

Impacts of SEC Rule Changes Allowing General Solicitation

By: Alex Arellano

The Securities and Exchange Commission (“SEC”) has lifted the long standing ban that prohibited companies claiming an exemption from registration for a private offering of securities under Rule 506 of the Securities Act of 1933 (the “Securities Act”), from advertising or marketing securities to the general public. As required by the Jumpstart Our Business Startups Act (“JOBS Act”), Rule 144A under the Securities Act has also been amended to allow persons reselling securities to use general advertising only if the securities are sold exclusively to qualified institutional buyers.

These SEC rule changes could significantly impact companies’ compliance and marketing functions, as well as the capacity of start-ups to expand the reach of their fund raising efforts through general solicitation. It remains to be seen, however, how many companies will take advantage of this new regime, given the additional regulatory hurdles imposed, or whether the change will ultimately increase the amount of capital raised by start-ups.

Companies offering securities in an effort to raise funds must either register the securities with the SEC or rely on an exemption from registration. One of the most commonly claimed registration exemptions today is Rule 506 of Regulation D, promulgated under the Securities Act. In order to qualify for a Rule 506 exemption today, an entity is permitted to raise funds from up to thirty five non-accredited, sophisticated investors, as well as from an unlimited number of “accredited investors.” Generally, investors must meet certain asset thresholds to qualify as “accredited investors.” In particular, for an individual to be considered an “accredited investor” as defined by Rule 501 of Regulation D, such individual must have:

- A net worth exceeding one million dollars (excluding the value of the individual's primary residence) or;
- Have an annual income of \$200,000 (or joint income with that person's spouse of \$300,000) in each of the two most recent years; and
- Have the expectation to reach the same income level in the current year.

Companies are required to have a reasonable belief that an investor is accredited which is usually satisfied by representations and other documents in the private placement offering packet.

An estimated seven percent of households in the United States currently qualify as accredited investors. Traditionally, the Rule 506 exemption was not available to a company that advertised to or solicited an investment from the general public, however, the changes in the JOBS Act have now removed this barrier to fundraising.

On July 10, 2013, the SEC ended the ban on general advertising and solicitation pursuant to the rules adopted under the JOBS Act. In an effort to aid capital raising efforts, the new SEC rules allows issuers offering unregistered securities under Rule 506 to advertise such securities to the general public and still maintain their Rule 506 exemption. To maintain the requirement to sell only to accredited investors, companies seeking to solicit investment from the general public must take affirmative steps to verify the accredited status of each of their investors.

Under the new rules the SEC will require companies to take "reasonable steps to verify that purchasers are accredited investors." The new rules provide a list of four non-exclusive methods that issuers may employ in order to satisfy the verification requirement for investors who are natural persons. The four methods of verification include:

1. Verification on the basis of income, based on a review of IRS form W-2 and other forms for two most recent years;

2. Verification through recent bank statements (3 months), brokerage statements and appraisal reports;
3. Written verification from broker-dealer, attorney, CPA, or SEC registered investment adviser, that company has taken reasonable steps to verify accredited investor status; and
4. Previous investors who have qualified as accredited for prior offerings continue to be qualified as such.

None of the above methods will serve to verify an investor as accredited if the company has actual knowledge the investor is not accredited.

These rule changes, which are expected to be implemented in September of this year, may have a significant impact on the ability of companies to raise funds. Many start-ups will likely seek funding through general solicitation, but certain funds may be disinterested in general solicitation since they often have their own traditional network of funding sources.

Even after the rule changes, companies wishing not to engage in general advertising can conduct offerings according to the traditional Rule 506 procedures and rules. The new rules will require an amendment to SEC Form D accounting for several Rule 506 categories. Under the amended Form D, companies may continue to elect the traditional Rule 506 exemption and not engage in general solicitation.

There is some speculation and concern the rule changes will open the door to numerous cases of fraud. The rule changes will certainly increase the regulatory burden on start-ups and may also increase uncertainty since the rules do not specify the types of general solicitation permitted. It will be interesting to see the true impact of these rule changes as they come into effect.

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