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SEC Eliminates Prohibition Against General Solicitation in Rule 506 Offerings and Adopts Rule Disqualifying Bad Actors from Rule 506 Offerings

On July 10, 2013, the Securities and Exchange Commission (SEC) adopted an amendment eliminating the prohibition against general solicitation and general advertising in Rule 506 offerings. This rule amendment implements one of the provisions of the Jumpstart Our Business Startups Act (the JOBS Act) intended to make it easier for companies to access capital through private offerings of securities. Under the rule amendment, a company may conduct general solicitation and general advertising in an offering under Rule 506 as long as all sales are made to accredited investors and the company takes reasonable steps to verify accredited investor status. The SEC also adopted an amendment disqualifying an issuer from the exemption in Rule 506 if the issuer or certain related parties is a felon or other "bad actor."

Although the SEC's original rule proposal for the elimination of the prohibition against general solicitation generated a good deal of criticism and comment, the SEC ultimately adopted the amendment to Rule 506 largely as proposed. The SEC did state that the adoption of the "bad actor" disqualification provision would address some of the concerns of the rule's critics. The SEC also proposed additional changes to Rule 506 to address other criticisms. These proposed changes are also summarized in this alert.

Rule 506

Rule 506 of Regulation D is a non-exclusive safe-harbor to comply with the exemption in Section 4(a)(2) of the Securities Act of 1933 (the Securities Act) for "transactions by an issuer not involving any public offering."[1] Rule 506 does not limit the amount of securities that may be sold in reliance on the exemption and permits sales to an unlimited number of accredited investors and up to 35 investors who are not accredited. If any sales are made to non-accredited investors, each such non-accredited investor must meet certain "sophistication requirements" and the issuer must provide the non-accredited investors with fairly extensive disclosure. The Rule 506 exemption is conditioned on the issuer complying with the applicable provisions of Rule 502, which includes taking reasonable care to limit resales of the securities by investors and complying with

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the prohibition against general solicitation and general advertising (referred to herein as "general solicitation"). The prohibition against general solicitation provides that neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of general solicitation or general advertising.

General Solicitation

Regulation D does not define general solicitation. Rule 502(c) includes a number of nonexclusive examples of general solicitation such as advertisements or articles in a newspaper or magazine, television or radio broadcasts, and seminars or meetings whose attendees have been invited by any general solicitation. In practice, SEC staff guidance through no-action letters has defined the scope of permitted solicitation much more narrowly. The SEC staff has focused on whether the issuer has a pre-existing, substantive relationship with each potential investor. A relationship is considered pre-existing if it was established before the solicitation for the offering in question. A relationship is considered substantive if it would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons solicited.

The SEC's interpretation of the prohibition on general solicitation can create significant barriers to capital raising for early stage companies. A founder may quickly exhaust the available resources of friends, family and business acquaintances, and often will not have pre-existing relationships with a broader group of potential investors. The company may engage a registered broker to serve as placement agent and obtain access to the broker's list of accredited investors, but that will increase the costs of the offering.[2] Presumably, the company also may leverage the pre-existing relationships of its lawyers, accountants, bankers and other service professionals, although the SEC has only addressed the use of investor lists of registered brokers.[3]

The prohibition on general solicitation can also cause issues because it is based on making "offers" to potential investors, and under the Securities Act an "offer" is generally defined broadly to include any communication that could generate interest in the company. For example, an article in the local paper regarding a company planning a private placement can risk a general solicitation, especially if there is any reference to the company's capital raising activities. Similarly, any mention of capital raising on a company's website could be construed as a general solicitation.

In the face of these practical issues with the prohibition on general solicitation, a

number of commentators had advocated the elimination or reform of the prohibition on general solicitation.[4] Congress took up the issue in Section 201(a)(1) of the JOBS Act by directing the SEC to amend Rule 506 to eliminate the prohibition on general solicitation for sales to accredited investors.

