VOLUME 27 NUMBER 30 JULY 29, 2013

Missouri Lawyers WEEKLY
www.molawyersmedia.com

JOBS Act delivers new opportunities

Public advertising for the sale of securities now permissible, but companies must proceed carefully

By Matt Kitzi

The recent finalization by the U.S. Securities and Exchange Commission of certain rules necessitated by the 2012 Jumpstart Our Business Startups Act related to private securities offerings creates a new environment in which a variety of small businesses, entrepreneurs and startup companies and private funds can raise capital.

The upshot is that businesses, hedge funds and private equity firms can still avoid costly regulatory registration of their securities by engaging a private offering exemption but can now publicly advertise that activity. Until the commission's recent action, such public marketing had been expressly prohibited for the past 80 years.

As only a single component of the JOBS Act, and finalized a full 15 months after the law requiring the rules was passed, the new provisions cannot be called the immediate relief the JOBS Act was presumably intended to provide in the spring of 2012. Still, this public advertising feature constitutes a development that could expand the investor universe and possibly lower costs related to capitalization.

But issuers must proceed with some caution, as a few wrinkles in the law's implementation may not rest comfortably in the collective business intuition. The removal of the long-standing prohibition on general advertising will eliminate some common pitfalls and perhaps economize marketing efforts, and it will likely deepen the largest pool of investors for those offering these securities. But just as before, the securities can only be sold to accredited investors (read: wealthy), and a previously eligible, though limited, class of investors is no longer viable. Further, issuers must satisfy a new test for vetting their investors to ensure they meet the accredited standard, and the commission is now considering an additional bundle of obligations which could be added to requirements placed on publicly advertising issuers. A disorganized issuer can easily stray outside the parameters of the new exemption despite its expanded track.

Public solicitation

The crowdfunding provisions of the 2012 JOBS Act caught the fancy of many commentators and actors in the capital formation universe during the run-up to the law's passage in April 2012. The financial press, bloggers, pop culture commentators, skeptical regulators and would-be Internet financiers made crowdfunding the darling of the bipartisan legislative effort to "jumpstart" American business and job growth leading into the political frenzy of the 2012 presidential elections. Once the act reached its final form, however, would-be tycoons seeking a grass-roots path to seed capital found that route to be a one-way street through a required funding portal littered with extensive disclosure requirements. Those conditions, coupled with a low-ish ceiling on capital to be raised ($1 million for the entire issue, $2 million with audited financials) and widespread concerns over fraud in the market, may have transformed crowdfunding into a fairly insignificant, though once provocative, component of the JOBS Act. And the commission still has not finalized the rules establishing those portals or required disclosures.

Instead, it is the public solicitation element in the JOBS Act that is gaining and will likely continue to have some legs. At bottom, the new law, to be known as Rule 506(c) of Regulation D, allows the public marketing of private offerings. Those private offerings can still only be purchased by the technically well-off set, but now everyone with an Internet connection, a television, or newspaper subscription will be able to see the investment opportunities only the privileged could view, before. In the 80 years preceding the commission's recent action, the highlights of these offers were left to the imagination of the middle class. Now, all will be able to see such offers in full color.

This is a fairly significant policy shift that can get lost in the weeds of the sometimes impenetrable securities law lexicon and detail. Political and financial leaders are blowing past a rather tortured linguistic composition to embrace the idea of the public peddling of private offers. From this point forward, the Rule 506 capital formation industry, including hedge funds, private equity firms, small businesses and entrepreneurs, can take to the airwaves, Internet and billboards to spread awareness of their offerings. To the extent that accredited investors were uninformed or unaware of the opportunities reserved only for them, the power of modern American marketing will be deployed to remedy that problem. And it is unlikely to be a mere blip on the national advertising radar. The commission estimates that in 2012, Rule 506 of Regulation D was used to raise $898 billion (compared to $1.2 trillion in fully registered offerings).

So, the landscape for raising private capital is about to change, and in a very public sense. Everyone will be (or could become) aware of who is raising money and how. And those who are accredited (read: wealthy), will be eligible to purchase these securities, just as before. The firms issuing the investments to raise needed dollars or expand their fund can take their offer to the market much quicker, or at least, in a much less meticulous fashion. And the regulators, particularly at the state level, have no added authority to supervise or oversee these issuances and offers. So what's not to like?

Apparently, plenty, if you poll those who opposed the new rule prior to its adoption. Major players in the investor protection community such as Consumer Federation of America Investor Protection Director Barbara Roper, Fund Democracy Inc., founder Mercer Bullard, and Arkansas Securities Commissioner Heath Abshure have all taken shots at the removal of the public solicitation ban. And, SEC Commissioner Luis Aguilar was the lone "no" vote on the rule's July 10 passage.

Quirks and sharp edges

Most of their objections focus on investor protections and the perceived need for more in the rules. Indeed, the meeting where the public solicitation ban was lifted also featured the proposal (but not the passage) of possible rules that would require issuers to submit their advertising to regulators, explain how they will advertise, and slap warnings labels on their materials. Less concern has been expressed for the businesses that may leap at this new exemption with the expectation of lower transaction costs, deeper prospective investor pools and minimal government oversight.

