ROBERT G. HUTCHINS - LEGAL BULLETINS

January 2013 - "General Solicitation" Proposed for Rule 506 Securities Offerings

Overview - Congress vs. the SEC - The "JOBS Act" Directives

Last April, with much fanfare, Congress adopted the "JOBs Act" to shore up the US economy. Among other things, the Act directs the SEC to revise the Securities Act Rules to lift the ban on "advertising" and "general solicitation" in two types of unregistered transactions: offerings by issuers to accredited investors and resales by financial intermediaries to "qualified institutional buyers." The SEC was also directed to create a new exemption for advertised issuer offerings up to $50 million in any 12 month period. After a frustrating delay, the SEC grudgingly responded to the first directive by proposing to allow general solicitation in offerings made by issuers solely to investors they had "verified" as accredited. The proposal is not popular with regulators, but Congress has spoken. The JOBS Act directives will eventually provide small business with unprecedented access to capital sources, bringing about a sea change in corporate finance.

Background

Congress attributed the stock market collapse that triggered the "Great Depression" of 1930-1941 to insufficient federal supervision over transactions in securities. To correct that oversight, Congress adopted the Securities Act, which became law at the low point of the Depression on May 27, 1933. The Act imposed three legal principles that, for the ensuing 79+ years, have dominated capital formation in the United States. First, no offer or sale of any security is lawful unless a registration statement containing a full disclosure document, or "prospectus," is in effect for the underlying transaction, or an exemption from registration is available for either the transaction or the security itself. Second, securities originally issued in an exempt transaction, though lawfully outstanding, are "restricted." They may not lawfully be resold unless the resale transaction is registered or exempt. Third, with minor exceptions exempt transactions in securities may not be promoted by advertising or any other form of "general solicitation."[1]

Congress attributed the financial crisis that triggered the "Great Recession" of 2007-2009 to insufficient federal supervision over mortgage lending and the minimum capital and other risk management requirements imposed on banks that invest in "derivative" securities. To correct this oversight, Congress adopted the Dodd Frank Wall Street Reform and Consumer Protection Act, which became law on July 21, 2010. Dodd Frank imposed highly controversial restrictions on financial institutions. Depending on the commentator, either the Act stopped abusive lending, created needed consumer protection agencies and erected safeguards against "too big to fail" corporate bailouts, or it suppressed the credit markets, administered the coup de grace to a moribund housing market and threatened to ruin an already sputtering economic recovery.

[1] Issuers may use approved public announcements to "solicit interest" in exempt offerings up to $5 million under Securities Act Regulation A. Issuers may also use general solicitation under Rule 504 to promote exempt offerings up to $1 Million that are completed: (a) exclusively in compliance with state registration requirements, (b) by registering them in at least one state and providing all purchasers, in all states, with the "substantive disclosure document" approved by the registration state, or (c) by limiting purchasers to accredited investors and complying with state regulations that exempt the offering from registration but still permit general solicitation.

The debate raged on, but by early 2012 even Dodd Frank supporters were conceding that, though the financial crisis had ended, the recovery had stalled. This time, Congress' response was the JOBS Act, which became law on April 5, 2012. The JOBS Act encourages capital formation and hiring through several initiatives. Title II expressly directs the SEC to (a) amend Rule 506 to permit general solicitation in exempt issuer offerings to "accredited investors;" (b) amend Rule 144A to permit general solicitation in exempt resales of "restricted" securities to "qualified institutional buyers" or "QIBs" and (c) amend Regulation A (or add a new Regulation) to exempt issuer offerings of equity, debt or convertible securities in amounts up to $50 Million in any twelve month period. This Bulletin concerns the SEC's proposed amendments of Rule 506. The final amendments and the other JOBS Act initiatives will be examined in future Bulletins.[2]

The SEC's Response to the Rule 506 Directive - Proposed Rule 506(c)

The SEC, having zealously supported the ban on general solicitation, did not embrace the JOBS Act with much enthusiasm. Its final amended Rule 506 was due by July 3, 2012, but it was not until August 29th that the SEC issued a release *proposing* to amend the Rule by adding a new subsection designated 506(c). The ensuing comment period expired October 5, but at year end there was still no final Rule and the ultimate scope of the general solicitation contemplated by the JOBS Act remained in doubt. Indeed, Mary Shapiro, the former SEC Chair who resigned December 14,th stands accused of delaying the rule making process until after her departure to avoid being, as she put it, "tagged with an Anti-Investor legacy."[3]