Elimination of the Prohibition Against General Solicitation

To implement Section 201(a)(1) of the JOBS Act, the SEC amended Rule 506 by adding new Rule 506(c). Rule 506(c) permits the use of general solicitation to offer and sell securities under Rule 506 as long as:

- the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;
- all purchaser of the securities are accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors at the time of the sale of the securities or the issuer reasonably believes that they so qualify; and
- all other applicable terms of Regulation D are satisfied (particularly the restrictions on resale).

There are no limits on the form or content of permitted general solicitation under Rule 506(c), although any communications relating to an offering of securities are subject to applicable anti-fraud rules, including Rule 10b-5.

The exemption in Rule 506(c) allowing the use of general solicitation adds to rather than replaces the existing terms of Rule 506, so that an issuer retains the option of conducting an offering without general solicitation under Rule 506(b) which would allow sales to nonaccredited investors (subject to the additional requirements of the rule applicable for sales to non-accredited investors).

Reasonable Steps to Verify Accredited Investor Status

Section 201(c)(1) of the JOBS Act directs the SEC to require issuers to take reasonable steps to verify accredited investors status in an offering under Rule 506 that uses general solicitation. Rather than specifying any specific mandatory

verification steps, the final amendment to Rule 506 simply states that the issuer must take reasonable steps to verify the accredited investor status of any purchasers in the offering. Whether the steps taken are "reasonable" would be an objective determination, based on the facts and circumstances of each transaction. This provision reflects a determination by the SEC to provide flexibility for an issuer to tailor the verification procedures to the individual circumstances of the offering. The verification requirement is separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers actually happen to be accredited investors.

The SEC's release adopting the final amendment to Rule 506 does provide guidance on the relevant factors when determining the reasonableness of the verification steps taken by an issuer. In addition, Rule 506(c) contains a non-exclusive, non-mandatory list of four methods of verification of natural persons that are deemed to be reasonable.

Nature of the Purchaser. The accredited investor definition in Rule 501(a) of Regulation D consists of eight enumerated categories of persons and entities. Reasonable steps to verify accredited investor status will often depend on the category of accredited investor that the purchaser is expected to satisfy, particularly since investors generally qualify as accredited investors based on some combination of their status and financial condition.

- For investors who qualify based solely on their status, such as a registered broker-dealer or a registered investment company, it should be sufficient for an issuer to confirm their status. For example, FINRA's BrokerCheck website allows the public to search the name of a broker-dealer to confirm that it is registered.
- For investors who qualify based both on status and financial condition, such as a 501(c)(3) organization, corporation, business trust or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5 million, the issuer will need to take reasonable steps to verify both status and financial condition.
- For natural persons who are accredited investors based on either net worth or annual income, the SEC recognized the greater practical difficulties in verifying financial information, which can be exacerbated by privacy concerns. Verifying net worth can be particularly difficult, especially since it may be easier to show a certain level of assets than to show the absence of liabilities. As discussed

below, the final rule adopts certain safe harbor verification methods for natural persons to address these concerns.

Information About the Purchaser. The amount and type of information that an issuer already has about a purchaser would be a significant factor on the scope of the steps the issuer must take to verify accredited investors status. The SEC notes in the adopting release that if an issuer has actual knowledge that a purchaser is an accredited investor, then the issuer would not have to take any verification steps at all. This might apply as to a purchaser that is a relative or close friend of a founder where the founder has actual knowledge as to the purchaser's income or net worth.

Other examples in the adopting release of the types of information that an issuer may rely upon include the following:

- Publicly available information with regulatory authorities, such as whether an individual investor is a named executive officer of a public company whose compensation is disclosed in SEC filings or a Section 501(c)(3) organization whose returns filed with the IRS disclose total assets in excess of $5 million.
- Third party information which provides reasonably reliable intelligence relevant to accredited investor status, such as copies of pay stubs for an individual investor.
- Verification of a person's status as an accredited investor by a third party such as a broker-dealer, accountant or attorney, provided that the issuer has a reasonable basis to rely on such third party verification. In this regard, the SEC suggested that services may develop to verify a person's accredited investor status.

