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Private Offering Rule Changes Since JOBS Act

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

As the end of 2014 approaches, I find myself reflecting on the significant successes and failures in the private offering arena since the enactment of the Jumpstart our Business Startups Act ("JOBS Act") on April 5, 2012. Some provisions under the JOBS Act became law without further rule-making action on the part of the SEC; others took time to pass; and significantly, Title III Crowdfunding, the most anticipated change in capital market access, has completely stalled. This blog is a summary of the in-depth detailed blogs I've previously written on each of these topics with some added commentary.

506(c) – The Elimination of the Prohibition Against General Solicitation and Advertising in Private Offerings to Accredited Investors; Broker-Dealer Exemption for 506(c) Funding Websites

The enactment of new 506(c) resulting in the elimination of the prohibition against general solicitation and advertising in private offerings to accredited investors has been a slow but sure success. Trailblazers such as realtymogul.com, circleup.com, wefunder.com and seedinvest.com proved that the model can work, and the rest of the capital marketplace has taken notice. Recently, more established broker-dealers such as National Securities have begun their foray into the 506(c) marketplace with accredited investor-only crowdfunding websites accompanied by marketing and solicitation to draw investors. As a result of the success and growth of this business model, the general improvement in the economy, and the willingness again by accredited investors to allocate private placements as a portion of their risk capital portfolio, I foresee a large cash infusion into new businesses in 2015.

According to Crowdnetic, $217.7 million in equity was raised this year using the 506(c) model, with investments growing each quarter. Crowdfunder completed funding raises for 31 companies in the first nine months of operations, with the average deal size being $1.6 million and most of them completing Seed or Series A rounds. Companies listed on AgFunder raised over $10 million using 506(c) between February and October 2014. According to several sources, technology and service sector companies are finding the greatest success. Title II crowdfunding is firmly a small or even micro-cap playing field. Although some more mature entities may enter the arena, for now Title II is primarily being used by early-stage entities, and early-stage entities create new jobs.

There are still many more failures than successes; however, I firmly believe that this is shifting and that 2015 will see a dramatic growth in the success rate. Title II equity crowdfunding took a while to take shape, but it is taking shape.

Although Title II contains an exemption from broker-dealer registration for equity crowdfunding websites, the statutory exemption limits the revenue model such that most sites have partnered with a broker-dealer to allow transaction based revenues. This trend will continue with most, if not all, successful Title II web platforms opting to either partner with or become licensed broker-dealers. Recently, more broker-dealers see this avenue as a sustainable and necessary business model and are launching Title II crowdfunding web-based portals as divisions of their investment banking operations. I think this trend will continue such that most broker-dealers with active small-cap investment banking divisions will have a Title II web-based portal and division for 506(c) offerings.

Moreover, when Title II first launched, there was a concern from accredited investors regarding the verification process. Simply, accredited investors do not want to share private financial information with the small and start-up companies they invest in (or any companies they invest in, for that matter). However, over the years trusted third-party verification services have established market share, easing privacy concerns and allowing for a smooth verification process. The industry is figuring it out. Just like the transition from early concerns with providing banking information to Paypal, to Paypal being the trusted norm, third-party verification providers are becoming and will continue to become the trusted norm. I suspect one or two will emerge as industry leaders.

Brief Summary of 506(c)

Effective September 23, 2013, the SEC adopted final rules eliminating the prohibition against general solicitation and advertising in Rules 506 and 144A offerings as required by Title II of the JOBS Act. For a complete discussion of the final rules, please see my blog HERE.

Title II of the JOBS Act required the SEC to amend Rule 506 of Regulation D to permit general solicitation and advertising in offerings under Rule 506, provided that all purchasers of the securities are accredited investors. The JOBS Act required that the rules necessitate that the issuer take reasonable steps to verify that purchasers of the securities are accredited investors using such methods as determined by the SEC. Rule 506 is a safe harbor promulgated under Section 4(a)(2) (formerly Section 4(2)) of the Securities Act of 1933, exempting transaction by an issuer not involving a public offering. In a Rule 506 offering, an issuer can sell an unlimited amount of securities to accredited investors and up to 35 unaccredited sophisticated investors. The standard to determine whether an investor is accredited has historically been the reasonable belief of the issuer.