Rule 506(c) is proposed as a companion to Rule 506(a), which provides a non-exclusive safe harbor exemption for certain offerings by issuers. These offerings need not be limited in amount. The offered securities may be sold to any purchasers already known to the issuer who qualify as "accredited investors" plus up to 35 other known purchasers who, though not accredited, are "sophisticated;" i.e., able, alone or with a qualified representative, to evaluate the offering. Rule 506(a) offerings are subject to the definitions, integration provisions and resale restrictions listed below in Note 6 and they must meet the following express conditions set forth in Rule 506(b): (i) the issuer must believe, and have a reasonable basis for believing, that each purchaser deemed an "accredited investor" satisfies at least one category for that term; (ii) the issuer must disclose specific financial and other information about itself, its business and its

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[2] "JOBS" is an acronym for "Jumpstart Our Business Startups." The term "accredited investor" is defined in Rule 501(a). See note 4, below. Securities are "restricted" if acquired from the issuer in one or a series of unregistered transactions. A "QIB" owns and invests on a discretionary basis at least $100 million in securities issued by non-affiliates. There is a huge market for unregistered, two-phase transactions in which issuers sell securities to brokers under Rule 506 and the brokers immediately resell them to QIBS under Rule 144A. The latter Rule did not originally contain, or need, a prohibition of general solicitation because it required that *offerees* as well as *purchasers* be QIBS. *"Offerees"* include *everyone* reached by a solicitation, QIB or not, but the QIB status of a potential *purchaser* can be verified prior to closing the sale. The SEC proposes to comply with the JOBS Act by expressly limiting the accreditation requirement to *"purchasers."*

[3] See, The Wall Street Journal, December 2, 2012, *"SEC Chief Delayed Rule Over Legacy Concerns;"* and its December 6; 2012 opinion page, *"Shapiro's Boss."* With due regard for Ms. Shapiro's legacy, I submit that removing the ban on general solicitation is "Pro-Investor." Victims of securities fraud are not duped because the securities were advertised. They are duped by material misrepresentations in offering documents or promotional materials and those have always been actionable. Sophisticated investors can evaluate any opportunity that is adequately disclosed, but no promotional blackout will protect credulous naïfs from themselves for long. Investors, by definition, welcome investment opportunities and many actively seek them. I regard the general solicitation ban as an impediment to both issuers and investors; a costly example of the flawed thinking of a nanny government.

securities to all purchasers who are not accredited investors; (iii) an interval of at least six months must elapse between allegedly discrete offerings to avoid "integration" (see Note 6); (iv) within 15 days after the first sale, the issuer must file a Notice of Sale on Form D with the SEC and affected state regulators; and (v) the offering must not be promoted by "general solicitation."

Rule 506(c) is thus an alternative to Rule 506(a) that would permit issuers to use general solicitation for any offering that otherwise complies with the Rule *provided* that all purchasers *"are"* accredited investors *and* the issuer has taken *"reasonable steps"* to *"verify"* that status.[4]

Moreover, Rule 506(c) securities would be "covered" under Section 18 of the Securities Act, as are securities sold without general solicitation under Rule 506(a). Section 18 provides an "exemption" for "covered securities" from substantive state regulation under the authority provided by the "Supremacy Clause" (Article VI, clause 2) of the United States Constitution. Accordingly, *state* bans on general solicitation would not apply to Rule 506(c) offerings.[5]

The text of Rule 506(c) as currently proposed is brief and relatively straight-forward.

