ADVERTISING FOR INVESTOR DOLLARS

RULE 506 CHANGES COMING AT LAST ... BUT STAYING WITHIN LEGAL BOUNDARIES STILL REQUIRES STEPPING CAREFULLY

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In its July 10, 2013, meeting, the U.S. Securities and Exchange Commission (SEC) adopted the new Regulation D, Rule 506(c), authorized by the JOBS Act (Title II). Under the new rule, persons (also named issuers, sponsors, syndicators or promoters) selling "securities" to private investors to fund their companies or real estate transactions will be able to advertise their private investment opportunities (securities offerings) under certain conditions.

WHAT THIS MEANS FOR YOU:

It will soon be legal to advertise for private investors to fund your real estate deals, provided you follow the new rules!

Rule 506(c) goes into effect Sept. 23, 2013, 60 days after its publication in the Federal Register on July 24, 2013. Until then, you still can't advertise for investors for your real estate transactions and then you will have to follow the new Rule 506(c) if you wish to advertise when Rule 506(c) takes effect.

WHAT'S A SECURITY?

If you are using other people's money for your real estate transactions, you are probably selling securities.

Securities include promissory notes or "investment contracts" between a manager or general partner and passive investors. Under the Securities Act of 1933, sales of securities must be registered (pre-approved as in a public offering) unless exempt. There are numerous exemptions (both federal and state) from registration.

By far, the most common exemption has been the Rule 506 private offering exemption. The SEC recently reported that as much as $898 billion may have been raised in Rule 506 offerings in 2012. Additionally, from 2009 to 2012, the average offering size was around $30 million, although the median offering size was only about $1.5 million.

Consistent with the SEC's findings, between 2006 and 2012, Trowbridge & Taylor attorneys wrote more than 100 private placement offerings (most of them under Rule 506) allowing investors to raise more than $272 million (most for acquisition of real estate.) The average offering size was $1 million to $3 million with many of these investors as first-time issuers.

THE OLD RULE 506(b)

In general, under the original Rule 506 (previously known as Rule 506, but which will hereafter be known as Rule 506(b), and is still in effect), an issuer of securities has a "safe harbor" exemption from registration, meaning it doesn't have to obtain SEC pre-approval of the offering or need a license to sell its own securities, as long as it follows the rules for the exemption.

Rule 506(b) allows an issuer of its own securities to raise an unlimited amount of money from an unlimited number of Accredited Investors and up to 35 Sophisticated Investors.

However, the issuer cannot make any offers or sales of the securities by any means of general advertising or solicitation. To prove they didn't solicit investors, issuers must be able to demonstrate a pre-existing relationship with an investor that pre-dates any offer to sell securities. For issuers relying on Rule 506(b), the investors may self-certify that they are Accredited or Sophisticated by checking a box on a pre-qualification form provided by the issuer.

A Sophisticated Investor is one who, alone or with his purchaser representative, has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.

An Accredited Investor is an individual (or couple) with a net worth of $1 million, excluding their primary residence, or an individual whose annual income exceeds $200,000 for the two most recent years (or $300,000 if married) and a reasonable expectation of the same for the current year.

THE PROBLEM WITH RULE 506(b)

Large funds ($10 million to $30 million) use registered investment advisers or the securities broker-dealer community to raise funds for their private offerings, based on their pre-existing relationships with investors.

This channel is not available for smaller funds, as investment advisers and broker-dealers typically won't market securities offerings of less than $10 million. Now the small issuer must develop relationships with prospective investors and sell securities on their own.

For these issuers, the pre-existing relationship and non-solicitation provisions or Rule 506(b) have been a source of great confusion, misinterpretation and a significant impediment to their ability to fund their real estate transactions or businesses.

THE NEW RULE 506(c) SOLUTION

The new rule offers promotion opportunities for small issuers who want to raise $1 million to $10 million or more.

After the effective date of the new Rule 506(c), issuers will be able to advertise to anyone as long as they only accept Accredited Investors in their offerings and comply with the rest of the Rule 506(c) provisions.

