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JOBS Act Implementation: Deregulation of Offerings

By Robert Karmel
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According to Securities and Exchange Commission (SEC) precedent and lore, preregistration offers to potential investors, generally known as "gun-jumping," may improperly prime the market for a securities offering.¹ Such offers are illicit because Section 5 of the Securities Act of 1933 prohibits offers of securities prior to the time a registration statement covering the offering is filed with the SEC.² Anti-solicitation rules were also imposed on private placements and analyst communications. If a private placement was generally advertised, it could no longer be classified as a private placement but instead became a public offering. Investment banks were subject to a "quiet period" with regard to research reports in advance of an initial public offering (IPO) or until 40 days after completion of an offering.

The Jumpstart Our Business Startups (JOBS) Act,³ passed on April 5, 2012, required the SEC to rethink all of these policies on solicitation and advertising in public securities offerings and in private placements. Some provisions of the JOBS Act with regard to solicitations became effective without SEC rulemaking. Other important provisions required rulemaking which was supposed to have been completed in July 2012, but final rules were not passed until July 2013.

Emerging Growth Companies

The JOBS Act permits emerging growth companies (EGCs) and their underwriters or other authorized representatives to communicate with qualified institutional buyers (QIBs)⁴ and institutions that are "accredited investors"⁵ to determine whether they have an interest in an offering prior to and after filing a registration statement.⁶ An EGC is a domestic or foreign issuer that has annual gross revenues of less than \$1 billion. A public issuer will remain an EGC until the earliest of:

1. The last day of a fiscal year during which it had gross revenues of U.S. \$1 billion or more;
2. The last day of the fiscal year following the fifth anniversary of its IPO;
3. The date on which it has issued more than U.S. \$1 billion in non-convertible debt during the previous three-year period; or

4. The date on which it becomes a "large accelerated filer" (has a public float greater than U.S. \$700 million).⁷

Oral and written communications are permitted without triggering existing "gun-jumping" restrictions on pre-filing communications. There is no filing requirement for these communications, which may prove a trap for the unwary due to the applicability of Securities Act liability provisions.

Pre-JOBS Act SEC quiet period rules prohibited investment banks from publishing research reports in advance of an IPO or until 40 days after completion of an offering. Also, research was required to be suspended for a period of 15 days before and after the release or expiration of any lock-up agreement. These rules came into effect after the research analyst scandals of the technology bubble because analysts were perceived to be functioning as cheerleaders for investment banking. These restrictions led to disuse of analyst reports for newly public companies, and issuers contemplating public offerings believed such a situation was inhibiting capital formation.

Under the JOBS Act, investment banks are permitted to publish research reports during the pendency of a public offering, even if they act as underwriters.⁸ Also, the existing research analyst conflict of interest rules will not apply to EGCs.⁹ Accordingly, research analysts will be permitted to make public appearances and participate in meetings with EGCs and their investment bankers. The SEC and FINRA will not be able to restrict such activities in their rules.¹⁰ Whether this intended new flexibility for analysts will be utilized remains to be seen because the 2003 Global Research Settlement seriously restricting the use of analysts in IPOs is still applicable to a number of the largest underwriters, and the SEC has not indicated it will seek to eliminate or ameliorate these restrictions.

Rule 506 and 144A

The "test the waters" and analyst communication rule changes described above did not require any SEC rulemaking. On July 10, 2013, the SEC voted, pursuant to the JOBS Act, to adopt a rule that will lift the ban on general solicitation and advertising for private placements pursuant to Rules 506 and 144A.¹¹ This rule was proposed in September 2012, and the proposal proved surprisingly controversial considering it was mandated by the statute. Indeed, Commissioner Luis Aguilar dissented from the final rule and Commissioners Troy Paredes and Daniel Gallagher dissented from a related proposal to require issuers taking advantage of the relaxed solicitation rules to provide additional information to the SEC for purposes of monitoring the new liberalization. Nevertheless, a new rule barring "bad actors" from participating in private offerings under Rule 506 of the Securities Act received unanimous support.¹²

Rule 506 is a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act, which exempts securities "not involving any public offering" from SEC registration requirements. It was part of Regulation D, passed in 1982, to facilitate offerings to "accredited investors," and to no more than 35 non-accredited investors. The exemption was conditioned upon the issuer, or any person acting on behalf of the issuer, not offering or selling securities through any form of general solicitation or advertising.

Rule 144A is a non-exclusive safe harbor for resales of restricted securities to QIBs. Generally, market participants have used Rule 144A to facilitate primary offerings of foreign securities sold offshore under Regulation S¹³ by allowing immediate resales of such securities to QIBs. Although Rule 144A does not expressly ban general advertising, since sales can only be made to QIBs, participants have so interpreted the rule.

