

# Nashville Bar Journal

November 2012 - VOL 12, NO. 10



## "SECURITIES FOR SALE! READ ALL ABOUT IT!"

The world of private offerings may not be so private anymore

by: Tracy Kane

The Moxie of Proxy Voting  
by the Tennessee Legislature  
Everette Parrish

NBA Board of Directors Nominees

Annual Meeting & Banquet Registration





## "SECURITIES FOR SALE! READ ALL ABOUT IT!"

### The world of private offerings may not be so private any-

by Tracy Kane

There is a delicate dance going on in Washington, D.C. and it is not about who is or is not occupying the White House. The Securities and Exchange Commission (the "SEC" or "Commission") has been tasked by Congress with relaxing (possibly "eliminating") what has been one of the bed-rock principals of modern Securities Law – the ban on general solicitation and advertising for non-registered offerings of U.S. securities. This policy change is a result of the passage of the JOBS Act in April of this year.

To understand the sea change that is (potentially) happening, though, we should take a brief stroll down memory lane and remember the genesis of securities regulation and the concept behind private offerings.

Following the stock market crash of 1929 and ensuing Great Depression, Congress enacted two major pieces of securities legislation – the Securities Act of 1933 (the "Securities Act"), which principally requires that investors receive financial and other significant information concerning securities being offered for public sale and prohibits deceit, misrepresentations, and other fraud in the sale of securities, and the Securities and Exchange Act of 1934 (the "Exchange Act"), which created the SEC with broad authority over all aspects of the securities industry, including the power to register, regulate, discipline and otherwise oversee various actors and behavior in the securities industry.

The Securities Act requires that, generally, securities sold in the U.S. must be registered. Section 4(a)(2) (formerly Section 4(2)), however, exempts from registration "transactions by an issuer not involving any public offering."<sup>1</sup> The Securities Act does not define the scope or otherwise set a boundary for this private

offering exemption. Over the years, there have been judicial interpretations as well as additional rule-making and interpretive opinions by the SEC. The leading Supreme Court interpretation of the law came in 1953 in *SEC v. Ralston Purina Corp.*, 346 U.S. 119 (1953). In a ruling that remains the leading opinion on private offerings, the Court declined to accept the Commission's request to define a "public offering" by setting a quantity limit, and instead interpreted the exemption in light of the statutory purposes of the Securities Act, which the Court explained was "whether the particular class of persons affected *needed* the protection of the [Securities] Act."<sup>2</sup> In 1962, the Commission issued a statement in which it provided its views on the limitations on the availability of the private offering exemption under Section 4(2) (now Section 4(a)(2)).<sup>3</sup> Among other things, the Commission stated that "public advertising of an offering is incompatible with a claim of a private offering."<sup>4</sup> The lack of general solicitation and advertising continues to be a hallmark characteristic of a private offering.

Beginning in 1972, the Commission adopted a number of interpretative safe harbors related to private offerings by issuers and re-sales of securities acquired in private offerings.<sup>5</sup> Then in 1982, the Commission adopted Regulation D.<sup>6</sup> Regulation D was designed to offer businesses, especially small businesses, easy-to-understand exemptions from the registration requirements of the Securities Act. When the regulation was released, the Commission was commended for striking the right balance between investor protection and

capital formation by providing issuers of securities a stair-stepped approach that required more investor protections (and, thus, transaction costs of the offering) as the size of the offering increased.<sup>7</sup> The basis of this framework was the Commission's assumption, one with which most scholars agree, that the two most important protections for investors are "their own sophistication – their ability to evaluate the merits and risks of any offering of securities – and the meaningful disclosure of or access to material investment information."<sup>8</sup>

Rule 502 of Regulation D sets forth some of the standards to be met to qualify an offering under Rules 504, 505 or 506. With respect to communication, Rule 502(c) does not define "general solicitation" or "general advertising;" however, it provides a non-exclusive list of examples, which include advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising.<sup>9</sup> The Commission has since released interpretations stating that other uses of publicly available media, such as unrestricted websites, also constitute general solicitation and general advertising.<sup>10</sup>

