ROBERT G. HUTCHINS - LEGAL ESSAYS
Advertising "Private" Securities Offerings
The "JOBS Act" and Amended Securities Act Rules 506 & 144A

Introduction

In early 2012, the Congress faced relentless pressure to do something about the torpid US economy. Its response was the "Jumpstart Our Business Startups Act" (the "JOBS Act"), a statute providing ambitious financing initiatives for a wide range of companies. The JOBS Act became effective April 5, 2012.

- To help startups, the Act directs the Securities and Exchange Commission (the "SEC ") to craft a new exemption from registration for online securities offerings up to $1 million in any 12 month period that are conducted through a registered broker or "funding portal" and sold to investors in small amounts ("Crowdfunding").

- To help smaller registrants meet reporting requirements, the Act eases their disclosure burden respecting compensation and financial statements, relieves them from audit and attestation requirements respecting internal financial controls and delays their obligation to comply with new accounting standards ("Reopening American Capital Markets To Emerging Growth Companies").

- To help successful private companies stay private, the Act increases the shareholder threshold for mandatory registration ("Private Company Flexibility and Growth") and directs the SEC to devise a new exemption based on existing Regulation A for "mini-public" offerings up to $50 million (initially) in any 12 month period ("Small Company Capital Formation").

- To help finance employers generally, the Act directs the SEC to remove the ban on advertising and other "general solicitation" long applicable to exempt offerings by issuers under Rule 506 and exempt resales by holders to qualified institutions under Rule 144A ("Access to Capital For Job Creators").

The JOBS Act increased the threshold for mandatory registration by amending Section 12(g) of the Securities Exchange Act to replace the existing private company limit of 500 record shareholders with new alternative limits of *either* 2,000 record shareholders *or* 500 who are *not* "accredited" investors. See, **"Accredited Investors,"** page 7. Registration is required if either of the new limits is exceeded, but companies need not look through record holdings and count beneficial owners to determine that question. To the extent securities are held of record in "street name" (by brokers on behalf of their clients), the actual number of a company's total and non-accredited shareholders will be higher than its record total. When the SEC implements the exemption for $50 million "mini-public" offerings (called informally, "Regulation A+"), companies able to rely on it will almost certainly conduct their offerings through brokers. If they wish to avoid registration and Exchange Act reporting, such companies should be able to remain private indefinitely without sacrificing the ability to raise substantial capital from the public.[1]

At October 20, 2013, the SEC had yet to propose, let alone adopt, implementing regulations for the Crowdfunding and Regulation A+ exemptions as directed by Congress. Effective September 23, 2013, however, the SEC did amend Rules 506 and 144A to remove the ban on general solicitation from unregistered offerings and resales that meet specified requirements. This Essay examines the amendments and previews the impact of all JOBS Act initiatives on the private capital market.

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[1] A related threshold of $10MM in total assets remains unchanged and will be exceeded by many private companies. However, *both* the asset threshold *and* the shareholder threshold must be exceeded before registration is required.

Contents

Background - The Market for "Unregistered" Securities 3
Traditional Rule 506 Offerings - Requirements and Limitations 4
Overview - Registration, Exemptions and Rule 506(b) 4
Finding Investors - The Existing "Substantive" Relationship 6
"Accredited" Investors 7
Other Purchasers - Limited Number and "Sophistication" Requirement 8
Purchaser Representatives 8
Brokers and "Finders" 8
Counting Purchasers 9
Preventing Structural Evasion - The "Integration" Doctrine 9
Information Requirements 10
Practical Tips - Rule 506(b) Offerings 11
Things to Avoid 12
Things to Emphasize 12
New Rule 506(c) Offerings - Requirements and Limitations 13
Overview - Sales solely to "Accredited Investors" - Verification of Accredited Status 13
Verification Methods and the Issuer's "Reasonable Belief" 13
Disclosure Issues - Advertising Content 15
Potential State Challenges 16
Practical Tips - Rule 506(c) Offerings 16
Things to Avoid 16
Things to Emphasize 17
Resales by Holders - "Restricted" and "Control" Securities 17
Relevant Definitions 17
Resales under the "Trading Exemption" - Securities Act Section 4(a)(1) 18
Rule 144 18
The "4(a)(1½)" Exemption 19
Resales to Qualified Institutional Buyers - Rule 144A 19
Other JOBS Act Directives and Proposals 20
Additional Observations 21

Background - The Market for "Unregistered" Securities

The last decade has seen steady growth in the demand for primary and secondary offerings of securities issued without registration, so-called "unregistered securities."[2] This growth has been driven by:

- The wide dissemination via the internet of basic product, service and segment information about private companies;
- The popularity of offerings authorized by paragraph (a) of Securities Act Rule 506 under which an issuer may raise an unlimited amount of capital from an unlimited number of acquaintances who qualify as "accredited investors," while avoiding the burdens of SEC registration, state regulation or compliance with a specific disclosure format, all at a fraction of the cost of a registered offering;[3]
- The prohibitive expenditure of time and money devoted by public companies to periodic reporting requirements imposed by the Exchange Act and the disclosure to competitors and hostile acquirers of sensitive information that inevitably results when the reports are filed;
- The influence on public companies of shareholder activists whose initiatives were originally submitted in reliance on the SEC's defunct proxy access rule (Exchange Act Rule 14a-11) and are now pursued in reliance on the SEC's shareholder proposal rule (Exchange Act Rule 14a-8);[4]
- The pre-IPO success of startups such as Facebook, Trulia, LinkedIn and Groupon;
- The easing of Rule 144's initial limitations on resales of "restricted" securities (those acquired without registration, directly or indirectly, in one or a series of transactions, from an issuer or its affiliate); and
- The emergence of internet trading platforms for unregistered securities.

Judging from the business press, it is widely assumed by securities professionals and market participants that the JOBS Act initiatives will increase significantly the popularity of unregistered securities offerings. Because the SEC has yet to implement the Act's directives respecting Crowdfunding and "Regulation A+," this process will begin with its removal of the ban on "general solicitation" from unregistered primary offerings by issuers to accredited investors and from unregistered secondary offerings by initial purchasers to "Qualified Institutional Buyers" ("QIBs"). To accomplish this, the SEC amended Rules 506 and 144A on July 10, 2013, effective as of September 23, 2013.[5]

Rule 506 was amended by the addition of paragraph (c), which permits issuers to promote offerings by general solicitation *if* (i) the securities are purchased *exclusively* by accredited investors; (ii) the issuers

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[2] The term "unregistered securities," though widely used, is a misnomer. In the absence of an exemption, the Securities Act of 1933 and its state counterparts require registration of the *transactions* in which securities are offered and sold; not the securities. Some securities, however, e.g., those issued by the federal government and the states, are deemed sufficiently risk-fee to be exempt in their own right without registration.

[3] A Rule 506(b) offering may include up to 35 non-accredited, but "sophisticated" acquaintances if all of them are furnished specific disclosures. See, **"Accredited Investors,"** page 7; **"Other Purchasers - Limited Number and Sophistication Requirement,"** page 8; and **"Information Requirements,"** page 10.

[4] Rule 14a-11 was struck down by the Court of Appeals for the DC Circuit and withdrawn by the SEC.

[5] A "QIB" is an insurance, investment or business development company, charity, trust, registered broker-dealer or investment adviser that owns and invests on a discretionary basis at least $100 million in securities issued by non-affiliates. The Proposing and Adopting Releases for amended Rules 506 and 144A are available at **www.sec.gov/regulation/proposed/final/rules.** See, #33-9355, August 29, 2012 and #33-9415, July 10, 2013.

take "reasonable steps" to "verify" the accredited status of all purchasers; and (iii) the offerings comply with the definitions found in Securities Act Rule 501 (e.g. of the term "accredited investor") and with applicable conditions found in Rules 502 and 506(b).

