White Paper

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Looking Forward: Practical Implications of the JOBS Act Changes to Private Placements

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Two key features of the JOBS Act – general solicitation in Rule 506 offerings, and the increased thresholds at which an issuer will be required to register a class of securities under the Securities Exchange Act of 1934 (the "1934 Act") – when combined with certain advantages already enjoyed by issuers in Rule 506 offerings, will open up an entirely new category of "publicly offered private offerings" that are largely exempt from substantive regulation at either the federal or state level, by issuers that will be able to avoid becoming public companies, for practical purposes, as long as they wish. Given the high costs and liability risks of operating as a publicly reporting company in the U.S., and the great advantages of being a Rule 506 issuer, this is a category that could prove to be very large, and very varied.

Rule 506. Rule 506 is the exemption used for more than 90% of all exempt offerings in the US, and more than 90% of all exempt offerings already are limited to accredited investors.[1] Rule 506, as it had existed until the recent amendments, permitted private placements to be sold in unlimited offering amounts, to an unlimited number of purchasers (subject to the need for 1934 Act registration when an issuer has 500 holders of record), so long as all of the purchasers are accredited investors and there was no use of general solicitation or public advertising.

The JOBS Act and General Solicitation. The JOBS Act directed the SEC to remove the prohibitions on general solicitation or public advertising for securities offerings relying on Rule 506. In particular, Section 201(a)(1) of the JOBS Act directed the SEC to amend Rule 506 to permit general solicitation or public advertising provided that the issuer has taken reasonable steps to verify that all purchasers of the

[1] During the two years leading up to October 2010, Rule 506 was used for 94% of the approximately 27,000 Reg D offerings for which Form D was filed. About 90% of Reg D offerings are 506 offerings, and about 90% of Reg D offerings are limited to accredited investors. Of the limited number of smaller offerings under Rules 504 and 505, more than half were limited to accredited investors Campbell, "The Wreck of Regulation D," 66 *The Business Lawyer* 919 (August 2011).

securities are accredited investors. On July 10, 2013, the Commission adopted amendments to Rule 506, including a new Rule 506(c) authorizing general solicitation, to accomplish this direction (Rel. 33-9415). The amendments became effective September 23, 2013.

The JOBS Act and 1934 Act Registration. In addition, Title V of the JOBS Act amended Section 12(g)(1)(A) of the 1934 Act to raise the thresholds at which an issuer will be required to register under section 12(g) of the 1934 Act. An issuer must register within 120 days after its first fiscal year in which the issuer has total assets in excess of $10 million and a class of equity securities (other than exempted securities) held of record by either (i) 2,000 persons, or (ii) 500 persons who are not accredited investors. For these purposes, the "held of record" definition in Section 12(g)(5) does not include securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempt from the registration requirements under Section 5 of the Securities Act of 1933 ("the 1933 Act"), or securities sold in exempt crowdfunding offerings under Title III of the JOBS Act.

As a result, under amended Regulation D, an issuer may conduct a Rule 506 offering by public advertising so long as all purchasers are accredited investors, and 1934 Act registration is not required until the issuer acquires 2000 holders of record (excluding holders who acquired their shares under the Company's employee benefit plans, or in exempt crowdfunding offerings).

Advantages to Rule 506. Apart from the ability to engage in general solicitation or public advertising, and the increased thresholds for 1934 Act registration, there are several very important advantages of Rule 506, as it has existed, that are important to understanding the significance of these two changes:

I. Rule 506 offerings require only notice filings with the SEC and the states. There is no required filing of, or review of the offering documents at either the federal or state level.[2] (FINRA requires broker-dealers to file copies of certain private placement offerings in which they participate, but these filings are only notice filings, and FINRA will not comment on or provide clearance for the offerings.)[3]

II. There are no specific required disclosures that must be included in a Rule 506 offering that is limited to accredited investors.[4] It is left to the issuer to determine what disclosures are appropriate to provide full disclosure and to avoid anti-fraud liability.

III. Disappointed investors cannot sue, under the federal securities laws, for negligent misrepresentation (that is, lack of due care or due diligence) in a Rule 506 offering. As a result of a 1995 Supreme Court decision, *Gustafson v. Alloyd*,[5] which held that the liability provisions of Section 12(a)(2) of the 1933 Act do not extend to a private sale, investors in Rule 506 offerings may assert federal claims only under section 10(b) and Rule 10b-5 under the 1934 Act, which require that the investor prove actual intent to defraud, or reckless indifference to the truth of the representations made in the offering. While investors might assert claims under various state laws, or common law, the practical effect of *Gustafson* has been to make it much harder for lawsuits to be maintained by investors in Rule 506 offerings.

[2] The National Securities Markets Improvement Act of 1996 ("NSMIA") preempted all state registration requirements (as well as special state disclosure requirements) with regard to certain "covered securities," as designated in Section 18 of the 1933 Act, including securities sold in exempt private offerings complying with Rule 506 of Regulation D.