Despite the general popularity of Regulation D (evidenced by the estimated amount of capital –both equity and debt– raised in Rule 506 offerings and Rule 144A offerings in 2011, which was \$895 billion and \$168 billion, respectively, compared to \$984 billion raised in registered offerings,<sup>11</sup>), it has not worked the way the Commission intended. Data derived from Form Ds, a notice filing for offerings under Regulation D, between 2008 and 2010 show that over 90% of Regulation D offerings are made under Rule 506 (as opposed to Rules

504 or 505) and limited to "accredited investors," including the vast majority of offerings of less than \$1 million.<sup>12</sup> Most scholars and practitioners agree that one of the main reasons for the over-reliance on Rule 506 is Congress' enactment of the National Securities Markets Improvement Act ("NSMIA") in 1996, which preempted state authority over the registration of securities offered under Rule 506, but did not do so with respect to offerings made under Rules 504 and 505.<sup>13</sup> The effect has been that small issuers structure their small offerings to be compliant with Rule 506 and limited to accredited investors, which many contend has limited access to capital for many issuers.<sup>14</sup>

Fast-forward to 2012 and the passage of the Jumpstart Our Business Startups (JOBS) Act, signed by President Obama on April 5th of this year.<sup>15</sup> The legislation was promoted by Congress and the White House as a bipartisan bill that will allow small and high-growth businesses to raise capital more efficiently and, as a consequence, create more jobs. The sentiment behind the Act was to reduce the regulatory burdens imposed by existing securities laws on relatively small companies so that they can raise capital less expensively and from more sources.

The JOBS Act has five key components: (1) creation of a new category of company, "emerging growth companies" (EGCs) and providing them with certain accommodations in the initial public offering (IPO) process and subsequent reporting obligations (*Title I*); (2) relaxation of the communication restrictions in private offerings (*Title II*); (3) creation of a new exemption allowing companies to utilize crowd-funding platforms to raise capital (*Title III*); (4) expansion of the scope of the exemptions from registration under Section 3(b) of the

Securities Act (*Title IV*); and (5) raising the trigger for when a company becomes subject to registration and reporting requirements under Section 12(g) of the Exchange Act (*Title V and VI*).

The law contains an ambitious timeline for SEC rulemaking, with the first rulemaking (under Title II) due on or before July 4, 2012. While the Commission did not meet this deadline, it released the proposed rules on August 29, 2012, and set a 30-day period for public comment.<sup>16</sup> The Commission is now considering whether to adopt the proposed rules as written or to further modify them.

#### **Title II of the JOBS Act: Changes for Private Offerings**

Section 201(a)(1) of the JOBS Act directs the Commission to amend Rule 506 of Regulation D to provide that the prohibition against general solicitation contained in Rule 502(c) of Regulation D not apply to offers and sales of securities made pursuant to Rule 506, as amended, so long as all purchasers of the securities are accredited investors and the issuer has taken reasonable steps to verify that purchasers are accredited investors.

Section 201(a)(2) directs the Commission to amend Rule 144A (a safe harbor rule for resales) to provide that securities sold pursuant to Rule 144A may be offered to persons other than "qualified institutional investors" (QIBs), including by means of general solicitation, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller "reasonably believe" are QIBs.

This rule relaxation will allow some form of general solicitation or general

Continued on Page 10 ➔

advertising, provided that securities are sold only to persons reasonably believed to be QIBs, in the case of Rule 144A, and accredited investors, in the case of Rule 506 of Regulation D. This change applies to all issuers, but is limited to offerings under Rule 506 and 144A and does not affect any other private offerings claiming an exemption from registration under Section 4(a)(2) of the Securities Act.<sup>17</sup> It is also worth noting that while the JOBS Act relaxes restrictions on the audience for communications, it does not eliminate anti-fraud rules.

