Access to Capital for Job Creators: Rule 506 of Regulation D After the JOBS Act, Part I

Mark T. Hiraide

Mark T. Hiraide a partner with Petillon Hiraide & Loomis LLP, Torrance, provided testimony on the JOBS Act to the U.S. Senate Securities Subcommittee. He specializes in defending directors and officers, broker-dealers, and investment advisers in cases relating to mergers and acquisitions, securities offerings, and investment management. He represents parties in SEC, NASD, DOJ, and DOC investigations and enforcement proceedings and advises boards of directors on corporate governance, fiduciary duties, internal investigations, SEC compliance, and private and public securities transactions. He previously served as an Attorney-Advisor in the SEC's Division of Corporation Finance in Washington, D.C. He is a co-author of Representing Start-Up Companies (Thomson West) and contributed to several publications of the Corporations Committee of the Business Law Section of the State Bar of California during his tenure on that committee. He is a graduate of the University of California, Berkeley, and the USC Gould School of Law.

INTRODUCTION

In the spring of 2012, in the aftermath of the financial crisis and calls to stimulate job creation, Congress enacted the Jumpstart Our Business Startups Act (JOBS Act) (Pub L 112–106, §201(a), 126 Stat 306, 313 (Apr 5, 2012)). The JOBS Act amends several provisions of the Securities Act of 1933 (Securities Act) (15 USC §§77a–77aa) and the Securities Exchange Act of 1934 (Exchange Act) (15 USC §§78a–78pp) to facilitate capital formation by businesses. Since 1933, when Congress first regulated the sales of securities, both public and private companies have been required to register their securities offerings with the Securities and Exchange Commission (SEC) whenever they intend to sell securities. Most private offerings of securities—offerings without any general solicitation of the public—are exempt from this registration requirement, which can be very costly and time-consuming.

The JOBS Act fundamentally changed this regulatory regime, eliminating the 80-year ban on general solicitation for certain private offerings. Subject to the rules adopted by the SEC on July 10, 2013 (effective Sept. 23, 2013), companies are allowed to advertise and sell their securities directly to the public without registration with the SEC.

But selling securities—taking other people's money—is still highly regulated. Permitting companies to sell their securities directly to the investing public potentially eliminates the middleman and reduces the cost of capital, but it also makes the offering much riskier for companies and their officers and directors. The JOBS Act did nothing to change the regulation of distribution of securities, nor did it change the civil remedies available to investors in securities offerings.

This article discusses new rules under Regulation D after the JOBS Act and reviews the exposure to officers and directors of companies that fail to comply with those rules.

THE JOBS ACT

Two New Exemptions

The JOBS Act makes available two new exemptions from registration for public securities offerings.

General Solicitation

Title II of the JOBS Act, titled "Access to Capital for Job Creators," directs the SEC to amend existing Rule 506 under Regulation D of the Securities Act (17 CFR §230.506) to eliminate the prohibition on general solicitation in offerings sold exclusively to "accredited investors," as defined by Rule 501 of Regulation D (17 CFR §230.501). These amendments are discussed below. Before the Rule 506 amendments under the JOBS Act, a company's sale of securities under Rule 506 was generally limited to investors with whom it had a preexisting relationship, with certain exceptions.

Crowdfunding

The second exemption is contained in Title III of the JOBS Act, which is titled "Crowdfunding." Title III amends §4 of the Securities Act to add an entirely new exemption from registration for public "crowdfunded" offerings of up to $1 million, which may be sold to an unlimited number of investors who are not accredited investors. Under the new crowdfunding exemption, codified in Securities Act §4(a)(6) (15 USC §77d(a)(6)), investors whose annual income or net worth is less than $100,000 are limited to investing the greater of $2000 or 5 percent of their annual income or net worth. Otherwise, investors may invest up to 10 percent of their annual income or net worth, up to a maximum individual investment of $100,000.

The issuer must conduct the crowdfunded offering through a registered broker-dealer or a "funding portal" that is registered with the SEC. The National Securities Markets Improvement Act of 1996 (NSMIA) (Pub L 104–290, 110 Stat 3416)) (see 15 USC §77r(b)(4)(D)) will preempt state regulation of securities sold in accordance with the new crowdfunding exemption.

