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Practice Update

SEC Issues Final Rules Implementing Provisions Under the JOBS Act and Dodd-Frank

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Prohibition on General Solicitation and Advertising in Certain Private Offerings Eliminated "Felons and Other Bad Actors" Disqualified from Participation in Certain Private Offerings

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On July 10, 2013, the Securities and Exchange Commission (Commission), issued final rules implementing provisions of the Jumpstart our Business Startups Act (JOBS Act) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The first of these final rules, which implements the requirements of Section 201(a)(1) of the JOBS Act, eliminates the prohibition on general solicitation and general advertising in certain private offerings where the issuer has taken reasonable steps to verify that all investors purchasing securities in the offering are accredited investors. The second of these final rules, which implements the requirements of Section 926 of the Dodd-Frank Act, disqualifies issuers from relying on the safe-harbor exemption from registration available under Regulation D under the Securities Act of 1933, as amended (Securities Act) where certain "felons and other bad actors" are involved in such offerings. Both of these final rules will become effective on September 23, 2013.

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Simultaneously, the Commission proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act of 1933, as amended (Securities Act), that, if adopted, will subject companies engaged in Rule 506 private offerings that involve general solicitation to additional filings and disclosure requirements. These proposed rules will be the subject of another client alert to be published in the near future.

The final rules dealing with the elimination of the prohibition on general solicitation and general advertising in certain private offerings were the subject of proposed rules issued in August 2012. A client alert about the proposed rules that we published shortly after the rules proposal was promulgated can be found here. With one important exception, the final rules largely follow the proposed rules. The final rules can be found here.

The final rules disqualifying securities offerings involving "felons and other bad actors" from reliance on Rule 506 under Regulation D were the subject of a rules proposal in May 2011. The new rules largely follow the proposed rules, but, most importantly, will apply only to triggering events occurring after the effectiveness of the new rules (with pre-existing events subject to mandatory disclosure). The final rules can be found here.

Elimination of the Prohibition against General Solicitation and Advertising in Certain Private Offerings

Since it was originally adopted, the Securities Act has banned general solicitation of investors in private securities offerings. In April 2012, Congress passed the JOBS Act, mandating that the Commission eliminate the general solicitation ban where sales are limited to "accredited investors" and the issuer has taken steps to verify that all purchasers of the securities are accredited investors.

As described below, under the final rules, which add new Rule 506(c) to Regulation D under the Securities Act, the determination as to the steps taken to verify an accredited investor is an objective assessment by the issuer. However, the final rules include a non-exclusive list of methods that issuers may use to satisfy the verification requirement for individual investors.

Importantly, the new rules continue to allow issuers to sell securities in private offerings without general solicitation under the guidance that exists today with respect to such offerings. Further, under a transition rule contained in the new rules, issuers who have an ongoing offering that began prior to the effective date of the new rules but continues after the effective date of the new rules may choose to continue the offering with general solicitation, and such election will not invalidate any prior sales to non-accredited investors in reliance on the existing rules (but will prohibit any such sales in the future).

Reasonable Steps to Verify

New Rule 506(c) requires that issuers take "reasonable steps to verify" that all investors purchasing securities in offerings using general solicitation are accredited investors. This standard is based upon an objective determination by the issuer, and is a facts-and-circumstances determination. This determination must be satisfied even if all purchasers actually are accredited investors. This determination must be made based on a non-exclusive list of methods which an issuer may use to verify accredited investor status. Among those factors are:

- ***The nature of the purchaser and the type of accredited investor the purchaser claims to be. The definition of "accredited investor" includes eight enumerated categories.*** Some, such as registered broker-dealers or investment companies registered under the Investment Company Act of 1940, are accredited investors

based on their mere existence. Others, such as state employee benefit plans with assets in excess of $5 million, or IRS 501(c)(3) organizations with assets in excess of $5 million, are accredited based on their total assets. Still others may be accredited on the basis of their net worth or income, such as individuals with income in excess of $200,000 (or joint income with a spouse in excess of $300,000) or individuals with a net worth of $1 million (excluding the value of a primary residence). As there are different types of accredited investors, there are different steps that an issuer might have to take to determine accredited investor status. A check to ensure that an entity is an accredited broker-dealer may be as simple as checking FINRA's BrokerCheck website. Verifying that natural persons are accredited may be more difficult, and the steps that must be taken depend on facts and circumstances.