### Commission's Proposed Rules

The Commission is proposing to amend Rule 506 to provide that the prohibition against general solicitation shall not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors. Specifically, the Commission proposed to create a new section (c) of Rule 506 that would permit the use of general solicitation to offer and sell securities so long as the following conditions are met:

1. The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors; and
2. All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or that the issuer reasonably believes that they do at the time of the sale of the securities; and
3. All terms and conditions of Rule 501 (accredited investor definition) and Rules 502(a) (integration) and 502(d) (limitations on resale) must be satisfied.<sup>18</sup>

A significant portion of the Commission's Release explaining the proposed rule discusses the verification requirement of the proposed Rule 506(c). The Commission decided not to specify the particular methods necessary, or even include a non-exclusive list of procedures, to satisfy the verification requirement. The Commission instead chose to use an "objective determination, based on the particular facts and circumstances in each transaction" to determine whether the steps taken by an issuer are "reasonable."<sup>19</sup> Under this approach, an issuer should consider a number of factors, including, the nature of the purchaser and the type of accredited investor that the purchaser claims to be (i.e., broker-dealer, entity, natural person, etc.), the amount and type of information that the issuer has about the purchaser, and the nature of the offering (i.e., the manner in which the purchaser was solicited or whether a minimum investment amount was required by the terms of the offer).<sup>20</sup> The Commission explained that this objective standard was preferred over a specified method to provide "sufficient flexibility to accommodate the different types of issuers . . . and the different types of accredited investors."<sup>21</sup> The Commission noted that despite the additional requirement that issuers making offerings under the proposed Rule 506(c) must take reasonable steps to verify that all purchasers are accredited investors, the definition of accredited investor under Rule 501(a), which includes the reasonable belief standard, remains unchanged.<sup>22</sup>

The Commission elected to create the new Rule 506(c) while preserving, under existing Rule 506(b), the existing ability of issuers to conduct Rule 506 offerings without the use of general solicitation.<sup>23</sup> In the Release announcing the proposed rule, the Commission recognized that offerings under existing Rule 506 represented an important source of capital for issuers of all sizes and that some issuers may not wish to engage in general so-

licitation or may wish to sell privately to non-accredited investors who meet Rule 506(b)'s sophistication requirements. As a result, the Commission is also proposing to amend Form D, a notice required to be filed with the Commission by each issuer claiming a Regulation D exemption, to add a check box to indicate whether an offering is being conducted pursuant to the existing Rule 506(b) or the proposed Rule 506(c).

To comply with the JOBS Act mandate of Section 201(a)(2), the Commission also proposed to amend Rule 144A to allow securities sold pursuant to 144A to be offered to persons other than QIBs, including by means of general solicitation, so long as the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Specifically, Rule 144A(d)(1) would be amended to eliminate references to "offer" and "offeree," such that the rule, as amended, would require only that the securities are sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a QIB.<sup>24</sup>

In explaining the proposed rule changes, the Commission addressed a couple other areas that some early commentators speculated would be affected by the JOBS Act and subsequent SEC rulemaking. The Commission noted that with respect to privately offered funds, i.e., hedge funds, venture capital funds and private equity funds, it believes Section 201(b) of the JOBS Act permits such funds to make a general solicitation under the proposed amended Rule 506 without losing any of their exclusions under the Investment Company Act.<sup>25</sup> The Commission also noted with respect to offerings under Regulation S, which provides a safe harbor for offers and sales of securities outside the U.S., that the Commission's proposed amendments for Rule 506 and 144A do not change the Commission's statement in adopt-

Continued on Page 18 ➞



ing the release for Regulation S, which is that “[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act,” including “domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as proposed to be amended.”<sup>26</sup>

### Comments

When the JOBS Act legislation was proposed, many critics, including Commission Chairman Mary Shapiro and former New York Governor Elliot Spitzer, worried publicly about the bill’s relaxation of important investor protections, including existing prohibitions on general solicitation and advertising for private offerings.