Though existing Rule 144A lacked an express prohibition of general solicitation, it did require that all *offerees* as well as all *purchasers* must be QIBS. That effectively prohibited general solicitation because resale offers promoted by general means would reach all manner of institutions, QIB or not. The SEC's solution was to amend Rule 144A to provide that only *purchasers* (whose status can be verified prior to closing) must be QIBs. Importantly, under either of Rules 506 or 144A, a purchaser who the issuer *reasonably believes* has the required status (as an accredited investor or QIB) will be deemed to have it.

The SEC determined that over 90% of unregistered primary offerings were already conducted in reliance on Rule 506 and limited to accredited investors when the JOBS Act became law. In addition, there is a huge sub-market for unregistered two-step transactions comprised of a primary offering under Rule 506 followed by a secondary offering under Rule 144A. In the primary offering, an issuer sells its securities to brokers registered as such under the Exchange Act and thus qualified as accredited investors. By pre-arrangement, the brokers then resell the securities to QIBs in a secondary offering. With the adoption of the general solicitation amendments, the utilization of both types of offerings should increase substantially, as generally assumed. To understand exactly why, it is helpful to review the rationale for, benefits and evolving structure of issuer offerings exempted under Rule 506.

Traditional Rule 506 Offerings - Requirements and Limitations

Overview - Registration, Exemptions and Rule 506(b)

The primary objectives of the Securities Act are first, to ensure that purchasers of securities offered to the public receive all material information they need to make an informed investment decision; and second, to prevent misrepresentation in the sale of securities. To realize those objectives, the Act requires that every offer and every sale of any security in the United States must be registered in advance with the SEC unless an exemption is available for either the security or the underlying transaction. If an offering or resale is neither registered nor exempt, or if the disclosures made to purchasers are materially misleading, the Securities Act, the Exchange Act and their state counterparts subject the issuer, its directors and its participating officers and promoters to liability to purchasers who may recover the price paid for their securities, plus interest, less distributions received. In most cases, purchasers also recover their reasonable attorney's fees and costs of litigation. In cases of willful violation, criminal penalties apply.

Registration involves a comprehensive review of the issuer's proposed offering by the SEC staff. The review is designed primarily to ensure that the issuer has addressed adequately each of a lengthy series of disclosure items set out in Securities Act regulations. The overall review process is time consuming and expensive. Before any security may be offered, the issuer must file with the SEC a detailed set of documents in two Parts called a "registration statement." The statement is prepared using the SEC disclosure form for which the issuer is eligible in light of such things as the length of time it has had a class of securities registered, whether it is a foreign or domestic issuer and the type of security offered.

Part I of the registration statement is comprised of information to be included in a disclosure document (a "prospectus") to be furnished purchasers of the securities. The prospectus information begins with an identification of the issuer, the securities, the proposed pricing, the exchange or market on which the securities are to be listed, the lead and managing underwriters and the amount each has underwritten. This is followed by a summary of the offering, a list of all factors that involve material financial risk to purchasers and, if the offering is of debt securities, a schedule showing the ratio of the issuer's earnings to its fixed charges.

The remainder of the prospectus information will describe in detail the issuer, its business and properties and the offered securities. It will highlight the issuer's financial position and results of operations with cross references to audited financial statements attached as exhibits. The risk factors will include any existing or reasonably anticipated fact or event that could have a material adverse effect on the issuer, its business or the securities plus any material conflicts between the interests of purchasers and those of the issuer, its directors, officers or affiliates. The information will also include the issuer's proposed use of the offering proceeds, the factors that determined the offering price, any dilution from that price to be experienced by purchasers in the book value of their securities when the offering is closed, the identity of any selling security holders and the underwriting arrangements.[6]

Part II of the registration statement is publicly accessible, but not part of the prospectus. It contains information of immediate interest only to the SEC, such as a detailed schedule of offering expenses, contractual provisions for the issuer's indemnification of its directors and officers, a list of recent unregistered sales by the issuer of its securities (with an identification of the exemption claimed for each), various exhibits (e.g. major contracts and financial statement schedules) and undertakings to update the prospectus disclosure when necessary through post-effective amendments.

While the staff review is under way, the issuer may furnish to brokers for distribution to their customers (primarily large institutional investors) a bound preliminary prospectus marked as such on the cover page in red ink (a "red herring" prospectus). This prospectus omits pricing information and the number of securities to be sold and contains legends stating that the information in it may change and no sales may be made until the SEC declares the registration statement to be "effective." The customers may express interest in buying securities if they receive the red herring prospectus at least 48 hours prior to final sale. When the registration statement is effective, the customers may convert their expressions of interest to purchase orders. The final, effective prospectus must be delivered to each purchaser with a detailed confirmation (and purchaser affirmation) of the terms of sale. After registration, the issuer will be obliged by the Exchange Act to update the market by filing quarterly and annual reports of its financial and business condition plus current reports of material events that occur between scheduled reporting dates.

The registration and disclosure obligations, insider trading limitations, governance restrictions and risk of liability imposed on a reporting company, its directors and officers by the Securities Act, the Exchange Act and subsequent statutes such as the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 are sufficiently onerous that all but the largest of enterprises are well advised to stay clear of them. That is accomplished by raising capital in accordance with any of several exemptions from registration permitted by Sections 3 and 4 of the Securities Act.

Section 3 exempts specified *securities*, such as those mentioned above that are issued by the federal government or the states. Section 4 exempts specified *transactions* in securities, such as those carried out by ordinary investors trading for their own account, those executed on an exchange by brokers in response to customers' orders, and those conducted privately by issuers. This Essay is concerned with Section 4(a)(1), which provides the "trading" exemption for transactions by "any person other than an issuer, underwriter or dealer" (i.e. an ordinary investor) and Section 4(a)(2), which provides the "private offering" exemption for "transactions by an issuer not involving any public offering." The trading exemption allows the New York Stock Exchange to function and it may also apply to resales of securities issued without registration. It is important to private issuers because it can provide liquidity to their purchasers. See, **"Resales under the "Trading Exemption" - Securities Act Section 4(a)(1)"**, page 7.

The private offering exemption of Section 4(a)(2) is commonly utilized by issuers for their unregistered offerings. Frustratingly, the terms "public," 'private" and "offering," though used repeatedly, are not defined in the statute for fear of inviting evasion by creating bright lines. As a result, the courts, the SEC,

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[6] See, **"Information Requirements,"** page 10, for a summary of the disclosure required for Rule 506 offerings.

state regulators and the securities bar struggled for years to devise an unambiguous set of principles for determining when an issuer offering to sell its securities has managed to "involve" the public. The struggle culminated in 1982 with the adoption of Securities Act Regulation D.

Regulation D is comprised currently of seven Preliminary Notes (Rule 500) and eight substantive Rules numbered 501 through 508. Rules 501, 502 and 503 contain, respectively, definitions, general conditions and notice filing requirements applicable to all Regulation D transactions. Rules 504 and 505, which are not discussed here, describe exemptions for offerings of $1,000,000 and $5,000,000 respectively. They were adopted by the SEC under limited exemptive authority granted by Securities Act Section 3(b).

Rule 507 disqualifies an issuer from relying on any Regulation D exemption if it, or any of its predecessors or affiliates, has been enjoined from doing so for failing to file the Form D Notice in a prior offering. Rule 508 preserves a challenged Regulation D exemption if (i) the alleged defect did not prejudice the plaintiff; (ii) the defect was insignificant respecting the offering as a whole and (iii) the issuer made a reasonable, good faith effort to comply with all terms and conditions of the exemption. The Rule adds that in traditional Rule 506 offerings failure to observe the ban on general solicitation or the limit on the number of purchasers is *always* significant respecting the offering as a whole.

Rule 507 has been joined by new paragraph (d) of Rule 506 which, from September 23, 2013, disqualifies an issuer from relying on the exemptions in Rule 506 if it or any of its predecessors, affiliates, officers, directors, 20% or greater beneficial owners or promoters has been (i) convicted within the prior ten years (five years in the case of the issuer or an affiliate) of a felony or misdemeanor arising from the purchase of a security, a false filing with the SEC, or misconduct as an underwriter, broker-dealer, investment adviser or paid investment solicitor (e.g. a "finder); or (ii) barred from the securities and certain financial services businesses by the final order of a securities regulator. See, **"Other JOBS Act Directives and Proposals,"** page 20.

