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JOBS Act ClientAlert

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# JOBS Act Rules – Limited Grandfathering for Current Investors; Certain Other Form D Developments

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Issuers taking advantage of the general solicitation allowance provided by Rule 506(c) must take "reasonable steps" to verify the accredited investor status of investors in the offering. We anticipate that when the rule changes become effective on September 23, 2013, most issuers making use of Rule 506(c) will rely, in whole or in part, on one of the new "non-exclusive" safe harbors provided by the SEC. One of the non-exclusive safe harbors provided by the SEC is a limited "grandfathering" rule.[1]

## Grandfathering Provision

The SEC saw a need for a "grandfathering" provision in part because the purpose of the verification mandate in Section 201(a) of the JOBS Act was to require the verification of the accredited investor status of prospective purchasers who come to the issuer "as a result of" an issuer's general solicitation activities, and not necessarily of investors who purchased securities without solicitation. This may be a limited distinction, though, given how expansively the term "general solicitation" has been interpreted.

Under the "grandfathering" provision, an issuer (i.e., a private fund or private company raising capital) is deemed to have taken "reasonable steps" to verify whether a natural person who purchases securities under a new Rule 506(c) offering is accredited, if : (a) that person purchased securities in that issuer's Rule 506(b) offering as an accredited investor before September 23, 2013, (b) the person continues to hold the pre-September 23 securities, and (c) the issuer, at the time of sale, obtains a certification from the investor that he or she still continues to qualify as an accredited investor.

While the "grandfathering" safe harbor will make add-on investments from pre-September 23, 2013 investors (Pre-Rule-Change-Investors) simpler, the usefulness of the "grandfathering" provision will, unfortunately, fade with time.

- The "grandfathering" allowance does not cover situations where an existing investor is investing in a new fund established by the same General Partner/Investment Manager/team of people, because the new fund is not the same "issuer."
- The allowance does not, on its face, cover investors who did not "purchase" securities in a prior Rule 506(b) offering: for example, consider an investor that received shares as a gift. Also, investors who purchased shares in a non-506(b) offering (i.e., who purchased in a straight Section 4(a)(2) offering under the Securities Act of 1933) are also not included in the "grandfathering" provision.
- Arguably, for issuers where interests are represented by actual units, the "grandfathering" allowance does not technically cover investors who redeem their pre-September 23, 2013 units and only hold later-acquired units. For example, if an investor purchases a share of stock from an issuer on September 1, 2013 and a second share of stock on October 1, 2013, and then subsequently sells the share purchased September 1 (but retains the October 1 share), the investor would no longer be able to use the "grandfathering" allowance. This wooden-though-accurate interpretation of the "continues to hold" requirement is a trap for the unwary,

and puts a premium on consulting with one's advisers before engaging in a sale and repurchase arrangement.

### Pepper Points

*For an investor that is not a Pre-Rule-Change-Investor, a certification by itself does not allow an issuer to rely on the grandfathering safe-harbor. Nevertheless, obtaining that certification is an important part in demonstrating that the issuer took "reasonable steps to verify that purchasers of securities sold" were accredited investors: a questionnaire and certification signed by the investor is still likely to form a key part of the "reasonable steps" process for most Rule 506(c) issuers. This is particularly true in light of the fact that other new safe-harbors also have important limitations. For example, the safe harbor that requires a review of "any Internal Revenue Service form that reports the purchaser's income for the two most recent years" could potentially be read to require IRS forms for the "two most recent" calendar years – even at times of the year in which IRS forms for the "two most recent" years may not yet be available to many prospective investors.*

*While the requirement of Rule 506(c) to take "reasonable steps" to verify accredited investor status does not formally apply to private offerings not employing Rule 506(c), we expect that the SEC may potentially take a dim view of parties making a traditional no-general-solicitation offering, if "reasonable steps" were not taken to verify accredited investor status. A non-506(c) Regulation D offering can be made to a limited number of non-accredited investors; however, few private funds or companies do so in light of the greatly expanded disclosure requirements once non-accredited investors are involved. The requirement for registered advisers to private funds that pay performance fees or allocations to only accept so-called "qualified clients" as investors limits the ability of funds to accept non-accredited investors.*

## Form D Developments

Other important Form D changes are currently in the works. In connection with a Rule 506 offering, issuers currently file an initial Form D within 15 days of the first sale of securities. As things stand at this writing, when the ability to make a Rule 506(c) offering goes effective on September 23, an issuer engaging in general solicitation or advertising in reliance on the new rule will file a Form D with the SEC within 15 days of the first sale. That form must have the appropriate box checked, indicating that the issuer is making the offering in reliance on Rule 506(c). An issuer relying on the long-standing, no-general-solicitation provisions, will do the same *but check the Rule 506**(b)*** box, instead. Both boxes may not be checked – a choice must be made.

### Pepper Points

*Under current guidance, the issuer could start selling without making a general solicitation after September 23, but employing the safe harbors of Rule 506(c). Depending on how sales are progressing, on the 15th day after the first sale, the issuer could then decide whether to make the SEC filing using Rule 506(b) (no-general-solicitation but with potentially lower accredited investor verification standards and the potential to admit limited numbers of non-accredited investors in offerings other than for funds with performance fees, allocations or carry) or Rule 506(c) (only accredited investors and higher accredited investor verification standards).*

*Perhaps in part due to the timing glitch identified above, the SEC has proposed[2] changes to the Form D filing requirements. As proposed, a Rule 506(c) election would have to be made 15 days before the first general solicitation.*

*Other proposed changes still subject to public comment include a requirement that issuers file a closing amendment to Form D after the termination of any Rule 506 offering; that written general solicitation materials used in Rule 506(c) offerings include certain legends and specific disclosures; that written general solicitation materials used in Rule 506(c) offerings be submitted the SEC (at least on a temporary basis);[3] and that issuers be disqualified from relying on Rule 506 for one year if the issuer (**or any predecessor or affiliate**) did not comply, within a five-year period,[4] with Form D filing requirements in any Rule 506 offering.*

If you have any questions, please contact the authors or any member of the Pepper Hamilton Investment Funds Group.

## Endnotes

1 The SEC noted in its rule release that Pepper's comment letter suggested a "grandfathering" provision. See footnotes 97 and 100 of the SEC rule release.

2 See SEC Release 33-9416, comments due September 23, 2013, available at http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

3 As proposed, issuers would submit any written general solicitation materials used in their Rule 506(c) offerings to the SEC no later than the date of the first use of these materials. Submission would be via the SEC's Web site and materials submitted would be not available to the public.

4 The applicable definition of an "affiliate" would include an entity that directly or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with the issuer.

In part as a stick to force issuers to timely submit filings of Form D, the proposed amendments to Rule 507 would disqualify an issuer from using Rule 506 for future offerings if the issuer, or its predecessors or affiliates, had conducted an offering under Rule 506 in which, within the last five years, it or they did not comply with the Form D filing requirements of Rule 503 in Rule 506 offerings. Disqualification would extend for a period of one year after the filing of all required Forms D and Form D amendments have been made. Fortunately, in the proposal, failures that occurred before the effective date of any final rule on the subject are to "be disregarded."

### More Resources on the JOBS Act

For additional information, please visit Pepper's JOBS Act Resource Center available online at www.pepperlaw.com/news.aspx?AnnouncementKey=1957.