Although the JOBS Act mandated that the SEC adopt rules to implement the Act's crowdfunding exemption before January 31, 2013, the SEC did not issue proposed rules until October 23, 2013. See http://www.sec.gov/rules/proposed/2013/33-9407.pdf. The proposed rules are anticipated to become final in mid-2014.

Other Changes

The JOBS Act makes other significant changes to the federal securities laws governing capital formation. Title I of the JOBS Act, titled "Reopening American Capital Markets to Emerging Growth Companies," contains a number of measures to encourage companies to undertake initial public offerings (IPOs). Among other things, it reduces disclosure requirements for IPOs of companies with gross revenues of less than $1 billion (so-called emerging growth companies); allows emerging growth companies to submit to the SEC a draft registration statement for confidential nonpublic review by the SEC; permits oral or written communications with qualified institutional buyers (QIBs) and institutional accredited investors (as defined in Rule 501 of Regulation D (17 CFR §230.501)) to "test the waters" and gauge their interest in a proposed IPO before or after the registration statement filing; and permits broker-dealers to publish research reports about an emerging growth company planning to conduct an IPO even if the broker-dealer will participate in the company's offering.

Title IV of the JOBS Act, titled "Small Company Capital Formation," increases the threshold for an offering exempt from registration under Regulation A under the Securities Act . . . from $5 million to $50 million.

In addition to the changes to Regulation D discussed in this article, Title II of the JOBS Act also directs the SEC to revise Rule 144A(d)(1) (17 CFR §230.144A(d)(1)) to provide that securities sold in accordance with Rule 144A may be offered to persons other than QIBs. The offering may include a general solicitation of potential investors, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Since its adoption in 1990, Rule 144A has been used by issuers to raise capital in the institutional market.

Title IV of the JOBS Act, titled "Small Company Capital Formation," increases the threshold for an offering exempt from registration under Regulation A under the Securities Act (17 CFR §§230.251–230.263) from $5 million to $50 million. Although securities offerings under Regulation A are exempt from SEC registration, the offering circular must be "qualified" by the SEC in a review process very similar to the review of registration statements in registered offerings. Once the SEC reviews and "qualifies" the Regulation A offering circular, the issuer may sell its securities in a public offering. Because a Regulation A offering is exempt from registration, it is not subject to the statutory liability provisions applicable to registered offerings.

The JOBS Act requires an issuer conducting a new Regulation A offering to file audited financial statements with the SEC annually. 15 USC §77c(b)(2)(F). State law regulation of securities sold in accordance with the new Regulation A will be preempted under NSMIA if the securities are sold on a national securities exchange or the securities are sold to a "qualified purchaser" as defined under the Securities Act. 15 USC §77r(b)(4)(D). The SEC has not yet promulgated regulations implementing these amendments to Regulation A.

Title V of the JOBS Act, titled "Private Company Flexibility and Growth," and Title VI, titled "Capital Expansion," increase the thresholds in §12(g) of the Exchange Act (15 USC §78*l*(g)). That section required issuers to register a class of equity securities with the SEC if, on the last day of the issuer's fiscal year, the class of securities is held by 500 or more record holders and the company has total assets of more than $10 million. Title V increases the shareholder threshold from 500 to a threshold of either 2000 persons or 500 persons who are not accredited investors, whichever occurs first. Securities sold in Title III crowdfunding offerings are not counted in the number of record holders, nor are securities held by persons who received the securities under an employee compensation plan in transactions exempt from registration. This latter change will alleviate a problem faced by companies that may be required to become SEC-reporting companies after issuing stock-based compensation to large numbers of their employees. The SEC has yet to adopt rules under Title IV.

TITLE II OF THE JOBS ACT: RULE 506(c) OF REGULATION D

Historical Ban on General Solicitation

Sales of securities not involving a public offering are exempt from SEC registration under §4(a)(2) (former §4(2)) of the Securities Act (15 USC §77d(a)(2)). Determining what is a "public offering" is not so easy, however. To assist issuers in making this determination, in the early 1980s, the SEC adopted Rule 506 of Regulation D (17 CFR §230.506), a safe harbor for determining whether an offering was exempt from registration under §4(a)(2). Before it was amended, Rule 502(c) of Regulation D prohibited the issuer or any person acting on its behalf to offer or sell securities by any form of general solicitation or general advertising, including but not limited to (1) any advertisement, article, or other published or broadcast communication; or (2) any seminar or meeting whose attendees have been invited by general solicitation or advertising.