Rule 506 provides a *safe harbor* for claiming the statutory Section 4(a)(2) private offering exemption. Traditional Rule 506 offerings are authorized by Rule 506(b). It provides that an issuer may sell securities in any amount in each discrete offering, but (i) 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) may not sell to more than 35 non-accredited purchasers all of whom must be "sophisticated;" (iii) must disclose, to all purchasers who are *not* accredited, the financial and other information about itself, its business and its securities required by Rule 502(b); (iv) within 15 days after the first sale, must file the Rule 503 Notice on Form D with the SEC and the securities administrator in each state in which purchasers reside; and (v) must not offer the securities by means of advertising or "general solicitation."

Because it is only a safe harbor, Rule 506 is not the exclusive method for claiming the Section 4(a)(2) exemption and a failure to comply with it will not, as such, be a violation of law. An issuer may always rely on a large body of court decisions that, depending on the facts, may support its statutory exemption, e.g. because while the issuer failed to disclose all information specified by Rules 506 and 502(b), the disclosure it did provide was adequate given the sophistication of the purchasers and their familiarity with the issuer's business.

Finding Investors - The Existing "Substantive" Relationship

Because "general solicitation" is prohibited, a Rule 506(b) offering may not be promoted through public media, mass-mailings, seminars open to the public, or other means of indiscriminate communication. Such means are simply incompatible with a claim that the offering is "private" or "non-public" as required by Section 4(a)(2). Instead, with one exception, all persons to whom the securities are offered must already be known to a representative of the issuer. The exception involves unsolicited inquiries by prospects that learn of an offering from family, friends, colleagues or someone else the issuer lawfully solicited. The issuer may respond to such inquires so long as it did not intentionally set in motion the events by which the offering came to the prospects' attention, e.g. by encouraging acquaintances to mention the offering to friends. To avoid the appearance of an authorized solicitation or a brokered transaction, the issuer should respond solely through authorized representatives; not the referring person.

The securities laws are designed to ensure, as nearly as may be, that those who purchase securities can understand that investment and absorb its financial risk. Accordingly, the mere fact that an issuer can identify prospective purchasers from information gleaned from non-public sources such as private club directories, or even prior introductions, is not sufficient justification for soliciting them. There must be an existing social, familial, business or professional relationship between a representative of the issuer and each prospect. The relationship must produce information that provides a reasonable basis for a preliminary assumption that the investment is within the prospect's financial means and would be understood by the prospect (if adequately disclosed). Such a relationship is called "substantive" and it permits an issuer to *solicit* a prospect. It does *not*, however, mean the issuer can *sell* to the prospect. That question depends on whether, prior to sale, the preliminary assumption has been supplanted by a *reasonable belief* that the prospect really is accredited or, if not, is sophisticated. To establish and support that belief issuers typically rely on additional information gained from documents submitted to all prospects prior to closing. Principal among these are (i) confidential "private placement" memoranda that describe the offering and explain the exemption and purchaser eligibility requirements; (ii) investor questionnaires the answers to which provide information respecting the prospects' business experience, investment history and financial circumstances; and (iii) a subscription agreement in which the prospects warrant the truth of their answers. See, **"Practical Tips - Rule 506(b) Offerings,"** page 11.

"Accredited" Investors

Rule 501(a) defines an "accredited investor" as one *reasonably believed by the issuer* to be (i) a financial institution such as a bank or savings and loan association; (ii) a registered securities broker, dealer, investment company, or business development company; (iii) a Small Business Investment Company; (iv) an insurance company; (v) a state or state agency employee benefit plan; (vi) a private sector employee benefit plan trusteed by a bank; (vii) a natural person who has (A) a legal relationship with the issuer, e.g. as a director or officer, that provides ready access to material information; or (B) 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 (C) net worth (alone or with spouse) of at least $1,000,000 exclusive of equity in the primary residence; or (viii) a corporation, trust, 501(c)(3) organization, limited liability company or partnership not formed to make the investment with gross assets of $5,000,000+.

Because accredited investors are deemed able to afford a loss of their investments and to "fend for themselves," Rule 506 does not require that they be pre-qualified as "sophisticated" or that issuers furnish specific information to them. To those who believe accredited investors are as deserving of full disclosure as anyone else, this may seem anomalous, but the SEC has a practical bent. Providing full disclosure is expensive and time consuming, even when an offering is not registered. Requiring full disclosure for all offerings can strangle capital formation by smaller issuers. Accreditation lends itself to objective verification and, depending on the category, provides some assurance that investors have access to needed information on their own (directors, officers, etc.), are subject to other regulations requiring minimum capital and prudent investment policies (banks), or possess discretionary capital and can understand most investments if for no other reason than by previous exposure to them (relatively affluent individuals or entities). Overall, the SEC believes Rule 506 adequately protects investors while allowing issuers to control transaction costs.

In addition, for the protection of all investors there is no exemption from the anti-fraud and civil liability provisions of any securities law. When an investment goes bad, the disclosures that were actually made are apt to be exhaustively re-examined by purchasers with the aid of advisers, the benefit of hindsight and the objective of obtaining full recompense. Accredited investors, precisely because they are accredited, have the wherewithal, and often the inclination, to engage counsel the moment an investment does not perform as represented. Careful issuers will make all disclosures appropriate under the circumstances.

Other Purchasers - Limited Number and "Sophistication" Requirement

Rule 506(b) permits issuers to sell securities to up to 35 non-accredited purchasers in each offering, provided those purchasers (i) have an existing "substantive" relationship with the issuer; (ii) are "sophisticated" i.e., experienced enough in business and financial matters, alone or with a qualified "purchaser representative," to evaluate the offering; and (iii) are furnished specified information. See, **"Information Requirements,"** page 10.

The sophistication requirement has been the cause of some confusion. It is not necessary that non-accredited purchasers understand, say, "CDOs" ("Collateralized Debt Obligations") if CDOs are not being offered to them. It is necessary that such purchasers be capable of understanding the issuer's organizational structure, its business and material risks and the rights and limitations of the securities that are offered after reading the issuer's disclosure memorandum and, perhaps, asking questions of an attorney, accountant, broker or other qualified adviser functioning as a "purchaser representative."

Purchaser Representatives

For the purposes of Rule 506, consulting with a qualified "purchaser representative" will confer investment "sophistication" on an otherwise unsophisticated purchaser; a practical recognition of the value of professional advisers who are engaged routinely by the most sophisticated among us. The utilization of a purchaser representative has enabled many an issuer to preserve an offering by accepting funds from purchasers with general competence, but little or no business or investment experience.

Purchaser representatives are authorized by Rule 506(b) and defined by Rule 501(h) as, in effect, any person or organization having the requisite knowledge and experience who (i) is neither affiliated with nor employed by the issuer; and (ii) is acknowledged by the purchaser in writing to be the purchaser's representative after (iii) the purchaser has received full disclosure of any material relationship between the representative and the issuer. There are exceptions for purchasers represented by otherwise qualified relatives who happen to be affiliated with the issuer or by entities controlled by a qualified representative. It is assumed, in such cases, that the risk to the purchaser of biased or incompetent advice is negligible. Moreover, in no-action letters, the SEC staff has declined to recommend enforcement where *issuers* engaged and compensated personal representatives to consult with consenting purchasers. Of course, any such engagement, and all compensation, must be fully disclosed by the representatives to their purchasers and, if material to the offering as a whole, by the issuer to all purchasers.[7]

Note 1 to the Rule 501(h) definition of "personal representative" adds a pointed reminder that such representatives should "consider the applicability" of the registration and anti-fraud provisions imposed on broker-dealers by the Exchange Act. That reminder should be taken seriously. The function of a purchaser representative is to explain the offering documents and answer questions about the investment without taking a position on its merits. Were it not for that limitation, there would be little to distinguish the activities of a purchaser representative from those of a securities broker.