(c) ***Conditions to be met in offerings using general solicitation or general advertising:***

(1) ***General Conditions.*** **To qualify for exemption under this section, sales must satisfy all the terms and conditions of (Rules) 501 and 502(a) and (d).**[6]

(2) ***Specific Conditions.***

(i) ***Nature of Purchasers.*** **All purchasers of securities sold in any offering under this (Rule) 506(c) are accredited investors.**

(ii) ***Verification of accredited investor status.*** **The issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under (Rule) 506(c) are accredited investors.**

The SEC's proposal retains intact the remaining substantive requirements for Rule 506 offerings. These would apply whether or not the issuer engages in general solicitation and they make

[4] The proposing release is available at www.sec.gov. Click "Regulation/Proposed Rules" then scroll down to #33-9355 dated August 29, 2012. Briefly, an investor is "accredited" if *reasonably believed by the issuer* to be (a) an entity specified as accredited in Rule 501(a), e.g. a state agency, or a bank, an insurance company, etc.; (b) a natural person who has (i) a legal relationship with the issuer, e.g. as a director or officer, that provides access to material information; or (ii) annual income for the past two years of at least $200,000 ($300,000 with spouse) and a reasonable expectation of equivalent income in the current year; or (iii) net worth (alone with spouse) of at least $1,000,000 exclusive of equity in the primary residence; or (c) a corporation, trust, 501(c)(3) organization, pension plan or partnership not formed for the purpose of making the investment with gross assets of at least $5,000,000.

[5] Under the Supremacy Clause, the Constitution, laws and treaties of the United States "shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the constitution or laws of any state to the contrary notwithstanding."

[6] Compliance with Rule 502(c), which contains the ban on general solicitation, is omitted from the conditions. Rule 501 defines "accredited investor," as summarized in Note 4, and other terms. Rule 502(a) states factors that determine when allegedly separate offerings will be "integrated" (treated as one and the same offering). The integration doctrine is invoked to defeat schemes that artificially divide offerings into two or more parts to evade exemption requirements; e.g. the requirement that securities be sold to no more than 35 non-accredited investors in any one offering. Rule 502(d) categorizes Rule 506 securities as "restricted" and requires that the issuer take reasonable care to prevent initial purchasers from acting as "underwriters" by reselling the securities without registration as part of a pre-arranged "distribution." Issuers demonstrate "reasonable care" in various non-exclusive ways, e.g. by disclosing the resale restriction in the offering documents and on the securities certificates and obtaining a binding undertaking from each purchaser not to resell the securities without registration or an exemption.

liberal use of the concept of reasonableness. Thus, if the proposal becomes final, the definition of "accredited investor" would continue to include any person "reasonably" believed by the issuer to have that status, with or without verification. Indeed, in its proposing release, the SEC acknowledged that the accredited status of some investors will be sufficiently obvious as not to require any verification at all. The SEC has, however, proposed adding a box to Form D that issuers must check to notify regulators when general solicitation is used.

The Comments

The reaction to the proposed Rule has followed a predictable course. Securities professionals and the business community largely support it, while state securities regulators urged the SEC to impose additional restrictions that would water it down to the point that its use would be problematical. The comment letter submitted on behalf of the Massachusetts Securities Division articulates the reasoning behind the opposition to general solicitation in unregistered offerings shared by most states:

Massachusetts Securities Division Letter

The Division begins by quoting the JOBS Act directive to amend Rule 506 to:

"…provide that the prohibition against general solicitation or general advertising … shall not apply to offers and sales of securities made pursuant to (the amended Rule) provided that all purchasers of the securities are accredited investors. Such (amendments) shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."

Based on the quoted language, the Division argues that:

First, it follows from the requirement that all purchasers *"are"* accredited investors that all purchasers must, in fact, *be* accredited. This requirement therefore *omits and replaces* the old "reasonable belief" standard.

Second, the requirement that issuers *verify* the accredited status of investors is *distinct* from the accreditation requirement itself. Both requirements must therefore be satisfied for an exemption to be available if general solicitation is used.

Third, given its importance, the required verification *process* should be spelled out by the SEC and strictly enforced. It should be based on *documentary* evidence. Completing it should be made the responsibility of a *key person* or independent third party representative of the issuer.

Fourth, as an additional condition to the exemption, Form D must be filed *prior* to the start of the offering to enable the SEC and state regulators to identify suspect promotions before they can cause significant harm.