But the new exemption is not without its quirks, or with-

Key points

Crowdfunding exemption is still NOT available. The commission's recent action only implements the general solicitation provisions of the JOBS Act. It did not address the more-publicized crowdfunding component; even when the crowdfunding rules are finalized, it will be the removal of the ban on general solicitation, not the still-pending crowdfunding provisions, which will prove the biggest difference maker in the JOBS Act

Public advertising of private offers. Issuers can now generally solicit (read: publicly advertise as big and often as desired) exempt private offerings which are not registered with the federal or state regulators

Securities offers coming to a channel near you. A private offering under Rule 506 of Regulation D can be advertised on the Internet, on television, in newspapers or any other means of mass communication, meaning many more Americans will be viewing marketing efforts from hedge funds, private equity firms and others seeking capital for private ventures

You can look, but you can't buy (if you're not wealthy). Restrictions remain on who can actually purchase the publicly marketed, exempt securities. They can only be advertised generally, not actually sold to the masses

Sophistication is no substitute for riches. Generally solicited Rule 506 offerings can only be sold to accredited investors; non-accredited, "sophisticated" investors, eligible in limited numbers under the prior Rule 506 approach, are not eligible to purchase generally solicited securities

"Reasonable" securities laws? Issuers under the new Rule 506 approach must take reasonable steps to verify their purchasers' accredited investor status, and no uniform verification method or standard has been mandated by the Commission

No more "check-the-box" questionnaires. The commission has indicated that taking the investor's word for it is insufficient and active inquiry or effort is necessary; so employing the customary investor questionnaire will likely fail regulatory scrutiny

More steps in the making? Though not finalized in the recent action, The commission now has an additional set of requirements before it in the form of late-arriving proposals requiring additional submissions to regulators and warning labels; these requirements are not in effect now but may be added by later Commission action

Tried-and-true still available. The traditional Rule 506 offering mechanism (privately offered securities sold to accredited or sophisticated investors) still exists. The option remains for issuers who want to pursue 35 or fewer sophisticated, non-accredited investors, or for those who prefer to avoid the "reasonable steps" verification required in generally solicited offers

No exemption from fraud. Though issuers may now publicly advertise their offering and maintain their exemption from registration, they are not exempt from federal or state anti-fraud provisions, and thus must still take care to make all necessary disclosures in an accurate and full manner out the sharp edges that can snag an unaware issuer. Here are five specific issues that anyone seeking to raise capital under the new Rule 506(c) should keep in mind:

1. The removal of the prohibition on public advertising is a major shift in both policy and practical application. But the change only applies to the marketing process, not the actual sale and purchase. Securities issued under the Rule 506(c) exemption may still only be sold to accredited investors, even though many more, who are ultimately unable to act, will be aware of the securities' availability.

This change could make marketing of a private offering less expensive, or at least less technical. Rather than working limited channels for fear of placing an inaccessible investment opportunity before an unqualified prospect, issuers can blast their message as broadly as desired. But issuers must understand that the sheer number of actual investor prospects is not what has enlarged —instead, it is only the access which has expanded. The longstanding thresholds for the most common accredited investor qualifications remain in place: $200,000 annual income ($300,000 joint income for a married couple) over the past two years, or $1 million in net worth (without counting the value in a primary residence, the one change to the qualification standard that came from the JOBS Act's older cousin, the Dodd-Frank Act).

2. Until the commission recently finalized its JOBS Act rules, Rule 506 issuers had a lesser-known but still relevant sub-category of potential purchasers: up to 35 non-accredited but "sophisticated" investors. The standard for qualifying (or

> The recent SEC rulemaking action has loosened some constraints while introducing new requirements, and careful navigation will continue to be key.

verifying) these sophisticated investors who did not meet the bright-line accredited investor standards could be challenging, and was often a more subjective exercise. The new Rule 506(c) exemption that features general solicitation removes that challenge by wholly eliminating non-accredited "sophisticated" investors from the equation.

A publicly advertised private offering cannot be purchased by a single investor under the sophisticated-only standard. The JOBS Act language did not specify that this sub-group was to be excluded from publicly advertised Rule 506 offerings, but the commission staff appears to have drawn an implication that such exclusion was necessary. So, the 35 sophisticated investors who might have accompanied their accredited colleagues in an offer may no longer do so, at least where the offer was generally solicited.

3. This public nature of the discussion around private offerings is almost certainly going to pique the interest of a broad swath of people — ranging from the experienced investor who most certainly meets the "accredited" standard across to folks who have no business purchasing interests in what are often risky, prone-to-losses startup businesses or funds. It is the prospective investor who is on the tipping point, however, that is like to create a challenge. The fact is, new businesses and entrepreneurs who are seeking startup capital or later-round funding for an expansion will undoubtedly be encouraged by the interest shown in their business, regardless of the income or assets of that interested person.