Brokers and "Finders"

The Exchange Act and its state counterparts define a securities "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Most securities brokers register with the SEC and join a self-regulatory organization such as the Financial Institution Regulatory Authority ("FINRA") or the Municipal Securities Rulemaking Board. Brokers that operate within the borders of a single state need register only with that state's securities authority. The salient point here is

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[7] A cynic might view the SEC's invention of the purchaser representative as merely another practical solution; this time to the knotty problem of protecting the credulous while ensuring an adequate supply of investors.

that securities transactions closed through an unregistered broker are illegal. That illegality can destroy any exemption for an offering, regardless of the merits of the investment, the good faith of the issuer or the quality of the issuer's disclosure.

Persons licensed in other fields, e.g., lawyers, accountants, realtors and architects, in addition to self-styled "consultants" and others whose business or lifestyle brings them into contact with affluent people, sometimes act as intermediaries or "finders" to match potential investors with companies seeking capital. In many such instances, the finders expect to be compensated for their efforts. A request for compensation conditioned on the closing of the offering, or calculated as a percentage of invested capital, is an obvious and compelling indication that the "finder" is functioning as a broker. The payment of transaction-based compensation to an unregistered finder is fatal both to the issuer's exemption claim and the finder's defense against sanctions imposed by regulators.

In rare instances, the SEC staff has granted no-action relief where unregistered persons proposed to act and be compensated as "finders" for issuers. In all such instances, however, the finder was compensated at an hourly rate or on a fixed sum basis and the compensation was not conditioned on the success of the offering or the closing of any individual purchase. The finder's efforts were isolated, not part of an ongoing business, and played only a limited role in the relevant offering. The finders provided the issuer with contact information for prospective purchasers and occasionally made preliminary introductions, but they did not participate in negotiations, or express an opinion to the prospects on the issuer, the investment or the securities.

Of course, corporations and other statutory entities necessarily act through natural persons. Such entities may sell their own securities through their unregistered officers, directors and employees if no compensation is paid for that effort, but no issuer should engage an unregistered outside party to find investors without first consulting with securities counsel.

Counting Purchasers

Rule 506(b) provides that in any Rule 506 offering there can be no more than 35 purchasers, or the issuer must reasonably believe the offering is so confined. The exclusion of accredited investors from the 35 purchaser limit is authorized by Rule 501(e), **"Calculation of Number of Purchasers."** That Rule also allows the issuer to exclude (i) any relative, spouse, or relative of the spouse of a purchaser who has the same principal residence as the purchaser; or (ii) any trust;, estate, corporation or other entity in which a purchaser and any such relative or spouse have, collectively, more than a 50% beneficial interest or own, beneficially and collectively, more than 50% of the equity securities. The Rule anticipates, and prohibits, two obvious means of gaming the count by also providing that corporations, partnerships and other entities shall be treated as a single purchaser only if they were not formed specifically to invest in the securities and that a non-contributory employee benefit plan will be so treated only if the trustee makes all investment decisions for the plan.

Preventing Structural Evasion - The "Integration" Doctrine

Not surprisingly, offerings artificially divided into purportedly discrete segments to evade exemption requirements (e.g., the prohibition against selling under Rule 506(b) to more than 35 non-accredited purchasers), may be "integrated" (combined and treated as a single offering for legal purposes). Rule 502(a), which sets out general requirements, begins with a warning that all sales comprising part of the same offering must meet all terms and conditions of Regulation D. In keeping with the SEC's time-honored pronouncements in **Release 33-4552 (1962)** and various no-action letters, the Rule describes the following "five factor" test for determining when allegedly separate offerings or "sales" should be integrated: (i) whether they are part of the same plan of financing; (ii) whether they involve the same class of securities; (iii) whether they occur at about the same time; (iv) whether the issuer is receiving the same kind of consideration; and (v) whether they are made for the same general purpose.

The Rule provides a safe harbor escape from integration for offerings completely separated by at least 6 months. The Rule also notes that, "generally," offerings that qualify for an exemption will not be integrated with simultaneous offerings that are both initiated and completed off-shore and are not subject to US jurisdiction; a proposition to be supported by compliance with Regulation S.

Information Requirements

Rule 502(b) provides that, if the issuer sells securities to any purchaser who is not an accredited investor, it shall furnish specified information to that purchaser "to the extent material to an understanding of the issuer, its business and the securities being offered." The quoted limitation is necessary given the wide range and varying complexities of the businesses that seek capital, but it has been the source of many a justification for omitting material information from offering documents; particularly in the area of risk disclosure or when the offering is limited to accredited investors.

Indeed, more than a few executives resist disclosure of anything other than the obvious and commonplace. They assert that detailed disclosure requires substantial and needlessly expensive collaboration between the issuer and its advisers. They argue that such collaboration delays the start of the offering and produces a colorless, technical and unduly negative disclosure document that is unfair to the issuer, confusing to investors and, in many cases, unlikely to be read. They contend that the cost of audited rather than reviewed or compiled financial statements is too great for the comfort level gained; particularly in the case of a startup with no operations and no material financial results to disclose. Ironically, because of their genuine belief in the ultimate success of their company, it is often hard to convince these executives that their business and financial interests, and those of the company itself, may conflict with the interests of investors and that such potential conflicts must be disclosed.

The reality, of course, is that all issuers face problems and uncertainties. The issuer's current and anticipated economic, competitive, regulatory and technological environments, credit and capital markets and customer, supplier or employee relationships all have the capacity to create serious risk. Indeed, most issuers will be at least as dependent for success on their operating prowess as on their break-through ideas. With respect to financial information, even startups typically have accepted capital contributions from founders, acquired initial assets, incurred shareholder debt or generated other material balance sheet data that is of acute interest to investors. With respect to the cost of financial statements, issuers should remember that the difference in reliability between an audit and a review is far greater than the accompanying accountant's letters might suggest and accountants provide no assurance at all respecting the accuracy of a compilation.

In fact, sophisticated investors do read offering materials (by themselves or with their advisers) and base their investment decision in large part on the perceived quality of the disclosure. They want to know specifically how the securities were priced, what the issuer will do with their money and how the issuer's business will generate an investment return. They realize all business is associated with risk, expect issuers to disclose the risks that apply to them, will decline to invest if that disclosure seems absent or cursory and will react favorably to a forthright discussion of risks together with the steps the issuer will take to manage them.

Rule 502(b) divides its information requirements into "non-financial statement" and "financial statement" components. Issuers eligible to use Form 1-A must provide "the same kind" of information as would be required by Part II of that Form. Form 1-A is used for the preparation of an Offering Circular for the exemption provided by Regulation A and is less burdensome than a registration Form. It is available for non-reporting US issuers that are neither development stage companies (with no specific business plan), nor investment companies registered or required to be registered as such, nor companies issuing fractional interests in oil, gas or other mineral rights. The Regulation A exemption is not available, and Form 1 A may not be used, by any issuer disqualified by virtue of prior violations of law under Rule 262. If not eligible to use Form 1-A, the issuer must use the registration Form for which it is eligible.

All registration Forms function as checklists for collecting, organizing and presenting in logical order narrative and financial information about the issuer; the principal risk factors associated with the offering; the issuer's business and properties; the factors that determined the offering price; the issuer's proposed use of proceeds and capitalization; a description of the securities and the issuer's plan of distribution (plan for selling the offering). The subject matter in Form 1-A is similar to that disclosed in Part I (the prospectus) of a registration statement, though not as extensive or detailed.

On the financial side, Rule 502(b) requires financial statements prepared by an independent certified public accountant in accordance with generally accepted accounting principles in the US ("GAAP"). The audit requirements, components and periods covered by these statements vary directly with the size of the offering. For offerings up to $2,000,000, the issuer must provide, as a minimum, full GAAP-based financial statements (including a balance sheet and statements of income and cash flow) for the last two fiscal years or such shorter time as the issuer has been in business, but only the issuer's balance sheet, dated within 120 days before the start of the offering, need be audited.

For offerings up to $7,500,000, the issuer must provide two years' full audited financial statements, but if an issuer, other than a limited partnership or limited liability company, cannot obtain such statements without unreasonable effort or expense, only the balance sheet, again dated within 120 days before the start of the offering, need be audited. Limited partnerships and limited liability companies in that position may furnish financial statements prepared on the basis of federal income tax requirements that have been examined and reported on in accordance with generally accepted auditing standards by an independent certified public accountant.