Fifth, a conservative interpretation of the JOBS Act directive is critical because Rule 506(b) already omits ("waives") both the investor "sophistication" requirement and any specific financial or other disclosure requirement when investors are accredited. Yet, accredited investors, solely by virtue of being accredited, are no less susceptible to fraud than other investors. Since, by definition, there is no advance regulatory review of an exempt offering, the dual requirements that all investors must actually be accredited, and affirmatively verified as such, are the only effective deterrents against fraud that will remain for offerings under the new Rule. The anti-fraud and civil liability provisions contained in all securities laws, standing alone, do not provide sufficient protection to any investors.[7]

Initial Observations

Advertising and General Solicitation

The SEC refused to propose specific rules respecting promotional content or solicitation methods for Rule 506(c) offerings. However, the issuer, its directors, senior executives and other representatives who participate in such offerings can be liable personally for materially misleading statements or omissions in promotional materials. To limit that exposure, the solicitations should conform generally to Rule 134 governing non-prospectus communications in a registered offering. Promotional content should be limited to an announcement of the offering (including its duration and the amount, designation and price of the securities); the names of the issuer and any brokers (with contact information for each); the names of any selling security holders; a brief summary of the issuer's business; a balanced summary of the merits and risks of the investment; a statement whether, in the opinion of counsel, the securities are tax exempt or a legal investment for banks, fiduciaries and similar investors; a summary of the intended use of the offering proceeds; the means for obtaining a full disclosure memorandum; the fact that the offering is limited to accredited investors; and a summary of the accreditation requirements.

Based on the history of Rule 504 offerings, I think it unlikely that advertising alone will induce accredited investors to purchase securities issued without registration; particularly when the issuers are little-known, private companies. Small issuers serving local or niche markets, e.g., restaurants and micro-brewers, occasionally sell securities under Rule 504, but all too often the money trickles in at a glacial pace because the securities are purchased in small lots by loyal customers simply as an inexpensive means of showing support. These customers view the issuer's stock certificates as promotional devices analogous to branded sweatshirts. By contrast, most Rule 506 issuers need substantial immediate capital and are interested in finding serious investors. For these issuers, the advantage provided by proposed Rule 506(c), which cannot be overstated, lies in the freedom to search aggressively for affluent prospects and "cold call" those they can identify. That is truly a revolutionary change.

Verification of Accredited Investor Status

If the SEC yields to the demand that Rule 506(c) purchasers must, in fact, be accredited, the final Rule will be useless unless the accredited status of all purchasers can be "verified" by unimpeachable evidence. Even if a reasonable belief that purchasers are accredited remains

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[7] Of course, accredited investors are susceptible to fraud, but if they were as vulnerable to its consequences as everyone else, devising special Rules for them would be pointless. In fact, apart from the anti-fraud and civil liability provisions, protective measures are not thought necessary for accredited investors because it is presumed, not without reason, that they can either absorb the loss of an investment financially or ferret out on their own the information necessary to evaluate it. The Massachusetts Securities Division letter, dated July 2, 2012, is authored by William Galvin, Secretary of the Commonwealth. All comment letters may be accessed through the link in note 26 of the Proposing Release, or the "Submitted Comments" at www.sec.gov/comments/jobs-title-ii/jobs-title-ii.shtml.

sufficient, I suspect many issuers with solid investor relationships will forego general solicitation and continue to offer securities solely in reliance on Rule 506(a) simply to avoid the risk that verification will be viewed both as necessary for one or more of their purchasers and inadequate as carried out. The proposing release gives examples of verification methods without either mandating any specific method or providing extended guidance. Among the examples: (i) issuer reviews of filings by public companies that list compensation and stock holdings for executives included among the purchasers, (ii) similar reviews of trade publications listing average compensation for selected positions plus evidence that a purchaser occupies one such position; and (iii) third party certifications, opinions or endorsements by persons who are familiar with a purchaser's financial position (accountants, lawyers, brokers, bankers, investment advisers, etc.). The website for the Financial Industry Regulatory Authority ("FINRA") is cited by the SEC as a convenient source for identifying securities brokers who can be engaged as placement agents for a Rule 506 offering. Stock brokers can provide independent verification of the accredited status of their investor clients. If registered, the brokers will be accredited in their own right. The IRS' public list of qualified charitable organizations, or its formal acknowledgment letter, can confirm the status of a purchaser believed to be accredited as a 501(c)(3) organization. Self-certification questionnaires and subscription agreements that contain warranties of accreditation can help establish both reasonable verification and a reasonable belief that the signing purchaser is accredited. Such devices are common in offerings under Rule 506(a).