Since the bill’s passage, the Commission solicited comments from the public on its proposed rulemaking required by the JOBS Act both before and after issuing the current rule proposals. The Commission received more than 160 comments on the proposed rule changes, including submissions from Senators and Members of Congress, State Securities Commissioners, representatives of the American Bar Association (“ABA”), consumer and investor advocacy groups, and various practitioners and individuals, and has published all comments at [www.sec.gov/rules/proposed.shtml](http://www.sec.gov/rules/proposed.shtml).

The Federal Regulation of Securities Committee of the Business Law Section of the ABA largely approved of the proposed rules. Specifically, the Committee supported the preservation of the existing Rule 506(b) for Rule 506 offerings without the use of general solicitation as well as the view that the accredited investor verification should be an objective determination based on the particular facts and circumstances of each transaction. The Committee also supported the Commission’s continued inclusion of the “reasonable belief” standard in

the definition of “accredited investor” in Rule 501(a). In its letter, the Committee asked the Commission to provide issuers with transitional guidance in the final rule or release as many issuers may be in the process of offering securities and may determine after final implementation of the rules that they want to use general solicitation for the remaining portion of the offering and no such guidance was offered in the proposed rule. Many of the other practitioner comments supported the Commission’s flexible approach to the amended rules.

Comments expressing concern with the proposed rules largely focused on the Commission’s elimination of the general solicitation ban and on the lack of specificity regarding the verification of accredited investor status under the amended Rule 506. Senators Jack Reed, Carl Levin, Dick Durbin, Tom Harkin, Frank R. Lautenberg, Al Franken, and Daniel K. Akaka submitted a letter urging the Commission to establish specific “methods,” including “common-sense documentation and/or verification practices and procedures,” issuers must use in order to qualify taking “reasonable steps” to verify that only accredited investors participate in the offering. The Senators also contended that the Commission misconstrued the Section 201 mandate with respect to general solicitation and urged the Commission to “significantly revise” the rules and not adopt elimination of the prohibition on general solicitation, but instead to promulgate “clear, objective, and meaningful regulation of the manner or substance of general solicitation that may be allowed in private offerings.” The Senators also thought the Commission’s rules should differentiate between issuers engaged in operational businesses and “those that are merely investment vehicles.” Specifically, the Senators believe “Congress did not contemplate removing the general solicitation ban – without retaining any limitations on forms of solicitation – for private investment vehicles,” such as hedge funds or private funds. Many

state securities Commissioners urged the Commission to place reasonable restrictions on the use of advertisements and some suggested further rulemaking, such as adding the requirement that a Form D be filed in advance of any public advertising.

The Commission stated that it will consider all public comments before finalizing the proposed rules and has not set a deadline for releasing the final rule changes.

### Conclusion

Most practitioners appear to agree that the JOBS Act and the Commission’s proposed amendments will improve issuers’ and resellers’ access to capital; however, these amendments, along with the other changes under the JOBS Act, do little to fix what many have found problematic with the current Regulation D scheme – namely that smaller issuers with smaller offerings will still structure offerings under Rule 506 (whether under the amended 506(b) or 506(c) with its associated higher transaction costs, rather than utilize Rules 504 and 505. One part of the JOBS Act that offers the most hope for smaller issuers wanting to make smaller offerings is the crowdfunding provisions (Title III of the JOBS Act).

Title III of the JOBS Act requires the SEC to create a new exemption from registration allowing a private company to sell securities in small amounts to a large number of investors that are not accredited over a 12-month period.<sup>27</sup> The SEC is further directed to establish new rules that exempt funding portals from broker-dealer registration as long as they are subject to the authority of the SEC and are a member of a national securities association, among other requirements. Compensation of funding portals will also be subject to rules that require disclosure of receipt of compensation.