For offerings above $7,500,000 the issuer must provide the financial information required in a registration statement filed on the Form the issuer would be entitled to use - typically comprised of three years' full audited financial statements. However, limited partnerships and limited liability companies have the same option of furnishing tax basis statements as they have in offerings under $7,500,000 if they cannot obtain audited statements without unreasonable effort or expense.

Rule 502(b) notes, succinctly but ominously, that when an issuer provides information to non-accredited investors "it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws."

Practical Tips - Rule 506(b) Offerings

Because disputed Rule 506 offerings reach the courts infrequently, it might be assumed that private issuers and their representatives rarely face claims. Nothing could be further from the truth. An issuer in a Rule 506 offering can face regulatory sanctions or liability to purchasers for its failure to comply with one or more of the Rule's structural requirements, which causes a loss of the exemption, or for its use of materially misleading offering materials, which triggers civil liability and, if willful, criminal penalties. Typically, an issuer first realizes that its offering may be defective, or that purchaser grumbling has escalated into a claim, when it receives a formal notification or demand letter from the SEC, a state securities administrator, or a lawyer for one or more security holders.

A letter on behalf of a regulator may include a copy of an emergency order that the issuer cease and desist from specified conduct and show cause why the order should not be made permanent, or it may arrive accompanied by service of a formal complaint seeking monetary penalties or other relief, or it may advise the issuer that formal charges are being considered. In the first case, the issuer must comply with the order or win an uphill battle to convince the regulator that its conduct was lawful. In the second and third cases, the issuer's response may require the production of a mountain of documents. In any case, the issuer will face an expensive administrative proceeding with a potentially draconian outcome.

A letter on behalf of one or more security holders will state grounds for various civil claims and demand that the issuer rescind the holders' subscription agreements and refund the purchase price paid for their securities, plus interest and, of course, the lawyer's fees. The letter will threaten immediate suit if the demand is not satisfied. It will require a document intensive and expensive response in the best of circumstances and will be followed by a judgment for the plaintiffs in the worst.

Even if the stated grounds for relief are of dubious merit, a letter from a regulator or plaintiffs' lawyer can create overwhelming pressure to settle because word of the letter, to say nothing of an ensuing administrative proceeding or lawsuit, can collapse an entire financing. Importantly, unless the letter is frivolous on its face, it will be material and must immediately be disclosed if an offering is ongoing.

The following checklist may be useful in preparing an issuer to minimize the risk of such letters, or to defend against them.

Things to Avoid

× Media advertising or cold calls that tout a securities offering directly or indirectly;

× References in product or service advertisements to "our prior investment offerings," "investment opportunities," "our investors," or similar phrases;

× Purchased mailing lists, referral sources, or third party networks;

× Unrestricted mass mailings touting or alluding to a securities offering;

× Sponsorship of 'investment," "retirement," "financial planning," or similar seminars promoted by general announcements, RSVP cards, etc.;

× Reliance on finders or intermediaries who are not registered securities brokers, or who do not understand, or will not observe, the Rule 506 selling restrictions;

× Compensation paid for selling securities (no matter how devised) unless the arrangement is reviewed by securities counsel; and

× Offering documents, investor questionnaires and subscription agreements that merely cite Rule 506 without explaining its terms and definitions.

Things to Emphasize

√ A pre-offering list of all prospective purchasers whose existing business, professional, familial, or social relationship with a representative of the issuer provides a basis for the issuer's preliminary belief that the prospects are accredited investors or, if not accredited, are sophisticated, plus a summary of the reasons for the belief.

√ A written record of the prospects actually contacted in connection with an offering containing the date(s) and confirming the reasons for such contact;

√ Small, face-to-face and documented meetings or one-on-one negotiations with prospects;

√ A questionnaire to be completed and signed in advance of purchase by which all purchasers summarize their investment history, business experience and financial circumstances, plus a formal subscription agreement in which they warrant the truth of their answers, confirm their existing relationship with the issuer and acknowledge they did not learn of the offering though any form of general solicitation;

√ A dated, separately numbered confidential memorandum delivered to each investor against a correspondingly numbered, dated and signed receipt that explains the basis for the issuer's claim of exemption, the concepts of accreditation and investment sophistication and contains, in addition to a discussion of the merits claimed for the investment, full disclosure of all material risks and other facts listed by category in the relevant disclosure Form; and

√ Review of all supplementary selling materials to ensure that they do not change the facts, minimize the risks, or expand the returns or other benefits described in the memorandum.

New Rule 506(c) Offerings - Requirements and Limitations

Overview - Sales solely to "Accredited Investors" - Verification of Accredited Status

Rule 506(c) has been adopted as an optional alternative to Rule 506(b), which remains effective. Presumably, issuers confident of their ability to sell an offering without resorting to general solicitation will continue to rely on the latter Rule. Issuers lacking such confidence might previously have contented themselves with relatively limited debt financing or even abandoned their search for capital and postponed or substantially reduced their underlying projects. They may now offer Rule 506(c) securities by means of advertising and other general solicitation so long as all purchasers are accredited investors *and* the issuer has taken "reasonable steps" to verify their status as such.

Rule 506(c) securities are "covered" under the National Securities Market Improvement Act ("NSMIA") (now Section 18 of the Securities Act) as are securities sold under Rule 506(b). Thus, *state* bans on general solicitation will not apply to *valid* Rule 506(c) offerings. Nevertheless, the states may challenge defective offerings that purport to comply with the Rule and the advertising and verification provisions of paragraph (c) give them additional grounds to do so. See, ***"Potential State Challenges,"*** page 16.[8]

The heart of the new Rule is as follows:

(c) *Conditions to be met in offerings not subject to limitation on manner of offering:*[9]

(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).*

(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 paragraph (c) of this section are accredited investors.*

As also noted, Rule 506(c) retains the definitions found in Rule 501 and the conditions imposed by Rule 506(b). The latter Rule will not require a specific disclosure format for Rule 506(c) offerings, though, because all purchasers must be accredited. Nevertheless, the anti-fraud and civil liability provisions of the securities laws apply to any offering and issuers will fail to provide full disclosure of all material facts at their peril. The "information requirements" for non-accredited investors found in Rule 502(b) will be a useful starting point for any issuer engaged in a Rule 506(c) offering.

Verification Methods and the Issuer's "Reasonable Belief"

Rule 506(c) does *not* require that purchasers must, *in fact*, be accredited. The issuer's *reasonable belief* that a given purchaser is accredited remains sufficient. However, the issuer's duty to take reasonable steps to verify accreditation is a separate requirement and the exemption will be lost if the issuer fails to

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[8] Section 18 of the Securities Act exempts "covered securities" from substantive state regulation. The exemption binds the states under the "Supremacy Clause" (Article VI, clause 2) of the US Constitution. Securities exempt from registration under Section 4(a)(2) by virtue of an SEC Rule are "covered" expressly by Section 18(b)(4)(D).

[9] The "limitation" is contained in Rule 502(c) which prohibits general solicitation or general advertising.

satisfy it. In its proposing release, the SEC acknowledged that the accredited status of some investors will be sufficiently obvious as not to require verification. Nevertheless, issuers should record the factual basis for any such conclusion and obtain confirmation (self-certification) from the investors involved. Issuers should also review their entire verification program with securities counsel before the start of the offering.

Rule 506(c) lists examples of verification methods for financial accreditation without either mandating a specific method or providing extended guidance. Among the examples: (i) 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 by persons who are familiar with a purchaser's financial position and bound by professional conduct rules imposing high standards of confidentiality and diligence i.e., brokers, investment advisers, lawyers and accountants.

The FINRA website 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. Securities 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 charities, or its formal letter acknowledging non-profit status, can confirm the accreditation of purchasers claiming to be 501(c)(3) organizations. Self-certification questionnaires and subscription agreements with warranties of accreditation can help establish both reasonable verification and a reasonable belief that the signing purchaser is accredited.