Determining whether a communication constitutes a "general solicitation" has not been easy either. This determination is based on all the facts and circumstances surrounding the communication, and the SEC staff's interpretation of general solicitation has been very narrow. In the staff's view, an issuer may demonstrate compliance with the prohibition on general solicitation by showing that a substantive relationship between the issuer and prospective investor existed *before* the issuer's solicitation of the investor. Although the SEC staff has publicly stated that a prior relationship is not the only way to show the absence of a general solicitation, a preexisting relationship has been the only means identified by the staff to satisfy the rule. See Securities Act Release No. 33–6825 n12 (Mar 15, 1989). See also Securities Act Release No. 33–7856 n86 (Apr 28, 2000). Moreover, the issuer bears the burden of proving an exemption from registration exists. Consequently, not having a preexisting relationship with an investor can be risky for the start-up and its founders if they are sued for rescission, as discussed in Part II of this article. Unfortunately, because most start-ups and early-stage companies do not have sufficient preexisting relationships with institutions or accredited investors, accessing capital for early-stage companies has been challenging.

Before it was amended, Rule 502(c) of Regulation D prohibited the issuer or any person acting on its behalf to offer or sell securities by any form of general solicitation or general advertising

Use of Broker-Dealers

Historically, an issuer addressed this problem by engaging a broker-dealer to act as its placement agent. In a series of no-action letters, the SEC staff established the now well-settled position that an issuer may, in effect, use the preexisting substantive relationships that a broker-dealer placement agent has with its existing clients in offering securities. See *H. B. Shaine & Co., Inc.*, SEC No-Action Ltr (May 1, 1987) 1987 SEC No-Act Lexis 2004; *E.F. Hutton & Co., Inc.*, SEC No-Action Ltr (Dec. 3, 1985) 1985 SEC No-Act Lexis 2917; *Bateman Eichler, Hill Richards, Inc.*, SEC No-Action Ltr (Dec. 3, 1985) 1985 SEC No-Act Lexis 2918. This well-settled principle applies only to registered broker-dealers, not to any unregistered financial intermediary, except for several SEC-recognized matching services and networks that are either nonprofit entities or affiliated with universities. See, *e.g.*, *Angel Capital Electronics Network*, SEC No-Action Ltr (Oct. 25, 1996) 1996 SEC No-Act Lexis 812; *IPONET,* SEC No-Action Ltr (July 26, 1996) 1996 SEC No-Act Lexis 642; *Texas Capital Network, Inc.*, SEC No-Action Ltr (Feb. 23, 1994) 1994 SEC No-Act Lexis 253.

Although the SEC staff stated in 2000 (and repeated this past July in its Release No. 33–9415, adopting the Rule 506 amendments) that there may be facts and circumstances in which a third party other than a registered broker-dealer could establish a "pre-existing, substantive relationship" sufficient to avoid a general solicitation, it has not yet provided no-action relief in this area. See Securities Act Release No. 33–9415 n67 (July 10, 2013); Securities Act Release No. 33–7856 (Apr. 28, 2000); *Lamp Technologies, Inc.,* SEC No-Action Ltr (May 29, 1997) 1997 SEC No-Act Lexis 638.

[A] broker-dealer that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it. . . . [A] more thorough investigation is required of "securities issued by smaller companies of recent origin."

The SEC staff position permitting issuers to use the preexisting substantive relationships of registered broker-dealers is based in part on the fact that broker-dealers are regulated by the Financial Industry Regulatory Authority (FINRA) and are subject to strict rules when selling securities in unregistered private placements to customers. In the wake of several high-profile Ponzi schemes, it is unlikely that the SEC staff will extend its no-action position anytime soon to third parties who are not so regulated.