Rules 506 and 144A are widely used. In 2012, according to the SEC, the amount of capital raised in Rule 506 offerings and Rule 144A offerings by operating companies was \$173 billion and \$636 billion, respectively, and by pooled investment funds, was \$725 billion and \$4 billion.¹⁴ In order to implement the JOBS Act, the SEC proposed to amend Rule 506 to eliminate the prohibition against solicitation, provided that all purchasers pursuant to the exemption are accredited investors. In addition, the SEC proposed amending Form D, a notice required to be filed by each issuer claiming a Regulation D exemption to indicate that the issuer is relying upon Rule 506(c).

The SEC also proposed a similar amendment to Rule 144A to provide that securities could be sold pursuant to that exemption provided that all purchasers are QIBs. Despite mountains of comments received by the SEC, in favor of and against the proposed changes, the SEC adopted final rule amendments as proposed, with only one modification. However, the SEC also issued a proposed release to amend Regulation D and Form D in order to enhance the agency's ability to analyze whatever market changes will come about under the new rules allowing general solicitation of offers.¹⁵ The liberalization of offerings adopted by the SEC were narrow. They affect only Rule 506 offerings and not Section 4(a)(2) offerings generally so other types of Regulation D offerings, in particular offerings under Rules 504 or 505, remain subject to the ban on general solicitations.

Controversies

One of the controversies regarding the Rule 506 amendment was what an issuer would be required to do to verify that purchasers are accredited investors. The new rule provides that "the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors,"¹⁶ but the SEC declined to specify how an issuer should do so. Rather, the SEC asserted that the method of verification should be principles based. Nevertheless, in response to comments requesting clarification of the verification requirement, the SEC set forth factors an issuer might consider, as follows:

1. "the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
2. "the amount and type of information that the issuer has about the purchaser; and
3. "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."¹⁷

Another controversy regarding the Rule 506 amendment was whether the non-solicitation rule should be changed for private funds. This issue is related to the general reliance by private funds

on an exemption from the definition of an "investment company" triggering Investment Company Act of 1940 obligations for an issuer whose outstanding securities are beneficially owned by not more than 100 beneficial owners and which is not making and does not propose to make a public offering of its securities.¹⁸

The JOBS Act made no reference to private funds, and some commenters on the SEC's proposed amendments to Rule 506 objected to the application of the new rule to offerings by private funds. The SEC, however, determined to give private funds the benefit of the new Rule 506 liberalization of solicitations, because these funds are investment advisers subject to the anti-fraud provisions of the Investment Advisers Act of 1940. Among other things, these provisions restrict the use of testimonials and regulate how past performance statistics are advertised.

With regard to Rule 144A, the SEC eliminated references to "offer" and "offeree" in the rule, requiring only that securities sold in a Rule 144A transaction are sold to a purchaser that the seller and any person acting on behalf of the seller reasonably believes is a QIB. The SEC reiterated its view that offshore offerings conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings conducted in compliance with amended Rule 506.

The SEC's amendments to Rule 506 raised the issue for many commenters concerned about investor protection under the JOBS Act reforms of whether the definition of an "accredited investor" needs to be changed. Also, Dodd-Frank required the SEC to eliminate the value of a person's residence from his or her net worth for purposes of a determination of whether the person is an accredited investor,¹⁹ and to review the "accredited investor" definition beginning in 2014 and every four years thereafter and conduct whatever rulemaking might be appropriate.²⁰

As a predicate for this review, the GAO studied possible alternatives to the existing accredited investor definition and issued a report on its findings.²¹ The focus of the report was on individual accredited investors, currently defined as directors, executive officers, and general partners of the securities issuers, or persons who have a minimum annual income in excess of \$200,000 (\$300,000 with a spouse) or net worth in excess of \$1 million excluding the person's primary residence. This definition is supposed to serve as a proxy for financial experience, sophistication and adequate bargaining power.²² The GAO focused particularly on the attributes of financial resources and understanding risk and endeavored to obtain the views of market participants with a sample of 27, divided into: attorneys who have experience with private placements; accredited investors who invest in private placement; retail investors meeting the accredited investor definition who do not so invest; and broker-dealers and investment advisers who work with accredited investors.

There was general agreement that net worth was the most important criterion for qualifying as an accredited investor and this factor best balanced the goals of investor protection and capital formation.²³ Those interviewed were divided on whether the net worth standard should be increased. When the accredited investor definition was adopted in 1980, 1.87 percent of households qualified; in 2007, 9.04 percent of households qualified, but after removing the primary residence from the net worth calculation, 7.2 percent of households now qualify.