The SEC recognizes that a purchaser's income will be relatively easy for an issuer to verify without taking the overly intrusive step of reviewing personal financial statements or tax returns (e.g. by reviewing instead Forms W-2 or 1099, pay check stubs or employment agreements). Because liabilities are difficult to identify, though, it may not be feasible to verify a purchaser's net worth if a reliable balance sheet is not available or is withheld for privacy reasons. Of particular concern are liabilities not matched to assets, such as unsecured loans or credit card debt where verifiable information may not be available except from the relevant creditor. While managers of large 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, with the adoption of Rule 506(c), a fee-based cottage industry comprised of verification "experts" will develop quickly. It may be wondered how providers will manage the risk of liability for an erroneous verification, but because an issuer's reasonable belief in the accredited status of its purchasers remains sufficient, providers who base their verifications on a reasonable investigation should also be protected. On the other hand, issuers may 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 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 rights provided by securities laws. The courts have endorsed that position. As a result, exculpatory provisions in providers' verification contracts may be rejected by issuers and unenforceable when the contract is with the purchaser.

The SEC added the following list of verification methods to the version of Rule 506(c) finally adopted. Use of these methods will provide issuers with a safe harbor for establishing compliance with the verification requirement. The instructions add that documentation for both spouses would be necessary when accredited status is based on joint income or net worth.

The issuer shall be deemed to take reasonable steps to verify if the issuer uses, at its option, one of the following non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such person is not an accredited investor:

(A) In regard to whether the purchaser is an accredited investor on the basis of income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

(B) In regard to whether the purchaser is an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:

(1) With respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and

(2) With respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies; or

(C) Obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verity that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor:

(1) A registered broker-dealer;

(2) An investment adviser registered with the Securities and Exchange Commission;

(3) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law: or

(4) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.

(D) In regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of paragraph (c) of this section and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

Disclosure Issues - Advertising Content

In its adopting release for amended Rule 506, the SEC declined to provide guidelines for advertising and other promotional content despite repeated requests by various interest groups that it do so. However, in a separate release issued the same day, the SEC proposed the adoption of new Rule 509. That Rule would require that all general solicitation materials contain legends to the effect that (i) the securities may only be sold to "accredited" investors; (ii) the issuer need not comply with specific disclosure requirements; (iii) the SEC has not approved the securities, the offering or the offering materials; (iv) resale of the securities is restricted; and (v) securities investments involve risk and purchasers should be able to absorb the loss of their investment. See, **"Other JOBS Act Directives and Proposals,"** page 20.

In addition to inserting the legends, issuers might wish to consult Securities Act Rule 134, which governs non-prospectus communications in a registered offering. The text would be limited, as a maximum, to (i) an announcement of the offering (including its duration and the amount, designation and price of the securities); (ii) the names of the issuer and any brokers (with contact information for each); (iii) a brief summary of the issuer's business; (iv) a balanced summary of the merits and risks of the investment; (v) a statement whether, in the opinion of counsel, the securities are tax exempt or a legal investment for banks, and other fiduciaries; (vi) a summary of the intended use of the offering proceeds; (vii) the procedure for obtaining a full disclosure memorandum; and (viii) a summary of the accreditation requirements.

Finally, it bears repeating that even though the specific information requirements in Rule 502(b) will not apply and no specific disclosure format need be followed, the anti-fraud and civil liability provisions do 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 may face misrepresentation claims if the investment does not perform as promised or reasonably expected.

Potential State Challenges

To alleviate the cost to issuers of complying with state as well as federal law, particularly in multi-state offerings, Section 18 of the Securities Act was amended in 1996 to preempt (prohibit) substantive state regulation of "covered securities." As noted, securities issued under Rule 506 are "covered."

When Section 18 was amended, it was 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 Section 18 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 omission provided an opportunity for state regulators to sanction an issuer if they thought its offering did not comply with the Rule or with an equivalent state exemption.

In December 2006, the Ohio Court of Appeals decided *In re Blue Flame Energy Corp* and ruled that Section 18 "preempts" state regulation *only* of Rule 506 offerings that *actually* comply with all requirements of that Rule; a threshold question that may be determined by the states. Mere reliance on the Rule, even if in good faith, is not sufficient to prevent state intervention. The *Blue Flame* decision has been followed often enough that it is now accepted as definitive. State challenges of Rule 506(c) offerings will probably be based most often on allegations that the issuer failed to verify the accredited status of all purchasers, used misleading promotional materials or failed to complete Form D properly.[10]

Practical Tips - Rule 506(c) Offerings

A Rule 506(c) issuer must guard against the problems and claims that may confront a traditional issuer relying on Rule 506(b) and may also face additional claims made possible by its use of general solicitation. The following checklist may be helpful in avoiding or defending against the latter claims:

Things to Avoid

× The misconception that an issuer is under no obligation to provide accredited investors with material information or that puffery of the type seen in commercial advertising is acceptable in a securities offering;

× The misconception that the legality of misleading promotional materials may be salvaged by legends that advise purchasers to read, or incorporate by reference, an accurate disclosure document;

× Exclusive reliance on purchaser self-certifications of accredited investor status;

× Verifications submitted by third parties whose qualifications and methods are not disclosed or fully documented; and

[10] 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.

× Third party verifications that offer conclusions without identifying the documents reviewed, the methods used to authenticate them (or the reasons why authentication was not thought necessary) and the accreditation categories in which the prospect was deemed qualified.

Things to Emphasize

√ Promotional materials all of which are materially accurate and free of misleading omissions;

√ If promotional materials or offering documents are available online or transmitted electronically, compliance with the **SEC Interpretation: *"Use of Electronic Media,"* Release Nos. 33-7856, 34-42728, IC-24426, May 4, 2000,** with special attention to questionable or developing areas, such as obtaining telephone consent to the use of such media;

√ Standard provisions for the issuer's contracts with verification service providers (whether the contracts are prepared by the issuer or by the provider) that include, directly or by incorporating text from the provider's website: (i) an explanation of the verification requirement; (ii) a statement of the potential harm caused by a false verification (A) to the issuer (loss of the exemption) and (B) to the provider (contractual liability to the issuer and enforcement action by the provider's licensing agency); (iii) a requirement that the provider disclose its professional qualifications, licenses, disciplinary history, if any, and current good standing; (iv) a list of the safe harbor verification methods provided in Rule 506(c) (with check-the-box identification of the method(s) actually used by the provider); (v) a requirement that the provider identify and explain the reason(s) for use of any other verification method(s); (vi) a format for listing the financial documents that support the status of each purchaser certified as accredited by the provider; and (vii) a certification that the provider understands the reasons for, and used its best efforts in providing, verification services;

√ The engagement of a verification service operated by a member of FINRA, such as the **"Accreditation Verification Platform"** provided by **SecondMarket**, **www.secondmarket.com;** or by a registered securities broker or investment adviser that can verify the accredited status at least of its customers and may also offer investor accreditation verification as an independent service;

√ For issuer operated verification programs, a means of addressing the privacy concerns of potential purchasers, such as a password protected, secure website for the submission of financial documents.

Resales by Holders - "Restricted" and "Control" Securities

Relevant Definitions

"Restricted" securities are those acquired without registration from an issuer or its affiliate, directly or indirectly, in one or a series of transactions. Securities acquired by purchasers in a Rule 506 offering are thus "restricted." Restricted securities may not lawfully be resold without registration or an exemption and a Rule 506 issuer must take "reasonable care" to prevent its purchasers from violating that restriction. The issuer may demonstrate such care by, among other things, disclosing the restriction in its offering documents and on securities certificates and conditioning its recognition of any resale on registration or a satisfactory opinion of counsel that the resale transaction is, or will be, exempt. In any case, the securities will remain "restricted" in the hands of resale purchasers who, before selling on, must either register or secure an exemption for their own transaction.