The best disclaimers and conditions placed at the end of Rule 506(c) advertisements are likely to rival those previously found in sweepstake promotions and pharmaceuticals commercials. But it remains to be seen whether speed-read legalese at the end of a well-crafted pitch will be sufficient to dim the interest of an engaged but nonqualified viewer. All investors, including the great majority who are not accredited, desire access to the best ideas, the newest instruments and the exciting ventures that seem limited to the already rich and elite. The mass marketing of those opportunities will only intensify that desire, creating a rather classic look-but-don't-touch scenario for unqualified investors and issuers, alike.

The burden of compliance in this area will remain on the issuer. If a non-accredited investor gains access to a generally solicited but still private Rule 506(c) offering, it is likely the issuer who will risk punishment (loss of the exemption), rather than the investor. The lack of a specific penalty for falsely posing as an accredited investor could embolden a certain segment which wants access to the same opportunities enjoyed by those who have reached the station those in that segment aspire to. While it is the issuer who has much to lose if the wrong investor purchases in a private offering, this new publicly advertised-private offering space seems to invite scenarios where a small or new business is left in a precarious situation.

Is it hard to envision a scenario where a struggling but optimistic small businessman, a true believer in his idea and fully committed to his venture, wants so much to believe that a group of motivated, inspired, seemingly well-heeled professionals must surely meet whatever obscure financial means test a group of pro-business lawmakers has established? Is the small businessman even aware of those tests? Is he going to be able to resist the checks being warmly pushed in his direction by eager investors, even while he has the notion that maybe one or more of these investors might not meet the traditional image of a financial backer?

It is the lawyer for the issuer who will likely have the best opportunity to prevent these nonqualifying and exemption-threatening purchases. Early discussions of the parameters of a new Rule 506(c) offering are key, as is painting the picture of what the disaster may look like when non-accredited investors wheedle their way into an offering. The matter will really only take hold when the venture fails, and the investors, facing losses, turn to regulators for help, or at least answers. And when the non-accredited investors present a much less enthusiastic, less-well-heeled persona to the regulators, the exemption is in danger for the entire offering, not just that component impacting the non-accredited investors.

4. The difficulties generated by non-accredited interest will make vetting and verifying accredited status all the more important in publicly solicited Rule 506(c) offerings. The new standard expressed in the rules requires an issuer to take "reasonable steps to verify" accredited status. Congress did not specify the reasonable steps in the JOBS Act language and left it to the commission to determine appropriate methods. The commission adopted a principles-based objective standard for determining qualification, which will necessarily consider the facts and circumstances of the offering and the investors.

The commission also laid out a non-exclusive list of verification methods relevant to vetting natural persons. No issuer is required to use these methods, but can satisfy the verification obligation by reviewing completed official forms such as W-2s, 1099s, K-1s and other Internal Revenue Service documents that report income. Additionally, issuers can review financial statements and credit reports, coupled with a representation as to their truth, or may rely on a writing from a credible third party (such as a broker-dealer, attorney, or CPA) to meet the verification standard.

Though the principles-based "reasonable steps" test, even when combined with the approved vetting methods, does not provide ultimate clarity on an issuer's obligations, the commission did expressly eliminate a verification process that was quite common under Rule 506. The commission staff commented that issuers who solely rely on an investor-completed questionnaire professing accredit status will fall short of the "reasonable steps" threshold. This is newsworthy in that the investor questionnaire, featuring a check-the-box section indicating accredited status, might have been the most traditional type of verification previously used in Rule 506 offerings.

On top of this heftier verification requirement, issuers may soon have to tackle the additional submissions and disclosure obligations just proposed. As noted above, these changes to the Rule 506 safe harbor have not been without their critics, and a late-arriving but seemingly formidable array of proposed obligations was foisted onto the scene at the very meeting where the process was altered. These proposals are not law, and it remains to be seen if they will take hold, but their existence suggests that at least some in commission leadership remain uneasy with relaxed Rule 506 processes, and thus those same processes may change, again, and in a material manner.

+Under the just-finalized rules, Form D will now feature a check-the-box prompt that directs issuers to indicate whether they are proceeding under the prior, nonpublic-solicitation version of a Rule 506 offering (now a "Rule 506(b)" offering on the form), or are instead opting for the new version that allows general advertising (Rule 506(c)). With this feature, issuers will immediately and publicly signal to regulators and investors whether they have engaged or plan to engage in public solicitation.

Careful navigation

The commission has finally acted to implement a key component of the JOBS Act, and it appears that those efforts may produce increased private securities offering activity. But while the process of offering those securities now features additional options and may be, to some, less restrictive, the sale of private securities remains a highly regulated activity.

The recent commission rulemaking action has loosened some constraints while introducing new requirements, and careful navigation will continue to be key to keeping an offering moored in the Rule 506 safe harbor.

Matt Kitzi, a partner at Armstrong Teasdale and member of the firm's corporate services practice group, previously served as Missouri Commissioner of Securities for seven years.