Nature and Terms of the Offering. An issuer who solicits investors through a widespread public solicitation will likely need to take greater measures to verify accredited investor status than an issuer that limits solicitation to a list of pre-screened accredited investors. A single offering may include both investors obtained through a general solicitation and investors with a pre-existing relationship with the issuer, and the SEC's flexible approach to verification should allow an issuer to tailor its verification steps accordingly.

The terms of the offering also may affect the reasonableness of an issuer's verification methods. For example, where an offering has a high minimum

investment amount, an issuer may be able to justify less extensive verification procedures because it might be highly likely that only accredited investors could reasonably be expected the satisfy the minimum. For example, a minimum investment amount of $1 million might make it reasonable to assume that all investors are accredited even though it might be possible that an investor might not have net worth of at least $1 million due to debt.

The SEC does not believe it will be sufficient to rely only on an investor checking a box in a questionnaire or signing a form, absent other information about the purchaser indicating accredited investor status.

Regardless of the verification steps taken, it will be essential for an issuer to retain adequate records. As to each purchaser in the offering, the issuer should evaluate the verification steps taken and the rationale for considering the steps to be reasonable. An issuer claiming an exemption from the registration requirements of the Securities Act bears the burden of showing it is entitled to the exemption.

Safe Harbor Verification Methods for Natural Persons. Rule 506(c) does provide a nonexclusive safe harbor that any the following four methods of verification for natural persons will be deemed to be reasonable (assuming the issuer or its agent does not have knowledge that the person is in fact not an accredited investor):

- For accredited investor status based on income, reviewing any IRS form that reports the purchaser's income for the two most recent years (including Form W-2, Form 1099, Schedule K-1 and Form 1040) and obtaining a written certification from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify during the current year. The IRS forms may be redacted to show only information relevant to the investor's income.

- For accredited investor status based on net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed: (1) for assets, bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports by independent third parties; and (2) for liabilities, a consumer report from at least one of the nationwide consumer reporting agencies.

- Obtaining written confirmation from one of the following persons or entities

that such person or entity has taken reasonable steps to verify that the person is an accredited investor within the past three months and has determined that such person is an accredited investor: (1) a registered broker-dealer, (2) a SEC-registered investment adviser, (3) a licensed attorney, or (4) a certified public accountant.

- With respect to any person who purchased the issuer's securities in a Rule 506(b) offering prior to the effective date of new Rule 506(c) as an accredited investor and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification from such person at the time of sale that he or she qualifies as an accredited investor.

Privately Offered Funds

Privately offered funds such as hedge funds, venture capital funds and private equity funds typically rely on Section 4(a)(2) and Rule 506 to offer and sell their interests to investors without registration under the Securities Act. Privately offered funds also rely on the exclusions in Section 3(c)(1) and/or Section 3(c)(7) of the Investment Company Act of 1940 to avoid the need to register as an investment company, and both of those exclusions include a requirement that the fund not make a public offering of its securities. In the adopting release, the SEC stated its view that a fund may offer its securities using general solicitation as permitted under Rule 506(c) without losing the ability to qualify for the exemption in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940.

Bad Actor Disqualification Provision

The SEC also adopted Rule 506(d) disqualifying an issuer from relying on the Rule 506 exemption if the issuer or certain related persons are felons or other bad actors. This rule implements Section 926 of the Dodd-Frank Act.

In addition to the issuer, persons covered by the bad actor disqualification provision include the following:

- any predecessor of the issuer;
- any affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;

- any beneficial owner of 20% or more of the issuer's outstanding voting equity securities;
- any promoter connected with the issuer at the time of the sale;
- any investment manager of an issuer that is a pooled investment fund;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in the offering;
- any general partner or managing member of any such investment manager or solicitor; or
- any director, executive officer or other officer participating in the offering of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor.

Under the final rule, a "disqualifying event" includes any of the following:

- **Criminal convictions** in connection with the purchase or sale of a security, making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within 10 years of the proposed sale of securities (or five years in the case of the issuer and its predecessors and affiliated issuers).
- **Court injunctions and restraining orders** in connection with the purchase or sale of a security, making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The injunction or restraining order must have occurred within five years of the proposed sale of securities.
- **Final orders** from the Commodity Futures Trading Commission, federal banking agencies, the National Credit Unit Administration, or state regulators of securities, insurance, banking, savings associations or credit unions that:
  - Bar the person from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or;
  - Are based on fraudulent, manipulative, or deceptive conduct and are issued within ten years of the proposed sale of securities.