However, now the SEC has shifted the burden to the issuer to demonstrate "reasonable steps" were taken to ensure that all investors are Accredited. The SEC has offered some non-exclusive methods to verify Accredited status for natural persons, which include such things as:

Verifying income from past two years tax returns and written assertions that the income is expected to continue; Verification of assets by reviewing statement balances from brokerage houses or banks, reviewing tax assessments/ third-party appraisals of real estate holdings and verification of liabilities through an investor's credit report; or

Obtaining a written confirmation from a securities broker-dealer, registered investment adviser, licensed attorney or CPA, who asserts they have taken reasonable steps to verify the investor's Accredited status within the past three months and that the person is, in fact, Accredited; and There is an exemption for investors who previously invested with an issuer as an Accredited investor.

NEW "BAD BOY" PROHIBITIONS FOR RULE 506 OFFERINGS - New Rule 506(d)

Additionally, on July 10, 2013, the SEC adopted amendments to existing Rules 501 and 506 to implement Section 926 of the Dodd Frank Act, also effective Sept. 23, 2013, which will be codified as Rule 506(d).

These amendments will disqualify certain convicted felons and other "Bad Actors" from serving as an officer, manager or principal, or owning 20 percent or more of the voting interests in a Rule 506 Offering. Sometimes called

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"Bad Boy" provisions, per the SEC, this prohibition (which is similarly provided in other types of securities offerings), will now prevent persons "who have been convicted of, or are subject to certain court or administrative sanctions for, securities fraud or other violations of specified laws" (i.e., a cease and desist order, injunction, disciplinary order, etc.), issued by certain federal financial regulatory agencies or the postal service, from claiming a Rule 506 exemption. For such events occurring prior to the effective date, mandatory disclosure is required.

PROPOSED AMENDMENTS TO REGULATION D

The SEC has proposed some additional amendments to Regulation D that would apply to all Rule 506 offerings, including additional Form D filing requirements (pre-sale, first sale and closing notices of securities), filing of additional information about the issuer and marketing methods to be used, additional legends and disclosures and temporary submission of written ads to the SEC prior to use. The amendments are currently out for public comment through Sept. 23, 2013.

CLEARING UP CROWDFUNDING CONFUSION

However, none of this is to be confused with "crowdfunding," which is completely unrelated to the SEC's July 10 announcement.

Crowdfunding was a completely different funding scenario authorized in a separate part of the JOBS Act (Title III). The premise is that investors will be able to invest as little as $1,000 (with an expectation of profit) for offerings advertised through SEC-authorized funding portals.

Despite what you see and hear on the Internet and news, the SEC has NOT approved crowdfunding. Further, to date, no regulations for crowdfunding have yet been proposed by the SEC. The SEC even has a disclaimer on its website stating that crowdfunding offerings are currently unlawful.

To further confuse matters, the media and certain promoters have hijacked the term "crowdfunding" to describe a method of soliciting "donations" for advertised projects where the investor has no expectation of a financial return on investment. In this context, which apparently is not illegal, the investor might receive some non-monetary token for his investment, for example, a writer's advance book or widget generated with investor's funds, etc., but cannot be offered a financial return on investment as an inducement to invest. So, if you are perplexed, you are not alone, as the media and many others share your confusion.

CONCLUSION

For now, here's what you need to know:

There is a new Rule 506(c) that will allow you to advertise securities offerings to anyone, when the new rule takes effect on Sept. 23, 2013, providing you take "reasonable steps" to sell the securities only to Accredited Investors. Until then, it is not legal for you to advertise; and before you do, you will have to work with qualified securities counsel to ensure you understand and comply with the requirements under the new Rule 506(c) exemption.

Most of our clients tell us the bulk of their Rule 506 investors are Sophisticated, and that many of them are investing via their self-directed IRAs. The original Rule 506(b) – which prohibits advertising, requires demonstration of a pre-existing relationship before making offers and allows investors to self-certify their financial qualifications – will still be the rule of choice for issuers who want to include Sophisticated Investors in their offerings. So for many issuers, it will be business as usual.

Despite what you may have heard, advertising of crowdfunding deals that offer a return on investment is currently illegal, and no legal matching services for crowdfunding deals currently exist, so stand by for when, if ever, the JOBS Act crowdfunding rules get proposed and adopted by the SEC.

While the changes authorized in the JOBS Act are exciting, we must wait for them to be implemented, so proceed with caution and don't believe everything you hear in other media sources, as they often get it wrong.

To review the entire text of the new Rule 506(c) and Bad Actor provisions of Rule 506(d), or to review or submit a comment on the proposed Regulation D amendments to Regulation D, go to: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782#.Uff9zVMZ-kC.