New Rule 506(c) permits the use of general solicitation and advertising to offer and sell securities under Rule 506, provided that the following conditions are met:

1) the issuer takes reasonable steps to verify that the purchasers are accredited;
2) all purchasers of securities must be accredited investors, either because they come within one of the categories in the definition of accredited investor, or the issuer reasonably believes that they do, at the time of the sale; and
3) all terms and conditions of Rule 501 and Rules 502(a) and (d) must be satisfied.

Rule 506(c) includes a non-exclusive list of methods that issuers may use to verify that investors are accredited. An issuer that does not wish to engage in general solicitation and advertising can rely on the old Rule 506 and offer and sell to up to 35 unaccredited sophisticated investors. An issuer opting to rely on the old Rule 506 does not have to take any additional steps to verify that a purchaser is accredited.

Summary of Exemption from Broker-Dealer Registration in Title II of the JOBS Act

Title II of the JOBS Act created a limited exemption to the broker-dealer registration requirements for certain intermediaries that facilitate Rule 506 offerings. In particular, Section 4(b) of the Securities Act of 1933 ("Securities Act") added an exemption to the broker-dealer registration requirements such that an individual or entity will not be deemed a broker-dealer as a result of the following:

a) That person maintains a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means;
b) That person or any person associated with that person co-invests in such securities; or
c) That person or any person associated with that person provides ancillary services with respect to such securities.

Ancillary services are defined as (i) the provision of due diligence services, in connection with the offer, sale, purchase, or negotiation of such security, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors; and (ii) the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service.

The exemption from registration as a broker or dealer also requires that such person and each person associated with such person (i) does not receive any compensation in connection with the purchase or sale of the security; (ii) does not have possession of customer funds or securities in connection with the purchase or sale; and (iii) is not subject to statutory disqualification pursuant to Section 3(a)(39) of the Exchange Act (i.e., bad boy provisions).

Felons and Bad Actors are Disqualified from Participating in Rule 506 Offerings

The Dodd-Frank Act required the SEC to implement rules which disqualify certain Rule 506 offerings based on the individuals involved in the issuer and related parties. On July 10, 2013, the SEC adopted such rules by amending portions of Rules 501 and 506

of Regulation D. Like the new Rule 506(c), the rules went into effect on September 23, 2013.

The rules were not retroactive. Accordingly, disqualifying events that would have resulted in disqualification after September 23, 2013, only require disclosure if they occurred before that date. For that reason, in this past year I have participated in more discussions regarding the disclosure language than facing a disqualification event. Moreover, even that discussion has been surprisingly rare. As a matter of course of conduct, we now have all clients that are planning to embark on a private offering complete questionnaires related to "bad actor" disclosure and disqualifying events. Perhaps partly as a result of these rules and partly as a result of FINRA's recent efforts to locate and eliminate bad actors from the marketplace through its Rule 6490 power, entities are more cognizant of the company they keep and are cleaning house. For more on FINRA's 6490 power, see my blog HERE.

Summary of Bad Actor Disqualification and Disclosure Rule

Bad actor or "bad boy" disqualification provisions disqualify an issuer from relying on an exemption if the issuer or certain persons associated with the issuer and its predecessors and affiliates (including underwriters, placement agents, director, officers, general partners, promoters and significant shareholders) have been convicted of, or are subject to, court or administrative orders related to securities fraud and certain other enumerated laws. The bad actor disqualification provisions are found in Rule 506(d).

New Rule 506(d) applies to the following categories of persons ("covered persons"):

The issuer and any predecessor of the issuer or affiliated issuer;

- Any director, general partner or managing member of the issuer and executive officers (i.e., those officers that participate in policymaking functions) and officers who participate in the offering (participation is a question of fact and includes activities such as involvement in due diligence, communications with prospective investors, document preparation and control, etc.);
- Any beneficial owner of 20% or more of the outstanding equity securities of the issuer calculated on the basis of voting power (voting power is undefined and meant to encompass the ability to control or significantly influence management

or policies; accordingly, the right to elect or remove directors or veto or approve transactions would be considered voting);

- Investment managers of issuers that are pooled investment funds; the directors, executive officers, and other officers participating in the offering, general partners and managing members of such investment managers; and the directors and executive officers of such general partners and managing members and their other officers participating in the offering (i.e., the hedge fund coverage; the term "investment manager" is meant to encompass both registered and exempt investment advisers and other investment managers);
- Any promoter connected with the issuer in any capacity at the time of the sale (a promoter is defined in Rule 405 as "any person, individual or legal entity, that either alone or with others, directly or indirectly takes initiative in founding the business or enterprise of the issuer, or, in connection with such founding or organization, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities other than securities received solely as underwriting commissions or solely in exchange for property");
- Any person that has been or will be paid, either director or indirectly, remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- Any director, officer, general partner, or managing member of any such compensated solicitor.