- ***The amount and type of information that the issuer has about the purchaser.*** The more information an issuer has indicating that a prospective investor is an accredited investor, the fewer additional steps that will be needed to verify the prospective investor's accredited investor status, and vice versa. The Commission included in the final rule a non-exclusive list of steps that can be taken to verify a purchaser's accredited investor status:

    - Checking publically available information in filings with a federal, state or local regulatory body, such as SEC filings (where, for example, the purchaser is a named executive officer of a reporting company, and their compensation is disclosed in the filing) or, in the case of a 501(c)(3) corporation with $5 million in assets, checking the corporation's most recent publicly filed Form 990.
    - Third-party information that reveals reasonably reliable evidence that the purchaser is an accredited investor, such as pay stubs, information about average compensation

earned at the purchaser's workplace for employees such as the purchaser, or third-party verification, where the issuer has a reasonable basis to rely on the verification.

- ***Check the Box is Not Enough.*** The Commission made clear in the final rules (consistent with the proposed rules) that it does not believe that an issuer will have taken reasonable steps to verify accredited investors status if such issuer, or those acting on its behalf, require only that the purchaser check a box on a form regarding accredited investor status, absent of any other information.
- ***The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.*** The nature and terms of the offering, such as the means of public solicitation, is relevant in determining the number of steps that must be taken in order to verify accredited investor status. For example, an issuer that seeks out high net worth individuals through a brokerage firm is likely to be required to take fewer steps to verify accredited investor status than an issuer that seeks purchasers through social or print media.

These factors are interconnected, and are intended to be a guide to compliance, rather than an absolute list of verification steps that must be taken. The Commission stated that the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps that the issuer would have to take to verify accredited investor status, and vice versa.

Safe Harbor Methods to Verify Accredited Investor Status

In response to comments, the Commission included in the final rules four specific methods of verifying accredited investor status for an individual investor that, if used, will be deemed to satisfy the verification requirements under Rule 506(c); provided, however,

that none of the methods will be deemed acceptable if the issuer has information that the proposed purchaser is not an accredited investor.

- An issuer is deemed to satisfy the verification requirement by its review of copies of documents filed with the Internal Revenue Service, such as a Form W-2, Form 1099, Schedule K-1, or Form 1040 for the two most recent years, along with obtaining a written representation from such person stating that he or she has a reasonable belief that the income level necessary to qualify as an accredited investor will be achieved in the coming year. An issuer will also be required to check the individual's spouse's documents, if necessary, if the purchaser claims accredited investor status by virtue of combined income.
- Where an individual claims accredited investor status by virtue of net worth, the Commission provided a list of documents that should be reviewed, along with obtaining a representation from the investor and, if applicable, the investor's spouse. The Commission stated that for verification of assets, bank statements, brokerage statements or other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties are deemed to be satisfactory. For verification of liabilities, a review of the investor's credit report is deemed satisfactory.
- An issuer can seek out third-party confirmation of accredited investor status. A written confirmation from a registered broker-dealer, an SEC-registered investment advisor, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps within the prior three months to determine that the purchaser is an accredited investor is deemed sufficient. An issuer can also rely on third-party verification from others not listed above, provided that any such third-party takes reasonable steps to determine accredited investor status, and the

issuer has a reasonable basis to rely on their determination.

- With respect to any natural person who invested in the issuer's prior Rule 506(b) offerings as an accredited investor and remains an investor in the issuer, the issuer is deemed to satisfy the verification requirement by obtaining a certification from such person that he or she remains an accredited investor.

Form D

Under Rule 503 of Regulation D, an issuer offering or selling securities under Rule 504, 505 or 506 must file a notice of sales on Form D with the Commission for each new offering of securities no later than 15 calendar days after the first sale of securities under the offering. Form D contains basic identifying information, such as the name of the issuer and the issuer's year and place of incorporation or organization, information about related persons (executive officers, directors, and promoters), the exemption or exemptions being claimed for the offering, and factual information about the offering, such as the duration of the offering, the type of securities offered, and the total offering amount.

Under the new rules, Form D is being revised to add a separate checkbox for issuers claiming reliance on Rule 506(c). The current checkbox for "Rule 506" will be revised to reflect compliance with Rule 506(b) in which the offering will not include general solicitation or advertising. The Commission noted that, despite some requests from commenters to the proposed rule, issuers will not be allowed to check both the Rule 506(b) and Rule 506(c) boxes, since once general solicitation has been made, an issuer can no longer rely on Rule 506(b).

Amendments to Rule 144A

The JOBS Act required the Commission to revise Rule 144A(d)(1) under the Securities Act to provide that securities sold pursuant to Rule 144A may be

offered to persons other than qualified institutional investors (QIBs), including by means of general solicitation, if the securities are only sold to persons that the seller reasonably believes are QIBs or are acting on behalf of QIBs. As long as purchasers are limited in such manner, resales of securities under Rule 144A can be conducted by general solicitation.