Limiting issuers to using registered broker-dealer intermediaries, however, places a high cost on the offering. In FINRA Regulatory Notice 10–22, Regulation D Offerings (Apr. 2010), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf, FINRA reminded its broker-dealer members that the SEC and federal courts have long held that a broker-dealer that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it. FINRA also noted that the SEC and courts recognize that a more thorough investigation is required of "securities issued by smaller companies of recent origin," which could include many Regulation D issuers. Moreover, if the broker-dealer prepares the issuer's disclosure document or private placement memorandum, the scope of its duty to investigate the issuer's representations is higher than if it simply recommends the securities to its customers.

FINRA Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and nonaccredited investors. FINRA Rule 5123, which went into effect on December 3, 2012, requires FINRA broker-dealers selling securities in a private placement to file the private placement memorandum, term sheet, and other offering documents with FINRA within 15 days of the date of the first sale of securities. The FINRA rules are available at http://www.finra.org/Industry/Regulation/FINRARules/.

Finally, FINRA has aggressively enforced rules relating to broker-dealers' sales of private placements. See, *e.g.,* FINRA News Release: *FINRA Sanctions Eight Firms and 10 Individuals for Selling Interests in Troubled Private Placements . . . Without Conducting a Reasonable Investigation* (Nov. 29, 2011), available at http://www.finra.org/Newsroom/NewsReleases/2011/P125193. Among FINRA's regulatory and examination priorities for 2013 is the private placement of securities, and FINRA made clear its intent to supervise the private placement market closely by monitoring filings made under new FINRA Rule 5123, issued January 11, 2013, available at: http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p197649.pdf.

As a result of these regulations and the associated costs of compliance, registered broker-dealers are often reluctant to act as placement agents in early-stage offerings. The SEC's analysis of all Form D filings submitted between 2009 to 2012 shows that approximately 11 percent of all new Regulation D offerings reported paying sales commissions. The average commission paid to these intermediaries was 5.9 percent of the offering size, with the median commission being approximately 5 percent, or $50,000 for an offering of $1 million—an amount that is insufficient to cover regulatory compliance costs for most broker-dealers. Indeed, many broker-dealers will not act as placement agents for offerings of less than $5 million. See Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 Bus L 959 (2005) (explaining that small businesses seeking less than $5 million are "almost never interesting to professional capital").

Amendments to Rule 506: General Solicitation

Title II of the JOBS Act, titled "Access to Capital for Job Creators," is intended to address these challenges to capital access by requiring that the SEC amend Regulation D to eliminate the ban on general solicitation and advertising in private offerings made under Rule 506 of Regulation D, provided that sales are made only to accredited investors. Title II reads in relevant part:

> Offers and sales [of securities] exempt under [Rule 506 of Regulation D] shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation . . . provided that all purchasers of the securities are accredited investors.

The JOBS Act thus strikes the 80-year-old restriction that limited promotion of unregistered securities offerings to private channels, provided "the issuer [of the securities] take[s] reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." JOBS Act §201(a)(1) (PL 112–106, Title II §201(a)(1), 126 Stat 313). To give effect to this provision, the SEC amended Rule 506 to add a new paragraph (c), under which the prohibition against general solicitation is eliminated, provided that all purchasers are accredited investors and the issuer takes reasonable steps to verify that the investors are accredited.

[M]any broker-dealers will not act as placement agents for offerings of less than $5 million.

The definition of the term "accredited investor" applicable to Rule 506 is set forth in Rule 501(a) of Regulation D (17 CFR §230.501(a)) and includes any person who comes within one of the definition's enumerated categories of persons, or who the issuer "reasonably believes" comes within any of the enumerated categories, at the time of the sale of the securities to that person. Rule 501(a) defines an accredited investor as a person (1) whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence (the net-worth test); or (2) who had an individual income in excess of $200,000 in each of the 2 most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year (the income test).