New Rule 506(d) enumerates the following disqualifying events:

Criminal convictions (felony or misdemeanor) within the last five years in the case of issuers, their predecessors and affiliated issuers, and ten years in the case of other covered persons, in connection with the purchase or sale of any security involving the making of a false filing with the Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

Court injunctions and restraining orders, including any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any

security involving the making of a false filing with the Commission, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

Final orders issued by state securities commission (or any agency of a state performing like functions), a state authority that supervises or examines banks, savings and associations, or credit unions, state insurance regulators, federal banking regulators, the CFTC, and the National Credit Union Administration, that at the time of the sale bars the person from association with any entity regulated by the regulator issuing the order or from engaging in the business of securities, insurance or banking or engaging in savings association or credit union activities, or constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the last ten years before the sale;

Any order of the SEC entered pursuant to Section 15(b) or 15B(c) of the Exchange Act or section 203(e) or (f) of the Investment Advisors Act that, at the time of such sale, suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment advisor; places limitations on the activities, functions or operations of such person; or bars such person from being associated with any entity or from participating in the offering of any penny stock;

- Is the subject to any order of the SEC entered within five years before such sale, that at the time of such sale orders the person to cease and desist from committing or causing a violation of future violation of any scienter-based antifraud provision of the federal securities laws (including, without limitation, Section 17(a)(10) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 15(c)(1) of the Exchange Act and Section 206(1) of the Advisor Act, or any other rule or regulation thereunder) or Section 5 of the Securities Act;
- Suspension or expulsion from membership in, or suspension or a bar from association with a member of, an SRO, i.e., a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;
- Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the

Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; and

- U.S. Postal Service false representation orders, including temporary or preliminary orders entered within the last five years.

The Rules that Never Happened

Title III Crowdfunding

What many consider the most anticipated capital markets regulatory change in 80 years, equity crowdfunding for unaccredited investors, is still only an anticipated change.

As required by Title III of the JOBS Act, on October 23, 2013, the SEC published proposed crowdfunding rules. The SEC has dubbed the new rules "Regulation Crowdfunding." The entire 584-page text of the rule release is available on the SEC website. As of today, it is unclear when final rules will be released and passed into law and what changes those final rules will have from the proposed rules. Moreover, upon passage of the final rules, there will be a period of ramping-up time in which crowdfunding portals complete the process of registering with the SEC, becoming members of FINRA and completing the necessary steps to ensure that their portal operates in compliance with those final rules.

Federal crowdfunding is coming in some form, but it is a slow process. As tuned in as I am to the process, I still have no educated opinion on when we will see a new set of rules and progress on the ultimate initiation of Regulation Crowdfunding. Many industry insiders have simply stopped talking about it and focused on work-arounds such as state crowdfunding or Regulation A offerings.

While Regulation Crowdfunding has stalled, the capital markets have embraced Title II accredited investor crowdfunding, and the once ignored Regulation A has become increasingly popular. Regulation A allows solicitation and advertising to the crowd. Moreover, several states have either enacted or introduced state-specific crowdfunding legislation.

Regulation A+

Although Regulation A+ still remains highly objected to and debated in its current proposed form, it is believed that a new set of either proposed rules or final rules addressing the concerns of the opponents of the current form will be forthcoming in the near future.

On December 18, 2013, the SEC published proposed rules to implement Title IV of the JOBS Act, commonly referred to as Regulation A+. The proposed rules both add the new Section 3(b)(2) (i.e., Regulation A+) provisions and modify the existing Regulation A. The comment period closed March 24, 2014, and presumably the SEC is analyzing the information and deciding on the next reiteration.

Both the North American Securities Administrators Association (NASAA), a group whose members are comprised of state securities regulators, and the U.S. Senate have been overtly opposed to the proposed federal pre-emption of state law for Regulation A+ offerings.

The text of Title IV of the JOBS Act provides, among other items, a provision that Regulation A securities should be treated as covered securities for purposes of the National Securities Markets Improvement Act (NSMIA). In general the NSMIA was an attempt to unify securities regulations by enumerating classes of securities that are considered federally "covered securities." Federally covered securities are exempt from state registration and overview. For example, securities traded on a national exchange, securities issued pursuant to an effective registration statement (such as on Form S-1) and securities issued pursuant to Rule 506(b) or (c) under Regulation D are all covered securities.