The JOBS Act is attempting to harness the enthusiasm surrounding crowd-funding platforms, like Kickstarter (www.kickstarter.com), a funding portal for creative projects.<sup>28</sup> These platforms currently exist in a non-securities context, but the legislation's supporters hope the new exemptions will allow investment by "non-wealthy" individuals in a relatively low-risk manner. Importantly for many issuers and their advisors is that securities acquired pursuant to these new crowd-funding provisions will also be exempt from qualification under state blue sky laws. That being said, the JOBS Act preserves state enforcement authority over unlawful conduct by issuers and intermediaries (funding portals) and with respect to fraud or deceit. ■



**Tracy Kane** is an attorney with Dodson, Parker, Behm & Caparella, P.C. where she advises businesses on wide ranging transactional matters, including company formation, operation, mergers and acquisitions, intellectual property, and succession planning.

#### (Endnotes)

<sup>1</sup> Securities Act § 4(a)(2), 15 U.S.C. § 77d(2) (2006).

<sup>2</sup> SEC v. Ralston Purina Corp., 346 U.S. at 125.

<sup>3</sup> Non-Public Offering Exemption, Securities Act Release No. 4552, 27 Fed. Reg. 11316, Fed. Sec. L. Rep. (CCH) ¶ 2770 (Nov. 6, 1962).

<sup>4</sup> *Id.*; Other factors courts and practitioners consider in determining whether an offering is a private offering exempted from registration under Section 5 of the Securities Act include the relationship between issuer and offerees as well as between offerees and each other, the size of the offering, number of units offered, the type, access and content of information provided to offerees, and whether purchases are made with a view to resell. See Committee on Federal Regulation of Securities, ABA Section of Business Law, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors – A Report*, 66 The Bus. Law. 85-124 (2010).

<sup>5</sup> See, e.g., 1972 - Rule 144 (resales of securities acquired from an issuer or control person); 1974 - Rule 146 (issuer offerings), which were rules adopted under Securities Act § 19(a), 15 U.S.C. § 77s(a), which authorizes the Commission to define terms used in the statute.

<sup>6</sup> See 17 C.F.R. §§ 230.501-.508 (2011). The rules were adopted in *Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales*, Securities Act Release No. 33-6389, 47 Fed. Reg. 11251 (Apr. 14, 1982) (codified at 17 C.F.R. pts. 230 & 239). Regulation D consists of Rules 501 through 508 with Rules 501 through 503 and Rules 507 and 508 providing general rules of support for the exemptions found in Rules 504 through 506. Regulation was also an interpretative rule and while it uses the language of exemption, it was adopted pursuant to the Commission's authority to define terms under Section 19(a)

of the Securities Act. The Commission did not have general exemptive authority under the Securities Act until Section 28 was added in 1996. See *Law of Private Placements*, *supra* note 4, at 91.

<sup>7</sup> The Commission was directed by Congress, albeit after the regulation's adoption, to balance investor protection and capital formation. 15 U.S.C. § 77b(b) (2006) ("the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation"). The Regulation D framework starts with offerings up to \$1 million and contains no disclosure or purchaser sophistication requirements (Rule 504). The next "stair" in the regulation is for offerings between \$1 million and \$5 million (Rule 505), which requires the issuer in most cases to disclose investment information to the purchasers. Rule 506 allows an issuer to offer and sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors" and to no more than 35 non-accredited investors who meet certain "sophistication" requirements so long as the issuer, or any person acting on its behalf, does not offer or sell the securities through any form of "general solicitation or general advertising." 17 C.F.R. 230.504, .505, and .506.

<sup>8</sup> Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 The Bus. Law. 919-42, at 921 (Aug. 2011).

<sup>9</sup> 17 C.F.R. § 230.502(a).