"Reasonable Steps" to Verify Accredited Investor Status: The SEC's List

To be eligible to use general solicitation under the JOBS Act and the new Rule 506(c), issuers are required to take "reasonable steps to verify" that purchasers are accredited investors. 17 CFR §230.506(c)(2)(ii). Whether the steps taken are "reasonable" will be an objective determination by the issuer (or those acting on its behalf), based on the particular facts and circumstances of the transaction. To assist issuers, the SEC included in Rule 506(c) a nonexclusive list of methods of verifying accredited-investor status for individuals. The nonexclusive list covers methods to verify income and net worth and provides for reliance on certain third parties who verify accredited status. The methods are:

- To verify income, reviewing copies of any Internal Revenue Service form that reports income, such as a Form W-2 (Wage and Tax Statement), Form 1099 (a report of various types of income), Schedule K-1 of Form 1065 (Partner's Share of Income, Deductions, Credits, etc.), and Form 1040 (U.S. Individual Income Tax Return), for the 2 most recent years, along with a written representation from the purchaser (and the purchaser's spouse, if relying on joint income) that he or she has a reasonable expectation of reaching the income level during the current year necessary to qualify as an accredited investor. 17 CFR §230.506(c)(2)(ii)(A).
- To verify net worth, reviewing one or more of the following documents, dated within the prior 3 months, and by obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed: For assets—bank statements, brokerage statements, and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; for liabilities—a credit report from at least one of the nationwide consumer reporting agencies. 17 CFR §230.506(c)(2)(ii)(B).
- Obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that the third party has taken reasonable steps to verify that the

purchaser is an accredited investor within the prior 3 months will also satisfy the verification requirement. 17 CFR §230.506(c)(2)(ii)(C).

- For any individual who invested in an issuer's Rule 506(b) offering as an accredited investor prior to September 23, 2013 (the effective date of Rule 506(c)) and remains an investor of the issuer for any Rule 506(c) offering conducted by the same issuer, obtaining a self-certification from the investor at the time of sale that he or she qualified as an accredited investor will satisfy the verification requirement. 17 CFR §230.506(c)(2)(ii)(D).

To be eligible to use general solicitation under the JOBS Act and the new Rule 506(c), issuers are required to take "reasonable steps to verify" that purchasers are accredited investors.

Principles-Based Methods of Verifying Accredited Status

In lieu of the methods described above, an issuer may choose an alternative "principles-based" method of verifying a potential investor's accredited status. See Securities Act Release No. 33–9415 (July 10, 2013) (Adopting Release). Under this method, issuers should consider:

- The nature of the purchaser and the type of accredited investor that the purchase claims to be (*e.g.*, individual or institutional investor);
- The amount and type of information that the issuer has about the purchaser; and
- The nature of the offering, such as the manner in which the purchaser was solicited and the terms of the offering, such as minimum investment amount.

Under the definition of "accredited investor" in Rule 501(a), the issuer must reasonably believe that the purchaser is accredited. If, for example, an entity is an accredited investor by virtue of its registration as a broker-dealer, a check on FINRA's BrokerCheck website (http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/) may be sufficient to establish the issuer's reasonable belief that the entity investor is registered.

Similarly, the more information that the issuer has about the purchaser, the fewer steps it may have to take to verify status. Reliance on certain publicly available information about the purchaser could be, in and of itself, sufficient to constitute reasonable steps to verify a purchaser's accredited status. The staff cites as examples of this type of information executive compensation information in proxy statements of SEC reporting companies and publicly disclosed financial information filed by IRC §501(c)(3) organizations.

Unfortunately, reliable public information about most prospective investors, such as information contained in proxy statements and tax returns—which are filed with the government under penalty of severe sanction for false statements—may not be available. More likely, unless the issuer is able to verify accredited status with information provided by the investor, it will rely on a third-party service provider to verify the purchaser's accredited investor status. As noted above, the staff states that third-party service providers could obtain appropriate documentation or otherwise take reasonable steps to verify accredited investor status and that such services may develop for web-based Rule 506 offering portals. See Adopting Release, pp. 38–40.

However, the issuer must have a reasonable basis for the confidence it places in a third party's reliability. Here, again, the SEC cites examples of verification based on very high standerds, *e.g.*, pay stubs for the 2 most recent years and the current year. Adopting Release, p. 32. Inevitably, aggregators of information about prospective investors will offer accredited investor lists to issuers. Reliance on such lists with nothing more than a purported certification from the aggregator that the persons identified on the list are accredited will not likely satisfy the SEC staff. See Adopting Release, pp. 33–34 ("We do not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.").