- **Certain SEC disciplinary orders** relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons.
- **SEC cease-and-desist orders** related to violations of certain anti-fraud provisions and registration requirements of the federal securities laws.
- **SEC stop orders** and orders suspending the Regulation A exemption issued within five years of the proposed sale of securities.
- **Suspension or expulsion** from membership in a self-regulatory organization (SRO) or from association with an SRO member.
- **U.S. Postal Service false representation orders** issued within five years before the proposed sale of securities.

There is an exception from disqualification where an issuer can show 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. Issuers will need to conduct a reasonable amount of due diligence as to all covered persons participating in a Rule 506 offering. Such due diligence may include questionnaires and representations from certain participants, and under appropriate circumstances should also include background checks.

Disqualification under Rule 506(d) only applies to disqualifying events occurring after the effective date of the rule. Matters that existed before the effective date of the rule which would otherwise be disqualifying must be disclosed to investors.

Effective Date of New Rules

Both the elimination of the prohibition on general solicitation for offerings under new Rule 506(c) and the bad actor disqualification provisions under Rule 506(d) take effect 60 days after publication of the final rules in the Federal Register (which should occur within the next few days). The SEC did provide guidance that an offering commenced prior to the effective date without general solicitation will be permitted to use general solicitation after the effective date under Rule 506(c). No general solicitation may be used before the effective date.

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Additional Proposed Amendments to Rule 506

The SEC also proposed additional amendments to Rule 506 to address concerns raised by critics of the elimination of the prohibition on general solicitation. As these amendments are only a proposal, they will not take effect when the elimination of the prohibition on general solicitation takes effect, and may change if and when they are adopted. The proposed changes to Rule 506 include the following:

- A requirement that any issuer engaging in general solicitation as part of a Rule 506 offering must file a Form D with selected information at least 15 calendar days before engaging in any such general solicitation. This is in addition to the current requirement to file a Form D for all Regulation D offerings within 15 days after the first sale of securities in the offering.
- All Rule 506 offerings will require the filing of a final Form D within 30 days after the termination of the offering.
- Form D would require additional information, including the types of investors, the types of general solicitation used and the methods used to verify accredited investor status.
- Issuers who fail to timely file a Form D would be automatically disqualified from using the Rule 506 exemption for any new offering for a one year period after the required Form D filings are made, subject to a cure period and an ability to request a waiver from the SEC staff under certain circumstances.
- Written general solicitation materials would need to include specified legends and disclosures, with specific requirements for sales literature of private funds.
- Issuers would be required to submit written general solicitation materials to the SEC through a special page on the SEC website that would not be publicly available. As proposed, this requirement would expire after two years.

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[1] As Rule 506 is a non-exclusive safe harbor, an issuer who does not satisfy all of the requirements of Rule 506 potentially may be able to show that the offering nonetheless satisfies the exemption in Section 4(a)(2) of the Securities Act. However, the SEC's view is that any offering involving general solicitation that does not satisfy Rule

506(c) will not be able to qualify for the Section 4(a)(2) exemption.

[2] A broker will generally charge a placement agent fee of up to 8% to 10% of the amount raised, and may also want warrants or other compensation. Registered brokers also have obligations to perform due diligence with respect to private placements, which may cause greater expense or delay. See FINRA Regulatory Notice 10-22, April 2010. SEC no-action letters have provided guidance as to how a registered broker can build a contact list of accredited investors without violating the prohibition on general solicitation. See Bateman, Eichler, Hill Richards, Inc., SEC No-Action Letter (Dec. 3, 1985).

[3] Compensating a third party for soliciting potential investors creates issues under federal and state securities laws if the third party is not a registered broker.

[4] See, e.g., Final Report of the Advisory Committee on Smaller Public Companies (April 23, 2006) (Recommendation IV.P.5).