The SEC recognizes that a purchaser's income will be relatively easy to verify without taking the overly intrusive step of reviewing personal financial statements or tax returns (e.g. by reviewing Forms W-2 or 1099, pay check stubs or employment agreements). Because liabilities are difficult to identify, though, it will not be feasible to verify a purchaser's net worth if a reliable balance sheet is not available or is withheld for privacy reasons. While hedge funds often base accredited status for natural persons on a minimum investment of $1 million or more that is not financed, that tactic is obviously impractical for the vast majority of private companies.

The SEC anticipates that a fee-based cottage industry comprised of verification "experts" will develop quickly when Rule 506(c) becomes final. However, given the SEC's failure even to provide detailed verification guidance, let alone a safe-harbor verification rule, it may be wondered how providers will manage the risk of liability for an erroneous verification. Assuming an issuer's reasonable belief in the accredited status of its purchasers remains sufficient for Rule 506(c), providers who base their verifications on a reasonable and independent investigation should also be protected. On the other hand, issuers may well resist any attempt by a verification provider to limit its liability contractually and attempts to bind a securities purchaser to waive any provision of the Securities Act, its Rules or Regulations are void under Section 14 of that statute. The states have similar provisions and in the view of the SEC, *broad* contract waivers e.g. of claims for negligence, are unenforceable to the extent they purport to include any rights provided by the securities laws. The courts have endorsed the SEC's position. As a result, exculpatory provisions in verification contracts may be unavailable when the contract is with the issuer and unenforceable when the contract is with the purchaser.

Disclosure Issues

Since Rule 506(c) offerings will be directed exclusively to accredited investors, the information requirements in Rule 502(b) will not apply and no specific disclosure format need be followed. Many an issuer has yielded to the temptation to skimp on disclosure when purporting to offer securities only to accredited investors. These issuers lose sight of the fact that the anti-fraud and civil liability provisions apply to any offering regardless of the sophistication or accredited status of those who purchase the securities. If the disclosure actually furnished is materially incomplete or otherwise misleading, the issuer and all persons who participated in the offering will face claims if the investment does not perform as promised or reasonably expected. Accordingly, full disclosure should always be provided and there are no better guidelines for that than the Rules, Regulations, Policies and Interpretations formulated by the SEC.

Potential State Challenges

For many years, companies that raised capital by selling securities had to comply with both federal law and the law of each state in which the securities were offered. The result was a regulatory quagmire that few companies were willing, or financially able, to negotiate. To remedy this, the National Securities Markets Improvement Act of 1996 ("NSMIA") amended Section 18 of the Securities Act to "exempt" offerings of so-called "covered securities" from state regulation. As noted, securities issued under Rule 506 are "covered."

When NSMIA was adopted it was widely assumed that the SEC was now the only public authority that could enforce Rule 506 on its own initiative so that the federal district courts would be the proper judicial forum for challenging an enforcement action. But NSMIA did not deprive the states of their right to enforce their own anti-fraud provisions; nor did it specify which agency would decide in the first instance whether Rule 506 applied to an offering. That provided an opportunity for state regulators to sanction an issuer if they thought its offering did not comply either with the Rule or with its state equivalent.

The early NSMIA case law favored issuers and upheld complete preemption, but on December 26, 2006, the Ohio Court of Appeals decided *In re Blue Flame Energy Corp.* The Ohio Court ruled that, while NSMIA does "preempt" (prohibit) state regulation of any Rule 506 offering, it does so only when the offering "is" (in fact) exempt under the Rule; a threshold question that can be determined by the states. *Blue Flame* has since been followed by various courts, including the federal Court of Appeals for the Sixth Circuit where Ohio is located. State challenges may increase significantly when securities are offered under Rule 506(c) because allegations that the issuer failed to verify the accredited status of all purchasers, used misleading promotional materials or failed to complete Form D properly can be added to a state's legal arsenal.[8]

In adopting the JOBS Act, the 112th Congress got at least one thing right. It is unfortunate that the Act is not being implemented at a faster pace because its directives are sorely needed and long overdue. Nevertheless, the SEC has made a promising beginning.

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[8] 171 Ohio App.3d 514-Ohio-6892 - See also, www.hutchins-law.com/publiciations/bulletins; *"Who will Regulate Unregistered Securities Offerings under Rule 506?"* August 2008.