Although the SEC did not impose specific record-keeping requirements, it stated that "it will be important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor." Adopting Release, pp. 28–29. As mentioned above, the issuer has the burden of demonstrating that its offering is entitled to an exemption from the registration requirements of §5 of the Securities Act (15 USC §77e). As stated by the U.S. Supreme Court in *SEC v Ralson Purina Co.* (1953) 346 US 119, 126, given the broadly remedial purpose of the federal securities laws, imposing the burden of proof on an issuer asserting an exemption seems fair and reasonable. It will be important for issuers to retain adequate records of the steps taken to verify that a purchaser was an accredited investor.

Finally, under Rule 503 of Regulation D (17 CFR §230.503), an issuer must file a notice of sales on Form D not later than 15 calendar days after the first sale of securities in the offering, and the form will be modified to require issuers to check a box identifying whether the offering includes general solicitation activity. The SEC's modifications to Form D are discussed further below.

Offerings Under Existing Rule 506(b)

The JOBS Act preserves the existing Rule 506 exemption under Rule 506(b) (17 CFR §230.506(b)). Under existing Rule 506(b), an issuer may sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors," as defined in Rule 501(a) of Regulation D, and to not more than 35 nonaccredited investors who meet certain sophistication requirements. Each purchaser in a Rule 506(b) offering who is not an accredited investor must possess, or the issuer must reasonably believe immediately before the sale of securities that such purchaser possesses, either alone or through the investor's purchaser representative, "such knowledge and experience in financial and business matters that he [or she] is capable of evaluating the merits and risks of the prospective investment." Rule 506(b)(2)(ii) (17 CFR §506(b)(2)(ii)).

Under existing Rule 506(b), issuers and their counsel customarily obtain representations from investors that they are accredited and also (depending on the circumstances) supporting information, usually in the form of responses to an investor questionnaire. Absent information suggesting that the investor's self-certification is inaccurate, issuers and their counsel have relied on the investor's self-certification that he or she is an "accredited investor." See 2005 Report of The Corporations Committee of the Business Law Section of The State Bar of California, Legal Opinions in Business Transactions (Excluding the Remedies Opinion) (Oct. 2007 Printing, as Revised), at 80. See also No Registration Opinions, Subcommittee on Securities Law Opinions, Committee on Federal Regulation of Securities, ABA Section of Business Law, 63 Bus L 187 (2007). An issuer's reliance on proper investor self-certification presumably will continue to satisfy Rule 506(b).

DODD-FRANK AMENDMENTS TO THE DEFINITION OF "ACCREDITED INVESTOR"

Before the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) (Pub L 111–203, 124 Stat 1376) in 2010, an individual could include the value of his or her primary residence when calculating net worth. Although Dodd-Frank did not change the amount of the $1 million net-worth test, it did change how that amount is calculated, by excluding the value of a person's primary residence. See Net Worth Standard for Accredited Investors, Securities Act Release No. 33–9287 (Dec. 21, 2011).

Mortgage Debt

Special rules now apply to mortgage liability in the calculation of net worth. Debt secured by a primary residence is excluded from the calculation of net worth, provided that the estimated fair market value of the property exceeds the amount of indebtedness. See Rule 501(a)(5)(i)(A)–(B) (17 CFR §230.501(a)(5)(i)(A)–(B)); Rule 215(e)(1)(i)–(ii) (17 CFR §230.215(e)(1)(i)–(ii)). Any indebtedness secured by the primary residence in excess of the property's estimated fair market value is considered a liability for purposes of determining accredited investor status on the basis of net worth, whether or not indebtedness is subject to state law antideficiency statutes and whether the lender's right to seek repayment from other assets in default is otherwise limited. See Rule 501(a)(5)(i)(C) (17 CFR §230.501(a)(5)(i)(C)); Rule 215(e)(1)(iii) (17 CFR §230.215(e)(1)(iii)). A third-party appraisal is not required to establish the residence's fair market value; all that is required is an estimate of fair market value. See Securities Act Release No. 33–9287 (Dec. 21, 2011), n41 and related text.