One suggestion made was that net worth should be based on liquid assets, but this might be difficult to ascertain. The GAO Report considered whether factors suggesting an investor's understanding of financial risk should be included in the definition, which might be based on: licenses or certification; an SEC investor education class and a test; self-certification; education; an opt-in provision; or the use by the investor of a registered investment adviser. Whether these criterion for understanding financial risk would be feasible was asked, but the answers were somewhat inconclusive. The SEC has requested comment on the accredited investor definition in its proposal to amend Form D.²⁴

Conclusion

The SEC's narrow implementation of the JOBS Act effort to liberalize offerings is unlikely to satisfy critics of the SEC's gun-jumping rules. The new rules are also unlikely to satisfy commenters who opposed the amendments, but these commenters were essentially opposed to the JOBS Act itself. It is likely that some of them will seize upon the GAO Report to try and make the accredited investor definition more stringent, but the SEC is unlikely to do so unless the amendments to Rule 506 lead to abuses.

Although some commenters bemoaned the possible effect on investor protection that would occur because of the liberalization of the SEC's gun-jumping rules, there has been little analysis of exactly what investor protections are being compromised. Professor Michael D. Guttentag has analyzed the potential harms as follows: there will be no affirmative disclosure obligations placed on the issuer; there will be no mandatory waiting period between the time of an offer and the time of a final sale; there will be no SEC review of any offering document; and there will be no ongoing disclosure obligations.²⁵ Since the general anti-fraud provisions will apply to the sale, I regard the absence of ongoing disclosure obligations as the most problematic of these harms, but the JOBS Act generally creates a huge gap in investor protection by allowing EGCs to avoid public disclosure as long as they remain EGCs.

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Endnotes:

1. See Carl M. Loeb Rhoades & Co., Exchange Act Release No. 34-5870, 1959 WL 59531 (Feb. 6, 1959).
2. Securities Act of 1933, §5, 15 U.S.C. §77e (2006).
3. JOBS Act, Pub. L. 112-106, 126 Stat. 306 (2012).
4. A "Qualified Institutional Buyer" as defined in Rule 144A, 17 CFR §230.144A, of the Securities Act of 1933 is an entity, acting for its own account or the accounts of other QIBs, that

in the aggregate owns and invests on a discretionary basis U.S. \$100 million or more in the securities of issuers that are unaffiliated with the entity.

5. See Securities Act, §2(a)(15), 15 U.S.C. §77b(a)(15).

6. JOBS Act, §105(d).

7. JOBS Act, §101(a).

8. JOBS Act, §105(a).

9. JOBS Act, §105(b).

10. Id.

11. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415 (July 10, 2013), 78 Fed. Reg. 44771 (July 24, 2013).

12. See Maria Lokshin, "Split SEC Clears JOBS Act Advertising Rule, Issues Proposal on Enhanced Requirements," 45 Sec. Reg. & L. Rept. (BNA) 1285 (July 15, 2013). Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directed the SEC to adopt a rule to make Rule 506 unavailable for offerings in which "felons or other bad actors" were involved, and the SEC believed it was necessary to implement this provision simultaneously with passing the Rule 506 and Rule 144A amendments regarding offerings.

13. Regulation S Rules, 17 C.F.R. §§230.901 through 230.905 adopted in 1990 for off shore offerings.

14. Eliminating the Prohibition Against General Solicitation, 78 Fed. Reg. at 44773.

15. Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Securities Act Release No. 9416 (July 10, 2013), 78 Fed. Reg. 44806 (July 24, 2013).

16. Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering, 17 C.F.R. §230.506(c)(2)(ii) (2012).

17. Eliminating the Prohibition Against General Solicitation, Securities Act Release No. 9415, at 20.

18. Section 2(a)(51), 15 U.S.C. 80a-1(a)(51).

19. The SEC eliminated a person's primary residence from the net worth calculation in Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81793 (Dec. 29, 2011).

20. Dodd-Frank Wall Street Reform and Consumer Protection Act §413, 15 U.S.C. 77b n. (2010).
21. U.S. Gov't Accountability Office, GAO-13-640, SEC Alternative Criteria for Qualifying As An Accredited Investor Should Be Considered (2013).
22. Id. at 8.
23. Id. at 12-13.
24. 78 Fed. Reg. at 44829.
25. Michael D. Guttentag, "Protection From What? Investor Protection and the JOBS Act," Legal Studies Paper No. 2013-28, 13 UC Davis Bus. L.J. 207, 244 (2013).