Federally covered securities are still subject to state anti-fraud provisions, and states may require certain notice filings, such as a copy of a Form D filed with the SEC.

Title IV of the JOBS Act related to the revamp of Regulation A provides that "(b) Treatment as covered securities for purposes of NSMIA… Section 18(b)(4) of the Securities Act of 1933… is further amended by inserting… (D) a rule or regulation adopted pursuant to section 3(b)(2) and such security is (i) offered or sold on a national securities exchange; or (ii) offered or sold to a qualified purchaser, as defined by the Commission pursuant to paragraph (3) with respect to that purchase or sale."

In other words, Title IV of the JOBS Act provides that the Regulation A+ securities will be considered covered securities and therefore not subject to state registration or overview as long as they are sold on a national securities exchange or sold to qualified purchasers. "Qualified purchaser" is another way to describe an "accredited investor." The current proposed Regulation A+ includes the allowance of sales under Regulation A+ to unaccredited investors (i.e., non-qualified investors) while concurrently pre-empting state law. The SEC's proposal does clearly extend beyond the plain language of Title IV of the JOBS Act and is being met with significant, and likely fatal, objections.

While the NASAA opposed the state law pre-emption in the current draft rules, it praised the concept of the rule itself, including the two-tier structure, offering amount limits and importantly ongoing reporting requirements. The NASAA is supportive of many of the same provisions that have garnered support in the investment community, including that Regulation A/A+ permit general solicitation and advertising, allow test-the-waters communications and permit sales to both accredited and unaccredited investors.

It is the NASAA's view that the rules should be and can be better policed on a local level. The NASAA praised merit review states. Merit review generally includes rules related to and a review of such items as valuation, offering amount and general business plan. Moreover, some states require independent directors and other corporate governance standards.

The NASAA pointed to the new Coordinated Review Program for multi-state Regulation A and A+ offerings, which program has been adopted by 48 states. If implemented, the program would allow an issuer to submit its SEC qualified Regulation A/A+ for a single qualification process for all the participating states. A complete set of proposed rules have been prepared for the process, including the filing requirements, response time, and overall procedures. In reality, very few Regulation A offerings are filed in merit review states due to time and expense associated with the intense regulatory review.

The NASAA has stated that it will file a lawsuit in the event that the current broad state law pre-emption were to pass.

On August 1, 2014, the U.S. Senate wrote a letter to the SEC expressing its own opposition to the pre-emption provisions in the proposed Regulation A+ rules. The Senate letter is strong in its position, starting out saying plainly that the SEC lacks statutory authority under Title IV of the JOBS Act to "ignore investor protections

mandated by the plain letter of the statute" by having "proposed to broadly preempt state Blue Sky laws." The letter continues with "it must be withdrawn."

Regardless of the approach taken by the opposition, the message is clear and I believe the SEC will have no choice but to remove the broad preemption provisions from the proposed Regulation A/A+ rules. Of course, a statutory fix via an amendment to Title IV to treat all Regulation A+ issued securities as "covered securities" would be helpful, and this fix has not been lost on legislators. It is my understanding such amendments are being drafted, though whether they will pass remains to be seen.

Further Amendments to Regulation D, Form D and Rule 156

On July 10, 2013, the same day the SEC adopted final rules eliminating the prohibition against general solicitation and advertising in Rules 506 and 144A offerings as required by Title II of the JOBS Act, and adopted new rules disqualifying felons and other bad actors from participating in Rule 506 offerings as required by Section 926 of the Dodd-Frank Act, the SEC issued proposed rules further amending Regulation D, Form D and Rule 156.

The proposed amendments would have (i) required the filing of a Form D to be made before the issuer engages in any general solicitation or advertising in a Rule 506(c) offering and required the filing of a closing amendment to the Form D at the termination of the offering; (ii) required that all written general solicitation material used in a Rule 506(c) offering include certain legends and disclosures; (iii) required that all written material used in general solicitation and advertising be submitted to the SEC; (iv) disqualified an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, failed to comply with the Form D filing requirements for a Rule 506 offering in the last five years; (v) amended the Form D to include additional information about offerings; and (vi) amended Rule 156 to extend the antifraud guidance in the rule to include sales literature of private funds (hedge funds).

These proposed rule changes failed to gain any traction and appear to have been abandoned.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, The Securities Law Network.

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