

Corporate Finance and Securities Law Update

10/02/2013

Amending Rule 506 — Lifting the Ban on the General Solicitation of Investors and the New Bad Act Disqualification

The Securities and Exchange Commission (“SEC”) recently enacted amendments to Rule 506 (“the Rule”) promulgated under the Securities Act of 1933, as amended, (“the Securities Act”). These amendments were required by the Jumpstart Our Business Startups Act of 2012 (“the JOBS Act”). As a result of the change, entrepreneurs have the ability in some circumstances to publicly advertise that they are fundraising for their businesses, which was previously impermissible under the Rule. However, the SEC also added new disqualification provisions related to prior bad acts by certain individuals. These changes represent a significant evolution in the process by which securities may be sold in private placements.

Historical Background

Rule 506 is the primary exemption used by companies to raise capital through the private sale of securities. Historically, an issuer could use the Rule to exempt from registration the sale of an unlimited dollar amount of securities to an unlimited number of “accredited investors” and to no more than 35 non-accredited investors. However, general solicitation of investors was prohibited in such an offering. While the Rule did not define general solicitation or general advertising, Rule 502(c) gives several examples, including, “advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising,” as well as “other uses of publicly available media, such as unrestricted websites,” (e.g., social media such as Facebook, Twitter or LinkedIn). In the past, the prohibition on general solicitation typically limited an issuer to approaching only those prospective investors with whom it had a preexisting relationship.

Summary of Major Changes

The changes to the Rule became effective September 23, 2013, and will likely impact the way capital is raised in the U.S. These changes include the disqualification of issuers and their affiliates for engaging in “bad acts.” In addition, the changes permit issuers to engage in general solicitation or general advertising in connection with offerings under the Rule, provided the issuer takes “reasonable steps” to verify that all purchasers in the offering qualify as accredited investors. The changes to the Rule provide some guidance on what reasonable steps must be taken to verify accredited investor status and what bad action will disallow the use of the Rule.

Reasonable Steps to Verify Accredited Investor Status

The Rule sets forth a non-exclusive and non-mandatory list of methods that are deemed “reasonable steps” to verify accredited investor status:

- Documentation of income (e.g., review income tax returns, W-2s for past two years);
- Documentation of net worth (e.g., review of bank and brokerage statements for assets and a credit report for liabilities);
- Third-party verification/confirmation letter of accredited status from a broker-dealer, certified public accountant or attorney; and
- Reliance on written verification from an existing investor who previously purchased securities in the issuer’s Rule 506 private placement before the effectiveness of the new rules, where the investor continues to hold the previously purchased securities.

Bad Acts Under Amendment to Rule 506

The newly added “bad act” provision will make the Rule unavailable to an issuer if certain persons involved in the offering have engaged in specified “bad acts.”

In order to determine whether the Rule is available to an issuer, issuers will need to conduct an investigation regarding whether any “covered persons” have been involved in any disqualifying events. “Covered persons” under the Rule include: (i) the issuer and any predecessor or affiliated issuer; (ii) any director, executive officer or other officer participating in the offering, general partner or managing member of the issuer; (iii) any beneficial owner of 20 percent or more of the issuer’s outstanding voting equity; (iv) any promoter or investment manager connected with the issuer at the time of sale; and (v) any person who receives direct or indirect compensation for solicitation of purchasers in the offering.

Under the Rule, examples of disqualifying events include:

- Being convicted within 10 years prior to the sale (five years for the issuer or its predecessor or affiliated issuers) of any felony or misdemeanor relating to the securities industry or making false filings with the SEC;
- Being the subject of a final order of a court or various state and federal regulators, including banking regulators and the SEC, that bars the covered person from engaging in the securities, insurance or banking industries, or relates to claims of dishonesty;
- Filing or being named as an underwriter in any registration statement that was the subject of a stop order from the SEC within five years before the sale; or
- Being subject to a U.S. Postal Service false representation order.

Bad acts that occurred before September 23, 2013, will not prevent an issuer from using the Rule if those acts are disclosed to all investors in the offering within a reasonable time prior to the sale of the securities.

What Does This All Mean?

Companies looking for investors now have one more option when it comes to avoiding registration with the SEC. However, those issuers that want to take advantage of the ability to engage in general solicitation under the Rule must conduct more investor due diligence than previously required. The prior practice of self-certification via a “check-the-box” questionnaire completed by potential investors will not be sufficient for purposes of the Rule. Also, issuers will need to remain aware of situations in which the bad act disqualifications apply.

During this rulemaking process the SEC proposed additional amendments to Regulation D, Form D and Rule 156 under the Securities Act. These proposed amendments would require issuers using general solicitation to file a Form D at least 15 calendar days *before* engaging in general solicitation or general advertising, and file a closing Form D amendment within 30 calendar days after the termination of the offering under the Rule. Until the closing amendment is filed, the offering is deemed to be ongoing and the issuer would be required to file amendments to Form D at least annually and otherwise as needed to reflect changes in previously filed information. Failure to timely file these notices would mean loss of ability to rely on the Rule for a year.

Conclusion

Issuers intending to engage in general solicitation should review and revise both their offering documents and investor vetting procedures to satisfy the guidelines outlined in the Rule. The need to verify the status of an accredited investor or delve into the prior bad acts of an issuer or its affiliates is based on the facts and circumstances of the particular offering. Doing so will require, among other things, working more closely with the issuer’s legal counsel and obtaining from each prospective investor additional documentation supporting that investor’s qualification as an accredited investor. The issuer will also need to take reasonable steps to confirm that no disqualifying event has occurred with respect to any covered person.

**For more information, please contact the
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