The requirements to be observed when reselling restricted securities without registration vary depending on whether the reselling holder is an "affiliate" of the issuer. An "affiliate" of an entity is a person who has a "control relationship" with it, i.e. who controls, is controlled by, or is under common control with the entity. Parent and subsidiary corporations are thus affiliated with each other and with the other members of their corporate group. Directors, officers and large shareholders of a given corporation are its affiliates because they presumptively have the power to "direct" the management or policies of that corporation, but they are not affiliates of any other corporate group member unless they have a similar power with respect to such member. Offers and sales of an issuer's securities by its affiliates are treated as offers and sales by the issuer. Securities purchased from any such affiliate without registration are therefore "restricted" even if the issuer registered the offering in which the affiliate acquired them.

"Control" securities, as the name implies, are those held by an "affiliate." Control securities acquired without registration are subject to stringent manner of sale limitations even when an exemption is available for the resale transaction.

The legality of an unregistered resale can be challenged after the fact by regulators, issuers, other holders or purchasers and before the fact by issuers that seek to block the resale by enforcing restrictions contained in the underlying purchase or subscription agreements. In either case, the stakes are high because if the resale appears to constitute a public "distribution" of the issuer's securities, the issuer may forfeit its Rule 506 exemption and violate the registration requirement of Section 5 of the Securities Act.

Resales under the "Trading Exemption" - Securities Act Section 4(a)(1)

Reselling security holders commonly rely on the "trading" exemption provided by Securities Act Section 4(a)(1). That Section limits its exemption to "any person other than an issuer, underwriter or dealer." In a Rule 506 offering, the holder is obviously not the issuer and, with irrelevant exceptions limited to registered offerings, dealers have their own exemption. Accordingly, the issue becomes whether the holder is acting as an "underwriter" by participating in a "distribution" (of the securities to the public) by the issuer.

Reselling holders must respond to a challenge by showing they did not acquire their securities with a "view" to distribute them and were not, or will not be, participating in a "distribution" when reselling them. Holders occasionally try to make that showing by arguing they acquired the securities solely as an investment, but afterward their circumstances changed, unexpectedly and adversely, forcing a pre-mature resale. That argument has met with indifferent success unless it was made in the context of an informal exemption evidenced solely by SEC no-action letters. See, **"The '4 (1½)' Exemption,"** page 19.

Rule 144

A better response is to show the securities have "come to rest," meaning the holder retained them long enough to have absorbed the investment risk inherent in them. Such a showing supports the conclusion that the holder was not reselling for the issuer as part of a distribution to the public, but initiated the resale independently, for the holder's own account.

There may be extraordinary circumstances in which the major risks associated with a Rule 506 offering are clearly time-limited, so that an initial purchaser who retains the securities until the time has expired can claim to have absorbed those risks. In the majority of cases, however, the reselling holder will rely on Securities Act Rule 144. Rule 144 provides a non-exclusive safe harbor by which a holder of restricted securities may resell them under the Section 4(a)(1) trading exemption. The Rule provides that restricted securities may be resold *to the public* (on an exchange or in the over-the-counter market) after a minimum holding period of 6 months *if* the issuer has then been a non-delinquent reporting company for at least 90 days *or* adequate information about it is posted on the issuer's website or is otherwise publicly available. If not, the minimum holding period is 1 year; a full business cycle. In either case, the holding period may not begin until the price for the securities is paid in full.

Affiliates may resell under Rule 144 only in limited amounts in ordinary broker's transactions. They must ensure that "public information" is available about the issuer and file Form 144 with the SEC. Non-affiliates need not comply with those requirements but, as a practical matter, will resell to the public through brokers. Rule 144 also contains key definitions, an identification of the available public information deemed "adequate" if the issuer is not a reporting company, mechanisms for determining the holding period of securities acquired by trusts or estates, or through dividends, splits, recapitalizations or pledges and means for identifying the person for whose account the securities were actually resold.

When the issuer remains private, and adequate public information about it is not otherwise available, non-affiliates may resell freely under Rule 144, but only after the 1 year holding period has expired. Affiliates must avail themselves of the "4(a)(1½) Exemption" discussed below.

The "4(a)(1½)" Exemption

Even if Rule 144 is not available, both affiliates and non-affiliates may be able to resell, sometimes in much less than one year, under the SEC's informal "4(a)(1½) exemption." To support this exemption, holders must demonstrate that (i) they did not purchase the securities with the intent to distribute them; (ii) they held the securities long enough to absorb the risks of that investment; (iii) they did not solicit purchasers by general solicitation and (iv) they provided their purchasers with the information required by Rule 502(b). In short, they absorbed the risks of their investment and, when reselling, took the steps an issuer would take in an offering complying with Rule 506. When faced with evidence to that effect submitted by holders seeking no-action relief, the SEC staff has concluded that the resale combined elements of the Section 4(a)(1) "trading exemption" and the Section 4(a)(2) "private offering exemption" and has not recommended enforcement. Nevertheless, holders should resell in reliance on the "4(a)(1½) exemption" only after consultation with securities counsel.

Resales to Qualified Institutional Buyers - Rule 144A

There are institutions that, in light of their business segment, regulatory environment and existing investments, are deemed sophisticated and affluent enough to purchase securities issued without an SEC review. These institutions are called "Qualified Institutional Buyers" or "QIBs" and under Rule 144A restricted securities may be resold to them without registration, subject to various conditions and definitions. Virtually all Rule 144A resales are part of an integrated, two-step transaction that begins when an issuer sells securities under Rule 506 to registered broker-dealers (called the "initial purchasers") and ends when the initial purchasers, by pre-arrangement, resell the securities to QIBs. The initial purchasers are clearly "underwriters," but under Note 7 of the Rule that fact "will not affect the availability to (the) issuer of an exemption under Section 4(a)(2) of the (Securities) Act or Regulation D."

A QIB is defined in Rule 144A(a)(1) as an entity in any of the following categories that, for its own account or the accounts of other QIBs, owns and invests on a discretionary basis at least $100 million in securities issued by non-affiliates: a regulated insurance, investment, small business investment or business development company; a state sponsored or ERISA employee benefit plan; a trust trusteed by a bank or trust company; a registered investment adviser or securities dealer; a duly chartered bank, savings and loan association or equivalent; or any other entity wholly owned by one or more QIBs. Several provisions allow reselling holders to verify and tabulate an entity's existing investments by relying on a certification of the entities chief financial officer or on the entity's publicly available financial statements, SEC filings, filings with other government agencies or publications in a "recognized" securities manual but, in each case, the information must be dated within the past 16 months. Other provisions allow QIBs to purchase restricted securities through subsidiaries and group structures.

To qualify under the Rule, the securities sold may not be part of a class listed on a national exchange or quoted on an inter-dealer quotation system and they may not have been issued by a company registered or required to be registered under the Investment Company Act. If the security was issued by a private company, the holder is entitled to receive from the issuer, on request, a brief statement of the issuer's business, products and services as of a date within 12 months prior to the resale, *plus* the issuer's most recent balance sheet and earnings statements, *plus* "similar" statements for the past two fiscal years, each audited if audited statements are reasonably available. The balance sheet must be dated within the 16 months preceding the resale and the earnings statements must cover the two most recent 12 consecutive month periods ending prior to the balance sheet date. If the balance sheet is not dated within 6 months prior to the sale, the issuer must provide interim unaudited financial statements for the stub period.

Rule 144A does not contain the phrase "general solicitation." As originally formulated, it effectively banned such solicitation by requiring that all offerees, as well as all purchasers, be QIBs. In responding to the JOBS Act directive to remove the ban, the SEC simply omitted the reference to "offerees." That left a Rule which permits holders to solicit institutions by any means so long as the status of the institution as a QIB is confirmed prior to closing the sale. The methods used would be similar to those employed to verify the accredited status of investors in a Rule 506(c) offering with the focus on balance sheet information and an emphasis on publicly filed documents or certifications by chief financial officers. The confirmation process will be helped greatly by the NASDAQ Portal Market, which permits institutions to apply for a published listing as a QIB by completing a "Rule 144A Qualified Institutional Buyer ('QIB') Certification Form." Holders may rely on the listing to identify QIBs and such reliance will be deemed reasonable for purposes of the Rule.