[3] FINRA Rule 5123, which was approved by the SEC on June 7, 2012 and became effective December 3, 2012, requires each FINRA member firm that sells an issuer's securities in a private placement, subject to several exemptions, to file with FINRA a copy of any private placement memorandum, term sheet or other offering document the firm used within 15 calendar days of the date of sale, or indicate that it did not use any such offering documents. Filings with FINRA under Rule 5123 are considered "notice" filings.

[4] SEC Rule 502(b)(1).

[5] 513 U.S. 561 (1995).

IV. Rule 506 offerings may be made by both U.S. and non-U.S. companies, and may be made by both private companies and companies that are already public.

The New "Public Private Offering" and "Public Private Companies." The JOBS Act combines these existing features of Rule 506 offerings with public advertising and the ability to have up to 2000 holders of record, providing a very broad range of possibilities. The law also opens up many types of U.S. and non-U.S. financial products to Internet advertising, whereas until now the use of the Internet for solicitation in securities offerings has been very strictly limited by the prohibition of general solicitation or public advertising. While it probably is unlikely that we will see private placement memoranda bound into the Neiman Marcus catalog, or on the shelves at Costco, we could very well see:

- private companies and fund managers[6] advertising their private offerings on cable television networks;
- offerings being made broadly to a company's entire customer base, or to members of loyalty programs, or to retail customers;
- offers to shoppers in catalogs or on Internet sites, or to holders of a company's credit cards;
- offerings to members of large membership organizations, such as AARP, or churches;
- offers to Facebook "friends" of issuers, or to Twitter followers;
- offers to magazine subscribers, or holders of particular credit cards;
- offers to university alumni; or
- offers to people with whom the issuer has no direct or indirect association, but who are identified through "big data" analysis.

Further, by permitting an issuer to remain private until it has 2000 holders of record, the JOBS Act will permit the growth of a new class of "public private companies" that are able to raise capital without any public filings or review of disclosure documents, and without any required disclosures or reporting to their shareholders, and which can remain private, as a practical matter, as long as they choose to remain private. The effects of all this on capital formation, investor protection and securities regulation are likely to be immense.

The "Real" Crowdfunding Exemption. While Rule 506 offerings can be of any size, Rule 506 offerings are now arguably the "real" crowdfunding mechanism. "Crowdfunding," as envisioned by Title III of the JOBS Act, has two advantages shared by Rule 506(c) – the securities offered will be "covered securities" under NSMIA, preempting state securities regulation, and crowdfunding purchasers will not be counted against the thresholds for registration under Section 12(g) of the 1934 Act. Title III crowdfunding, however, is limited in ways that make it far less attractive than Rule 506(c):

I. The issuer may not be a public company, investment company, or foreign private issuer.

[6] Hedge funds, private equity funds and other private investment vehicles must still qualify for an exemption from registration under the Investment Company Act of 1940. This generally means that the private investment vehicles (1) must have fewer than 100 holders, or (2) must have only investors that are "qualified purchasers" (generally meaning they have $5 million in investments), in which case the vehicle can have up to 2000 holders before being required to register as a public company.

II. The aggregate amount sold to all investors in all offerings (not just crowdfunding offerings) cannot exceed $1 million in any 12-month period.

III. The aggregate amount sold to any one investor by the issuer in all offerings (not just crowdfunding offerings) may not exceed (a) for investors with annual income or net worth under $100,000, the greater of $2,000 or 5% of the investor's annual income, or (b) for investors with annual income or net worth of $100,000 or more, 10% of the investor's annual income or net worth, up to $100,000.

IV. The transaction must be conducted through an intermediary – a broker-dealer or funding portal.

V. Both the issuer and the intermediary must comply with disclosure and reporting requirements set out in the JOBS Act and to be established by regulations, not yet proposed.

While we do not have proposed regulations, the required disclosure and ongoing reporting requirements, combined with the need to compensate attorneys, intermediaries and others, will likely make Title III crowdfunding unreasonably burdensome for offerings that cannot exceed $1 million. Under 506(c), on the other hand, the issuer can sell in unlimited amounts, without any required ongoing reporting, so long as it keeps below the thresholds for 1934 Act registration. True, a crowdfunding offering can result in more than 2000 shareholders without 1934 Act registration, but a company with no more than $1 million in funding would drown under the weight of so many shareholders.

It is also true that a crowdfunding offering need not be limited to accredited investors, but it is fair to ask how much issuers would expect to raise, even in a Title III crowdfunding offering, from investors who are not accredited. Rule 506 offerings in recent years demonstrate that the overwhelming majority of private offerings are sold only to accredited investors. Accredited investors not only are "where the money is," but are presumed to be sophisticated, and disclosures to them can assume a certain level of knowledge of investment transactions. Disclosures to investors who are not accredited may more easily be criticized as misleading or incomplete where the investors are not presumed to have the sophistication to recognize the failings in disclosure.

For these reasons, Rule 506(c) is likely to be the "real" crowdfunding exemption, as well as the dominant exemption for most other unregistered offerings.

If you have any questions about the content of this white paper, please contact the Pillsbury attorney with whom you regularly work, or the author below.

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