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Public advertising in ‘private’ Regulation D offerings

The Securities and Exchange Commission on July 10 promulgated rules implementing the 2012 JOBS Act provision permitting public advertising in “private” securities offerings sold to “accredited” investors.

The action, more than a year overdue, permits implementation of one of the most controversial (and investor-risky) provisions of the JOBS Act.

The act assumed that advertising would spur investment, therefore creating employment. Investor protection was assured by restricting purchasers to accrediteds; no non-accredited would be permitted.

Section 4(a)(2) of the Securities Act of 1933 exempts from registration any sale of securities “not involving a public offering.” Because neither statute nor regulation provided clarity for achieving the exemption, in 1982 the SEC promulgated Regulation D, which, as amended, allows the sale of securities to an unlimited number of “accredited” investors and up to 35 non-accrediteds.

Accredited investors were, theoretically, wealthy people who could fend for themselves; the definition includes individuals earning $200,000 a year or with $1 million net worth exclusive of principal residence.

But Regulation D prohibited general advertising.

In August 2012, the SEC proposed Rule 506(c), allowing public advertising. During extensive public comment on that proposal, it became clear that there was concern that advertising would open the door for fraud.

New and proposed regulations

On July 10, the SEC:

- Adopted new Rule 506(c), allowing issuers to use general solicitation — including mass mailing, emails, websites, and social and broadcast media — to attract investors, provided only accredited investors could purchase and provided the issuer reasonably believed after verification that all purchasers were accredited.
- Adopted a rule, mandated by the 2010 Dodd-Frank Act, barring felons and “bad actors” from participating in Regulation D offerings, whether as a director or officer or 20 percent shareholder of an issuer, or as a promoter, investment manager or compensated solicitor.
- Proposed, but did not enact, “Proposed Rules” to gather information about Regulation D, to assist in its regulatory task. The Proposed Rules, subject to a 60-day comment period, are not now effective and for the time being can be ignored.

The Proposed Rules require in 506(c) offerings: filing with the SEC an advance notice of sale 15 days before any offering; inclusion of expanded information on the issuer, offered securities, types of investors, use of proceeds, type of solicitation and methods verifying accredited status; one year disqualification from using Rule 506 if Form D filing requirements are not made; disclosure that investors must be accredited and that there are “certain potential risks” in such offerings; and, for two years, submission of “written general solicitation materials” to the SEC (which submissions would not be available to the public).

Divided commission

More elucidating than the SEC actions were statements by SEC commissioners accompanying the new and Proposed Rules. Historically the commission has been divided between those staunchly in favor of less regulation and those concerned with protecting investors.

Chairman Mary Jo White urged adoption of all three measures (the new rules concerning public solicitation and “bad actors” and the Proposed Rules).

Commissioner Elisse B. Walter stood astride the philosophical abyss: “I agree with both sides of the debate that is raised about the issues before us today.”

Commissioner Troy A. Paredes supported everything but the Proposed Rules, as the limitations on 506(c) “would unduly burden and restrict the capital formation process” and “would undermine the JOBS Act goal of spurring our economy and job creation.”

Commissioner Daniel M. Gallagher also attacked the Proposed Rules: The Regulation D markets “far eclipse the size of the public equity markets” by a factor of nearly four times, and the Proposed Rules “would lead to smaller, more burdened private markets, their frictions mirroring those of our public markets, which for years now have been too costly and burdensome.”

Commissioner Luis A. Aguilar objected to the adopted rule facilitating general solicitation, as inducing fraud, and attacked the concept of general solicitation: The presumption that accredited investors are “knowledgeable about financial matters” is “flawed in important ways,” in that modest earnings and net worth standards for accredited status do not equate to sophistication in investments. Claiming it is reckless to move forward with Rule 506(c) while the protective limitations in the Proposed Rule are not in effect, Aguilar claimed that the rulemaking process was “fatally” flawed as the SEC failed to consider alternative methods of achieving the statutory goal.

The future

The big buzz is about how issuers will sustain their affirmative burden of proving they took “reasonable steps” to confirm that 506(c) purchasers were accredited.

There will be much commentary about how issuers should proceed, after which accepted methods of verification will emerge; see specific, non-exclusive verification suggestions contained in SEC “Release” 33-9415.

However, certain aspects of future practice are intriguing:

- Will a new industry of investor qualification services arise, whereby issuers will purchase a certification of accredited status, and will accredited investors sign onto such databases?
- The SEC Release invites professionals to provide verification: attorneys, CPAs and SEC registered investment advisors. Such professional confirmation must contain assurance that the certifying person took reasonable verification steps within the prior three months. Even if attorneys and CPAs are willing to certify, that is an expensive process for individuals paid by the hour.
- Will new practices develop in private placement memoranda? Today’s typical PPM attachment is a subscription agreement, including a “check the box” to establish accredited status. Will investors now be asked to pick one of the bases of verification suggested by the SEC and attach (and send to an issuer) the supporting information: tax return, bank statement, brokerage statement, credit report, copies of tax assessments or appraisal reports?

One problem with utilizing 506(c), noted by commentators and raised in this column in October 2012: Once an issuer utilizes public solicitation, it cannot then in the same offering rely upon Rule 506(b) (the current and surviving rule that permits up to 35 non-accredited investors but prohibits general solicitation). Since the ban on multiple approaches relates to a particular offering, how can an issuer assure that there has been a break in fundraising, so that utilizing Rule 506(b) will be deemed to be in a different offering and thus not “integrated” with a prior offering?

Nothing in the recent SEC action impacts the status of “finders,” unregistered individuals compensated for introducing investors (in violation of United States’ securities laws requiring broker/dealer registration) who historically have been “grease” in private capital formation and who often were tolerated as fulfilling an important function.

The theory of the JOBS Act, that deregulation of private offerings will facilitate capital formation creating employment, could be applied to finders. There have been numerous suggestions, although none recently, that some non-obtrusive regulation be applied to finders who do not function as traditional broker/dealers, but Congress has not so legislated nor has the SEC come forward with that proposal.

Will general solicitation in Regulation D offerings reduce the need for unregulated finders? Will accredited investors now be able to find potential deals through general publicity? A finder’s personal introduction to an issuer may increase the likelihood that the issuer will obtain an investment, and the value of that personal introduction and implicit endorsement will be absent in the case of any investor who contacts an issuer based on an ad on television or an anonymous tweet.

The SEC Release also endorses the proposition, criticized previously in this column, that the larger the investment the more likely that an investor is accredited.

While perhaps sometimes true, it fails to address the risk that an unsophisticated non-accredited investor, intrigued by public advertising for a deal, might scrape together all of his own money, mortgage his house, borrow from his friends and relatives, and go “all in” by buying a large piece of a particularly speculative company, with the issuer claiming that it reasonably believed such investor was accredited because of the size of the investment itself.

The commission also made it clear that a domestic offering under 506(c) can be combined with an exempt offshore offering, consistent with past practice and with the philosophy of the JOBS Act. And all of Regulation D continues to be a non-exclusive exemption from registration requirements; issuers will continue to rely on the statutory 4(a)(2) exemption (not involving a public offering), at least at early stages involving friends and family, and perhaps a sprinkling of angels.

Lastly, consider the analogy between general advertising of investments and the siting of a gambling casino in town. The very existence of the casino may draw through its doors, for a friendly game of chance, those very people who have no business gambling in the first place. Will the proliferation of general solicitation (pop-up ads, television, advertisements on T-shirts) heat up the gambling interests of non-accredited investors, drawing them through the doors to speculative private offerings where they have no business playing?

Those with a cynical view of human nature will be troubled by that thought.

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