Other JOBS Act Directives and Proposals

The SEC took other actions on July 10, 2013, the day it adopted the amendments to Rules 506 and 144A. In a companion release, the SEC implemented Section 926 of the Dodd Frank Wall Street Reform and Consumer Protection Act by adopting "bad actor" provisions codified in new Rule 506(d). This Rule, effective September 23, 2013, disqualifies an issuer from claiming a Rule 506 exemption if the issuer, any of its predecessors, or affiliates, or any of its directors, officers, managers or 20% or greater beneficial owners has been convicted of a felony or misdemeanor arising from a violation of the securities laws, or has been barred from association with an entity regulated by the SEC, or from participating in the securities, insurance, banking, savings association or credit union businesses by the final order of a court or securities regulator. The look-back period for convictions and regulatory sanctions is five years for the issuer, its predecessor or affiliate; ten years for the issuer's other agents and 20%+ owners.

A Rule 506(d) disqualification will not apply if: (i) the relevant conviction or order was entered prior to September 23, 2013 (but the issuer must disclose any such prior conviction or order to each purchaser a reasonable time prior to sale); or (ii) on a showing of good cause, the SEC determines it is not necessary to deny the exemption; or (iii) the court or regulator that entered the order advises the SEC staff in writing that disqualification should not be imposed; or (iv) the issuer has made a factual inquiry into whether a disqualifying event occurred and establishes it did not know and could not reasonably have known of it.

In a second release the SEC *proposed* to further amend Regulation D and Rule 506 so as to require, among other things: (i) that Form D be filed in a Rule 506(c) offering before general solicitation begins (to help all regulators identify suspicious offerings); (ii) that a closing amendment to the Form showing final sales and investor information be filed after any Rule 506 offering terminates (to help the SEC evaluate marketing practices); (iii) that an issuer would be disqualified from relying on Rule 506 for one year if it or any predecessor or affiliate failed to comply with the Form D filing requirements in a Rule 506 offering completed within the prior five years; and (iv) that, in accordance with proposed Rule 509, written general solicitation materials must, as noted previously, contain legends stating that (A) all purchasers must be accredited investors, (B) the issuer is not required to comply with specific disclosure requirements imposed when offerings are registered, (C) the SEC has not passed on the merits or otherwise approved the offering, (D) Rule 506 securities are "restricted" and (D) investing in securities involves risk and investors should be able to absorb the loss of their investment.[11]

The SEC also proposed to amend Securities Act Rule 156 to extend to "private funds" anti-fraud provisions that currently apply to misleading statements or omissions in "sales literature" published by Investment Companies. A "private fund" is, in effect, a hedge fund; a pooled investment vehicle

[11] See, **Release Nos. 33-9816; 34-69960; IC-30595, July 10, 2013.**

(typically structured as a limited partnership or limited liability company) that would be required to register as an investment company but for definitional exclusions available for entities that are not making or planning a public offering of their securities and either have fewer than 100 beneficial owners or are owned entirely by certain "qualified purchasers." As a consequence of these exclusions, "private funds" are unregistered entities. They are also the designated "clients" of their investment advisers.

The fund's activities are financed by investors who purchase ownership interests in the funds that are offered without registration under Rule 506. However, the owners are not "clients" of, and do not contract directly with, the fund's advisers. Accordingly, the advisers do not owe to private fund owners the contractual and fiduciary duties they owe to their advisory clients. Those duties are owed only to the funds as discrete entities. Frustrated judicially in its attempt to bridge this gap with its "ill-fated hedge fund rule," the SEC responded with Investment Advisers Act Rule 206(4)-8 effective September 10, 2007. This Rule makes it unlawful for an *adviser* to misstate or omit a material fact in a communication to investors or prospective investors in a "pooled investment vehicle," or otherwise to engage in conduct that has the effect of defrauding such investors. The Rule thus subjects an adviser to liability for material misrepresentations it makes to owners without regard to whether the owners are "clients." It will now be augmented as to a *fund's* sales literature by an extension of Securities Act Rule 156.[12]

As also noted, the JOBS Act directed the SEC to adopt new rules based on existing Regulation A that would allow issuers to offer and sell equity, debt and certain convertible securities to the public without registration in amounts up to $50,000,000 each 12 months ("Regulation A+"). The dollar limit is subject to upward adjustment by the SEC every two years. The securities would be freely tradable and issuers could solicit interest in them by general means prior to filing an offering statement. If traded on a national exchange, or sold to "qualified purchasers," the securities would be "covered" under NSMIA and free from substantive state regulation.[13]

Regulation A+ would require disclosure patterned on Regulation A, but with the added requirements of audited rather than reviewed financial statements and some periodic reporting as well as the existing post-offering report of sales. Until the SEC issues a proposing release, it remains to be seen whether Regulation A+ can be a cost effective alternative to registration. Nevertheless, this initiative carries the promise of a vast new market for "mini-public" offerings.

Finally, as noted, the JOBS Act amended Section 12(g) of the Exchange Act to increase the shareholder threshold for registration of a class of equity securities from 500 total record holders to either 2,000 total record holders or 500 such holders who are not "accredited investors." Issuers need not look through record holdings and count beneficial owners to determine whether they exceed either of those thresholds. Most publicly traded securities are held by brokers in "street name." Accordingly, the actual number of shareholders of a public company will substantially exceed the number of its record holders and a similar phenomenon may well apply to large private companies financed by a series of exempt offerings; particularly after Regulation A+ is adopted. As a practical matter, such private companies can now elect to remain private indefinitely.

Additional Observations

Not surprisingly, there is a great deal of excitement about the prospect of general solicitation for securities offerings that need not be registered. Rule 506(c) issuers will soon be promoting their offerings in all

[12] The hedge fund rule had a short, but colorful, life. See, ***Goldstein v. Sec*, 451 F. 3d 873 (2006).**

[13] "Qualified purchaser" is a term used elsewhere in the securities laws, but it has yet to be defined by the SEC in this context. "NSMIA" is an acronym for "National Securities Markets Improvement Act" enacted in 1996.

media (including social media) as well as soliciting investment along with normal course business communications (e.g. by posting solicitations on websites, tying them to generic product advertisements, inserting them in catalogues and direct mailings and including them with statements of account and invoices, etc.). Targeted potential investors may, depending on the issuer, include customers, suppliers, service providers and large affinity groups as well as institutional investors.

Of course, there is a down side. The initial environment for Rule 506(c) offerings may be chaotic as all manner of unscrupulous issuers and their promoters hawk worthless securities to the public and create a wild-west atmosphere that taints all 506(c) participants. State regulators automatically associate general solicitation with fraud schemes and, as noted, will not hesitate to challenge Rule 506(c) offerings on technical grounds; e.g., claims that the Rule was not available and the offering was neither registered nor exempt because the issuer's verification of the accredited status of purchasers was inadequate and the purchasers included non-accredited investors. Reliance on Rule 506(c) will also expose issuers to a new class of misrepresentation claims under *state* law based on misleading advertising. As these claims become publicized, the initial euphoria over Rule 506(c) may subside. [14]

However, the downside provides an opportunity for brokers. Issuers may continue to offer securities without general solicitation under existing Rule 506 and any offering involving a first tier broker could probably be sold that way. The ability to identify and approach any number of accredited investors without general solicitation simply by accessing an existing customer base may ultimately enable such brokers to dominate the market for private capital. In those instances in which general solicitation is thought necessary, the sophisticated client intake and data gathering procedures developed by brokers will allow them to verify the accredited status of purchasers effectively as an agent for the issuer and, in all cases, their due diligence reviews will raise the comfort level of investors.

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[14] Because ***Gustafson v. Alloyd,*** 513 U.S. 561 (1995) held that Securities Act section 12(a)(2) does not apply to private sales, investors in a Rule 506 offering may assert federal claims only under section 10(b) and Rule 10b-5 of the Exchange Act and must prove intent to defraud. (The JOBS Act provides expressly that the civil liability provisions of section 12(a)(2) *will* apply to persons offering or selling Regulation A+ securities.)