<sup>10</sup> See *Use of Electronic Media for Delivery Purposes*, Release No. 33-7233 (Oct. 6, 1995) [60 Fed. Reg. 53458] at Ex. 20; *Use of Electronic Media*, Release No. 33-7856 (Apr. 28, 2000) [65 Fed. Reg. 25843] at n.79-80 and accompanying text.

<sup>11</sup> See *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9354, at 8 [77 Fed. Reg. 54464].

<sup>12</sup> 4.4% of all Regulation D offerings are under Rule 504, 1.6% under Rule 505, and 94% under Rule 506. Further, 88.3% of offerings of \$1 million or less and 91.8% of offerings between \$1 million and \$5 million are made under Rule 506 and limited to accredited investors. See Campbell, *supra* note 8, at 926-31.

<sup>13</sup> In theory, Rules 504 and 505 were intended to be less expensive and less onerous on issuers, but if an issuer sells to persons located in more than one state, the issuer's transaction costs increase substantially in order to either comply with each state's registration requirements or find an exemption within such state.

<sup>14</sup> Regulation D defines "accredited investor" to include, among other categories, a natural person "whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceed \$1,000,000" and "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 a reasonable expectation of reaching the same income level in the current year."

<sup>17</sup> C.F.R. § 230.502(a)(5), (a)(6) (2011). Over the last 30 years, the number of individuals meeting the threshold for accredited investor status has increased, mainly because the annual income test has not been adjusted, but the relative number of persons who satisfy the accredited investor requirements remains a small portion of the general population. In 2010, the Dodd-Frank Act made the most meaningful revisions to the definition of accredited investor by excluding from the calculation of net worth the value of an individual's personal residence.

<sup>15</sup> Pub. L. No. 112-106, 126 STAT. 307 (to be codified in scattered sections of 15 U.S.C.).

<sup>16</sup> Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9354, 77 Fed. Reg. 54464 (Sept. 5, 2012) (17 C.F.R. Parts 230 and 239).

<sup>17</sup> See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9354, at 11 (noting that other bills that would have amended Section 4(a)(2) itself to permit the use of general solicitation were considered, but not enacted, by Congress. See Access to Capital for Job Creator, H.R. 2940, 112<sup>th</sup> Cong. (2011); Access to Capital for Job Creators, S. 1831, 112<sup>th</sup> Cong. (2011)).

<sup>18</sup> Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9354, at 11-12.

<sup>19</sup> *Id.* at 14.

<sup>20</sup> *Id.* at 14-20.

<sup>21</sup> *Id.* at 14.

<sup>22</sup> *Id.* at 29.

<sup>23</sup> *Id.* at 12.

<sup>24</sup> *Id.* at 37.

<sup>25</sup> *Id.* at 31-32 (citing, e.g., 15 U.S.C. 80a-3(c)(1) and (c)(7)).

<sup>26</sup> *Id.* at 39-40.

<sup>27</sup> Section 302(a) of the JOBS Act requires that the aggregate amount sold to all investors by the issuer during the 12-month period is not more than \$1,000,000. It also limits the total amount sold to any investor depending on the investor's annual income or net worth. For example, if the annual income or net worth of an investor is less than \$100,000, then the total amount sold to such investor may not exceed the greater of \$2,000 or 5% of the annual income or net worth of such investor. For investors with an annual income or net worth equal to or greater than \$100,000, then the amount sold may not exceed 10% of the annual income or net worth of such investor.

<sup>28</sup> To avoid the characterization as sales of securities, companies like Kickstarter facilitate rewards or the pre-purchase of products in exchange for funding of projects.

MJC

MORGAN JOHNSON CARPENTER & CO.  
A PROFESSIONAL CORPORATION

Forensic Accountants & Consultants

Professionals in Loss and Value Measurement

Mark N. Henry, CPA/CFF

555 Marriott Drive, Suite 800, Nashville, TN 37214

Phone: 615-231-6460 • Fax 615-231-6463

mhenry@mjcforensics.com • www.mjcforensics.com