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Practical Implications of the JOBS Act Changes to Private Placements: Rule 506(c), Crowdfunding, and Reg A+

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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, 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 percent of all exempt offerings in the US, and more than 90 percent 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), as long as all of the purchasers are accredited investors and there was no use of general solicitation or public advertising.

[1] During the two years leading up to October 2010, Rule 506 was used for 94 percent of the approximately 27,000 Reg D offerings for which Form D was filed. About 90 percent of Reg D offerings are 506 offerings, and about 90 percent 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).

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 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 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 long as all purchasers are accredited investors, and 1934 Act registration is not required until the issuer acquires 2,000 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.

[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).

III. In contrast to JOBS Act crowdfunding, there is no annual disclosure requirement or other ongoing oversight of a Rule 506(c) issuer.

IV. 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.

V. Both U.S. and non-U.S. companies, and both private companies and companies that are already public, may make Rule 506 offerings.

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 2,000 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.

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

[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 requirement 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 2,000 holders before being required to register as a public company.

Further, by permitting an issuer to remain private until it has 2,000 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.

JOBS Act Crowdfunding vs. Donation-Based Crowdfunding vs. 506(c) Crowdfunding.

While the advent of extremely large 506(c) offerings is likely to have a major effect on private capital-raising, public attention often seems to be riveted on the provisions of the JOBS Act authorizing regulations to permit "crowdfunding" offerings in which an issuer may accept relatively small amounts in small offerings, from investors who need not be accredited. The SEC published proposed crowdfunding rules in October 2013,[7] but at the time of this writing, no regulations have been adopted. "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.

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 percent of the investor's annual income, or (b) for investors with annual income or net worth of $100,000 or more, 10 percent 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 financial reporting requirements set out in the JOBS Act and to be established by regulations, both at the time of the offering and annually thereafter.

VI. In contrast to Rule 506(c) offerings, the issuer in a crowdfunding offering is subject to liability for negligent misstatements or omissions in an action for rescission – the same liability imposed on a statutory prospectus used in a public offering.

Compliance with the disclosure requirements is likely to impose the most significant costs on a JOBS Act crowdfunding offering. The new Form C created by the proposed regulation prescribes the sort of detailed disclosures typical of any securities offering, which invariably require the active involvement of securities counsel. The SEC estimates that a crowdfunding issuer will spend $6,000 on outside professional fees for nonfinancial compliance, regardless of the size of the offering and assuming that the issuer would perform 75 percent of the work.[8] This estimate seems woefully low, and many industry newsletters have warned

[7] Crowdfunding; Proposed Rule, SEC Rel. No. 33-9470, 34-70741 (Nov. 5, 2013) (the "Proposing Release").

[8] Proposing Release, 358, 358 n. 920.

that the regulatory and disclosure burdens will make crowdfunding too expensive to be useful. One *New York Times* writer noted that "a company hoping to raise $100,000 could end up paying more for capital than it would by borrowing money with a credit card."[9]

The SEC also estimated in the proposing release for the crowdfunding regulations that the cost of third-party intermediaries will vary from 5 percent to 15 percent of the offering.[10] Further, the issuer will have annual reporting requirements on Form C-AR that will be similar to the reporting requirements for the offering, and that will continue so long as the securities sold in the offering are outstanding (regardless of the number of investors that continue to hold the securities), or until the issuer becomes a public reporting company. The cost of these annual reporting requirements is likely to be an unreasonable burden for most crowdfunding issuers, and an enormous disincentive to use of the crowdfunding exemption.

While we wait for final JOBS Act crowdfunding regulations, startup companies that need to raise relatively small amounts of money have had tremendous success through donation-based crowdfunding, through sites such as Kickstarter, Indiegogo and Rockethub. This type of crowdfunding is by its nature exempt, since the fundraisers are not selling securities. Donation-based crowdfunding sites, for the first time, have permitted startups (and others) to raise funds from a vast audience of interested funders by offering planned products at discounted prices, or by offering other items of value, as varied as the right to be listed as a producer of a proposed movie. The important thing is, these sites have produced successful results without the costs of securities law compliance. As of a recent date, Kickstarter alone had raised over $1.25 billion for about 70,000 projects, from over 2,000,000 contributors, or "backers," who had made a total of over 17,000,000 pledges. Donation-based crowdfunding works, with little or no regulatory burden.

What should we expect, in contrast, from JOBS Act crowdfunding? The required disclosure and ongoing reporting requirements, combined with the need to compensate attorneys, intermediaries and others, will likely make JOBS Act 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 2,000 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, in a JOBS Act crowdfunding offering, from investors who are not accredited. 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.

The Great Unknown – Will Regulation A+ Succeed as an Alternative to 506(c)?

In the Proposing Release, the SEC also proposed rules to modify and expand Regulation A, the rarely-used "small offering exemption." The proposed new Regulation A ("Reg A+") would increase the limits on

[9] Robb Mandelbaum, "What the Proposed Crowdfunding Rules Could Cost Business," *New York Times* (November 14, 2013).

[10] Proposing Release.

such offerings from $5 million to $50 million in a 12-month period, and would provide for state securities law preemption, like a 506 offering. Securities sold under Reg A+ would not be restricted securities, but it is not clear what advantage purchasers will obtain by having the ability to transfer their securities outside Rule 144. Issuers that raise more than $5 million in a Reg A+ offering also will be subject to annual reporting requirements, including annual audited financial statements and semi-annual current reporting. Also, as is the case with the proposed crowdfunding regulations, public companies will not be able to use Reg A+ to raise capital.

Further, Reg A+ will require that an offering circular, with prescribed disclosure, be publicly filed with the SEC, and subject to review and comment, at least 21 days before commencement of the offering. Much has been made of the fact that Reg A+ issuers will be able to “test the waters” with prospective investors before or after the filing of the offering circular, but it should be noted that an issuer in a 506(c) offering can do the same thing. Finally, unlike 506(c) offerings, but like crowdfunding offerings, Reg A+ offerings will be subject to full disclosure liability for negligent misstatements or omissions.

Reg A+ certainly has its supporters, who believe that the ability to raise up to $50 million from investors who need not be accredited will lead to greater use than has been true of Reg A. The best argument for Reg A+ is that there are unusual situations in which an issuer may need to offer securities to a wide range of buyers, without being restricted to accredited investors, and the reasons for the offering are substantial enough to make the disclosure cost, ongoing reporting and risk of liability worthwhile. We expect, however, that offerings that have these special needs will be few and far between. While Reg A+ has a low bar to meet to become more successful than Reg A, it will not be more than a small-tent sideshow compared with 506(c).

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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