For ongoing Rule 144A offerings that commenced before the effective date of the new rules, offering participants will be allowed to conduct the offering by use of general solicitation without affecting the availability of Rule 144A for the portion of the offering that occurred before the effective date of the new rule.

Disqualification of Felons and Other Bad Actors from Participation in Private Offerings

To implement Section 926 of the Dodd-Frank Act, the final rules prohibit an issuer from relying on the Rule 506 exemption from registration (with or without general solicitation) if the issuer or any other "covered person" had a "disqualifying event." However, the final rules provide an exception from disqualification if the issuer can show that it did not know, and in the exercise of reasonable care could not have known, that a covered person with a disqualifying event participated in the offering. Further, the final rules only apply to disqualifying events that occur after the effective date of the final rules. However, prior events that otherwise would have triggered disqualification must be disclosed to potential investors.

Covered Persons. "Covered persons" include:

- Directors, executive officers and other officers of the issuer who participate in the offering (a determination of which officers are participating in the offering is a facts and circumstances determination based on the officer's involvement in due diligence activities, the preparation of disclosure documents or communication with

prospective investors or other participants in the offering)

- 20% beneficial owners of the issuer's outstanding securities
- Promoters
- Investment managers and principals of pooled investment funds
- Persons compensated for soliciting investors as well as general partners, directors, officers and managing members of any compensated solicitor

Disqualifying Events. "Disqualifying events" include:

- Criminal convictions of covered persons occurring within ten years of the sale (or five years, in case of the issuer, its predecessors and its affiliated issuers): (i) in connection with the purchase or sale of any security; (ii) involving the making of any false filing with the Commission; or (iii) 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 or restraining orders against covered persons which enjoin or restrain the person from engaging in or continuing to engage in any conduct or practice (occurring, within five years of the proposed sale of securities): (i) in connection with the sale of any security, (ii) involving the making of any false filing with the Commission, or (iii) 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 from a state securities commission (or an agency or officer of a state performing like functions), a state authority that supervises or examines banks, savings associations, or credit unions, a state insurance commission (or an agency or officer of a state performing like functions), an appropriate federal banking agency,

the U.S. Commodity Futures Trading Commission, or the National Credit Union Administration that, at the time of such sale: (i) bars the issuer or the covered person from association with an entity regulated by such commission, authority, agency, or from engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities; or (ii) is based on fraudulent, manipulative, or deceptive conduct and is issued within ten years of the proposed sale of securities

- Certain Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies and investment advisors and their associated persons
- SEC cease and desist orders 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 or future violation of: (i) any scienter-based anti-fraud provision of the federal securities laws, including Rule 10b-5 under the Securities Exchange Act of 1934, or (ii) Section 5 of the Securities Act
- Suspension or expulsion from membership in a self-regulatory organization ("SRO") or from association with an SRO member
- SEC stop orders and orders suspending the Regulation A exemption, issued within five years of the proposed sale of securities
- U.S Postal Service false representation orders issued within five years of the proposed sale of securities

Reasonable Care Exception

The final rules provide an exception from disqualification where the issuer is able to establish that it did not know and, in the exercise of reasonable care could not have known, that a disqualification existed because of the disqualifying event of a covered person participating in the offering. The Commission noted that the issuer must

take steps to inquire as to whether any disqualification exists, although the inquiry required depends on the facts and circumstances. For example, an issuer is expected to have an in-depth knowledge of its own officers, while further steps, such as questionnaires and contractual representations, may be necessary for other covered persons. For continuous, delayed or long-lived offerings, reasonable care includes updating the factual inquiry on a reasonable basis, the frequency and degree of which depends on the facts and circumstances.

Under the new rules, the Commission is authorized to grant waivers to the disqualification rules; and the Commission has delegated this authority to the Director of the Division of Corporation Finance. Waivers may be granted for good cause shown. The Commission declined in the final rules to articulate standards for granting waivers, although it stated that it may consider doing so in the future.

Next Steps

Issuers who wish to raise funds in private offerings that will utilize general solicitation or advertising should immediately begin to determine strategies for checking accredited investor status. Issuers should also immediately begin determining whether any of their covered persons has had a disqualifying event, since even if those events occurred before the effective date of the new rules, such events will need to be disclosed to investors in future private offerings (whether or not such offerings involve general solicitation).

Since the issuer has the burden of proving compliance with the new rules, it is important to formalize diligence regarding these issues. Akerman can assist you in developing procedures designed to document compliance with these new rules.

If you have any questions, please contact the authors or your Akerman securities attorney.