Liabilities related to refinancings or other debt secured by the investor's primary residence, however, must be considered in the net-worth calculation if the debt was incurred within 60 days before the investment. This rule is designed to prevent individuals from inflating their net worth by borrowing against their primary residence. Thus, any increase in the amount of debt secured by a primary residence in the 60 days before the time of sale of securities will be included as a liability for purposes of calculating an individual's net worth. This 60-day rule applies even if the estimated value of the primary residence exceeds the aggregate amount of debt secured by the primary residence. The 60-day rule does not apply to increases in debt as a result of the purchase of a new primary residence. See Rule 501(a)(5)(i)(B) (17 CFR §230.501(a)(5)(i)(B)); Rule 215(e)(1)(ii) (17 CFR §230.215(e)(1)(ii)).

Transition Rule for Certain Follow-On Investments

To protect an investor's follow-on right associated with an investment made prior to the enactment of Dodd-Frank, and to alleviate the burden on issuers because existing investors may be ineligible to make follow-on investments, there are special transition rules for certain follow-on investments. The former accredited investor net-worth test will apply to purchases of securities in accordance with a right to purchase such securities (*e.g.*, preemptive rights arising under state law; rights arising under an entity's constituents documents; and contractual rights, such as rights to acquire securities on exercise of an option or warrant or on conversion of a convertible instrument, rights of first offer or first refusal, and contractual preemptive rights), as long as (1) the right was held by a person on July 20, 2010; (2) the person qualified as an accredited investor on the basis of net worth at the time the right was acquired; and (3) the person held securities of the same issuer, other than the right, on July 20, 2010. Rule 501(a)(5)(ii) (17 CFR §230.501(a)(5)(ii)); Rule 215(e)(2) (17 CFR §230.215(e)(2)).

For example, if an investor who qualified as accredited based on net worth at the time of his or her original investment owned an issuer's Series A preferred stock on July 20, 2010, and on that date had a right of first offer to purchase any equity securities offered by the issuer in a future sale, and the issuer proposed to sell Series B preferred stock at a future date, then the investor's net worth will be calculated as it was before enactment of the Dodd-Frank Act for purposes of the investor's exercise of his or her right of first offer.

THE SEC'S PROPOSED RULES FOR FORM D

In addition to promulgating the final rules amending Rule 506(c), the SEC has issued for public comment proposed rules relating to changes to Form D. Securities Act Release No. 33–9416 (July 10, 2013). The proposed amendments to Regulation D would require (1) the filing of a Form D in Rule 506(c) offerings 15 days before the issuer engages in general solicitation; (2) the filing of an amendment to the Form D to add certain additional information within 15 days after the first sale of securities (as is currently required by Rule 503); (3) the filing of a closing amendment to Form D after the termination of any Rule 506 offering; (4) written general solicitations materials used in Rule 506(c) offerings to include certain legends and other disclosures; and (5) the submission, on a temporary basis, of written general solicitation materials used in Rule 506(c) offerings to the SEC not later than the date of first use of these materials.

The rule proposal also includes penalty provisions disqualifying an issuer from relying on Rule 506 for 1 year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply within the last 5 years with Form D filing requirements in a Rule 506 offering. The proposal does not, however, make the Form D filing a condition of Rule 506, so a failure to file will not result in loss of the exemption for the offering. As proposed, the disqualification rule would not affect offerings of an issuer or an affiliate that are ongoing at the time of the noncompliance, including the offering for which the issuer failed to make a required filing. The disqualification would apply only to future offerings. The proposal also includes a period of 30 days in which a filing violation could be cured.

The Form D rule proposals have been roundly criticized. See Comments on Proposed Rule: Amendments to Regulation D, Form D and Rule 156 under the Securities Act, available at: http://www.sec.gov/comments/s7–06–13/s70613.shtml. Many believe the penalty provisions to be too harsh, particularly in view of potential difficulties in determining the point in time at which an offering of securities begins for purposes of satisfying the proposed 15-day pre-filing requirement.

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The second and final installment of this article will appear in the next issue of the California Business Law Practitioner. It will address the new SEC rule disqualifying certain "bad actors" from relying on a Rule 506 exemption, civil liabilities for noncompliance with Rule 506(c), and secondary liability for individuals under the California securities laws.