factors are interconnected and are intended to help guide an issuer in assessing the reasonable likelihood that a purchaser is an accredited investor, which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status. After consideration of the facts and circumstances of the purchaser and of the transaction, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status, and vice versa. For example, if the terms of the offering require a high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor may be sufficiently high such that, absent any facts that indicate that the purchaser is not an accredited investor, it may be reasonable for the issuer to take fewer steps to verify or, in certain cases, no additional steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by a third party.

Regardless of the particular steps taken, because the issuer has the burden of demonstrating that its offering is entitled to an exemption from the registration requirements of Section 5 of the Securities Act, the SEC cautioned that it will be important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor.

Senate Reaction

Senator Carl Levin (D-MI) said that the SEC's decision to adopt the final regulations will do little to jump start investment, and much to weaken investor protections. The final rule puts essentially no effective limitations on the types or forms of advertising that can be used to promote high-risk investments, cautioned the Senator, exposing unsuspecting investors to potentially misleading claims they will be unable to evaluate. And the rule provides almost no requirements to ensure that potential investors are in fact able to absorb the possible losses from these high-risk investments. The SEC appears to recognize these flaws by simultaneously saying it will consider some limited repairs, which Senator Levin fears may be far too little and much too late. It's as if the SEC is jumping out of an airplane today, he analogized, and then proposing to check the safety of its parachute on the way down.

Rule Proposal on Disclosure of Information

Concomitant with the adoption of regulations lifting the general solicitation ban, the Commission approved a proposal intended to enhance its ability to assess developments in the private placement market now that the rule to lift the ban on general solicitation has been adopted. Release No. 33-9416. The proposal is designed to improve the SEC's ability to evaluate the development of market practices in Rule 506 offerings and would address certain concerns raised by investors related to issuers engaging in general solicitation.

Under the proposal, issuers that intend to engage in general solicitation as part of a Rule 506 offering would, in addition to the current requirements, be required to file the Form D at least 15 calendar days before engaging in general solicitation for the offering. The form is a type of notice that provides information about the issuer and the securities offering. Also, within 30 days of completing an offering, issuers would be required to update the information contained in the Form D and indicate that the offering has ended. Currently, an issuer selling securities using Rule 506 is required to file a Form D no later than 15 calendar days after the first sale of securities in an offering.

As proposed, the additional information provided by issuers will enable the SEC to assess the changes to the Rule 506 market that could occur now that the general solicitation ban has been lifted. The additional information would include the identification of the issuer's website, expanded information on the issuer, the offered securities, types of investors in the offering and the use of proceeds from the offering. There should also be information on the types of general solicitation used and the methods used to verify the accredited investor status of investors.

The SEC proposes to disqualify an issuer from using the Rule 506 exemption in any new offering if the issuer or its affiliates did not comply with the Form D filing requirements in a Rule 506 offering. As proposed, the disqualification would continue for one year beginning after the required Form D filings are made. Issuers would be able to rely on a cure period for a late Form D filing and, in certain circumstances, could request a waiver from the staff.

Issuers would also be required to include certain legends or cautionary statements in any written general solicitation materials used in a Rule 506 offering. The legends would be intended to inform potential investors that the offering is limited to accredited investors and that certain potential risks may be associated with such offerings. In addition, if the issuer is a private fund or type of pooled investment vehicle and includes information about past performance in its written general solicitation materials, it would be required to provide additional information in the materials to highlight the limitations on the usefulness of this type of information. The issuer also would need to highlight the difficulty of comparing this information with past performance information of other funds.

Importantly, issuers would be required to submit written general solicitation materials to the Commission through an intake page on the SEC Website. Materials submitted in this manner would not be available to the general public. As proposed, this requirement would be temporary, expiring after two years.

Currently, SEC regulations provide guidance on when information in sales literature by an investment company registered with the SEC could be fraudulent or misleading for purposes of the federal securities laws. Under the proposal, this guidance would be extended to the sales literature of private funds. It would apply to all private funds whether or not they are engaged in general solicitation activities.

Dodd-Frank, the JOBS Act and Bad Actor Provisions

Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that would prohibit the use of the Rule 506 exemption for any securities offering in which certain felons and other bad actors are involved. This section also requires the new rules to be substantially similar to the bad actor disqualification provisions of Regulation A, another exemption from registration for certain small offerings.

Disqualification Rule. Under the final disqualification rule approved by the SEC under Section 926, an issuer cannot rely on the Rule 506 exemption if the issuer or any other person covered by the rule had a disqualifying event. Release No. 33-9414. The SEC's Investor Advisory Committee had recommended that in conjunction with the rulemaking to lift the ban on general solicitation and advertising, the SEC adopt the bad actors provision, noting that this provision is particularly relevant to bolstering investor protection in connection with Rule 506 offerings.

Disqualifying Events. SEC regulations define a "disqualifying event" to include criminal convictions in connection with the purchase or sale of a security, making a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within 10 years of the proposed sale of securities (or five years in the case of the issuer and its predecessors and affiliated issuers). A disqualifying event also includes court injunctions and restraining orders in connection with the purchase or sale of a security, making a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries, as well as final orders from the CFTC, federal banking agencies, the National Credit Union Administration, or state regulators of securities, insurance, banking, savings associations, or credit unions that bar the issuer from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or are based on fraudulent, manipulative, or deceptive conduct and are issued within 10 years of the proposed sale of securities.

Similarly, a "disqualifying event" also includes SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons, SEC cease and desist orders related to violations of anti-fraud provisions and registration requirements of the federal securities laws, and SEC stop orders. Also included are orders suspending the Regulation A exemption issued within five years of the proposed sale of securities, as well as suspension or expulsion from membership in an SRO or from association with an SRO member.

The regulations contain a reasonable care exception from disqualification when the issuer can show it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering.

Covered Persons. The final disqualification rule covers the issuer, including its predecessors and affiliated issuers, as well as directors and certain officers, general partners, and managing members of the issuer. It also includes 20 percent beneficial owners of the issuer, promoters, investment managers and principals of pooled investment funds, as well as persons compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor.

Financial Market Impact

The SEC regulations implementing Title II have been eagerly awaited by the financial markets, and in particular the mutual fund and alternative investment fund industries. The prohibition on general solicitation and advertising in Regulation D had come to be interpreted to mean that potential investors must have an existing relationship with the company before they can be notified that unregistered securities are available for purchase. Congress, however, in the JOBS Act, determined that requiring potential investors to have an existing relationship with the company significantly limits the pool of potential investors and severely hampers the ability of small companies to raise capital and create jobs. The SEC has now implemented that Congressional vision and enabled increased capital formation in the financial markets.

As a result of the SEC's action, small, privately held companies will no longer be constrained by the general solicitation ban in soliciting new accredited investors. Rep. Carolyn Maloney (D-NY), explained that the measure removes a contradiction in federal securities regulation. Under the prior system, companies seeking to raise capital by selling shares were barred from many types of advertising and solicitations. In effect, the prior system told businesses to go out and create jobs, but not tell potential investors. The JOBS Act Title II, now implemented by the SEC regulations, ends this contradiction by removing the restrictions on general solicitation and advertising for certain private securities offerings, thereby assisting companies in attracting potential investors and raising capital (Cong. Rec. (Nov. 3, 2011), p. H7921). The impact has the potential to be profound and consistent in coming years for the capital markets.

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