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SEC Approves General Solicitation in Regulation D Offerings under New Rule 506(c)

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In a widely anticipated move, the Securities & Exchange Commission ("SEC") finally proposed to amend Rule 506 of Regulation D and Rule 144A of the U.S. Securities Act of 1933 ("Act") during its open meeting on July 10, 2013[1].

Both amended rules will go into effect on September 23, 2013 and enable issuers of private placements to engage in general solicitation and general advertising to broaden their pool of potential investors, provided that they comply with certain restrictions and requirements. This new rule proposal was the result of implementing Section 201(a)(1) of the Jumpstart Our Business Startups Act ("JOBS Act")[2], which was enacted by Congress on March 27, 2012 and signed into law by president Obama on April 5, 2012.

The SEC further adopted new Rule 506(d)[3] and 506(e), along with proposed changes to Form D, which, among other things, entail the disqualification of so-called "Bad Actors" in all Rule 506 offerings under Regulation D. This has become necessary as a result of implementing the provisions of Section 926 of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), which denies issuers access to Rule 506, if they are associated with certain individuals or events that indicate financial improprieties, misconduct, or fraud.

[1] SEC Release No. 9414, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings is available at http://www.sec.gov/rules/final/2013/33-9415.pdf
[2] The JOBS Act is available at http://www.gpo.gov/fdsys/pkg/BILLS- 112hr3606enr/pdf/BILLS-112hr3606enr.pdf
[3] SEC Release No. 9414, Disqualifying Felons and other Bad Actors from Regulation D, Rule 506 Offerings, by adopting new Rule 506(d) and Rule 506(e) on July 10, 2013. Please review our article "SEC Proposes Banning Bad Actors from Private Placements under Reg D, Rule 506, which is available at http://www.jacksonsteiner.com/insights-analysis/sec-proposes-ban-banning-bad-actors-from-private-placements-under-reg-d-rule-506/

Background

Under Regulation D of the Securities Act of 1933 ("Act"), Rules 504, 505, and 506 afford issuers of private placements an exemption from registration and annual reporting requirements with the SEC, if specific requirements are met.

Overview of Rules 504, 505, and 506

Requirements [4]	**Rule 504**	**Rule 505**	**Rule 506 (Safe Harbor)**
Maximum Offering Amount	$1,000,000	$5,000,000	Unlimited
Maximum Offering Period	12 months	12 months	12 months
Investor Qualifications	Unlimited Accredited/ Sophisticated Investors	Unlimited Accredited + up to 35 Non-Accredited Investors	Unlimited Accredited + up to 35 Sophisticated Investors
Prospectus Required	No	Yes (*2)	Yes (*2)
Advertising/Promotion Allowed	Yes (*1)	No	No
Restricted Securities	Yes (*1)	Yes	Yes
Form D Required	Yes	Yes	Yes

While each rule has it's own framework of requirements and limitations, the most notable restriction for all rules is that securities cannot be sold using general solicitation and general advertising (with a very narrow exception under Rule 504).

While there is no specific definition of what activities of an issuer would constitute acts of general solicitation and general advertising, Rule 502(c) provides a few examples, such as "any advertising, article, notice, or other communication in any media, newspaper, magazine or similar media, or broadcasts over television or radio" (which nowadays probably also extends to websites, blogs, and forum posts, promotional videos, etc.) and "any seminar or meeting, whose attendees have been invited by general solicitation" with a narrow exception for marketing activities conducted outside the United States.

With the proposed amendment to Rule 506 and Rule 144A, the SEC has now softened its position on general solicitation and general advertising in connection with private offerings and created new Rule 506(c) under which issuers can now employ general solicitation and general advertising to broaden their pool of potential investors. With that being said, it is important to note that this only applies to offerings pursuant to new Rule 506(c) and that existing Rules 504, 505, and 506 (now Rule 506(b)) remain unchanged and in effect.

[4] (*1) General solicitation and general advertising in connection with an offering under Rule 504 is only permissible, if the issuer meets at least one of the following requirements (i) the issuer registers his offering in a state, where such registration is required and also complies with mandatory disclosure requirements in other states, which may not require such compliance, (ii) the issuer offers and sells securities exclusively to Accredited Investors in a state that permits general solicitation and general advertising.
(*2) Issuers of securities pursuant to Rules 505 and 506 are not required to supply potential investors with a substantive disclosure document for so long as they market their securities exclusively to Accredited Investors.

New Rule 506 (c) of Regulation D

Provided that issuers of private offerings adopt new Rule 506(c) and ensure compliance with Rule 501 (Accredited Investor Definition), Rule 502(a) (Offering Integration), and Rule 502(d) (Restrictions on the Resale of Securities), they are now free to employ a whole menu list of solicitation and advertising techniques to broaden their pool of potential investors.

With that being said, it is important to note that with the requirement that all investors in an offering under new Rule 506(c) qualify as Accredited Investors[5], the SEC is now imposing greater due diligence standards on the issuer when it comes to verifying an investor's Accredited Investor status.

"Reasonable Steps" to Verify Accredited Investor Status

While the SEC requires issuers to take "reasonable steps to verify" an investor's Accredited Investor status, the new rule includes a non-exclusive list of procedures, issuers may rely on to satisfy this requirement. This may sound promising, but in reality, implementing any of these procedures may prove to be difficult:

- *Income Verification* would entail having to collect and review a potential investor's income reporting tax filings for the last two years; for example, forms W-2, 1099, K-1, and 1040. In addition to that, the potential investor would need to represent that he reasonably expects to reach a similar annual income during the current calendar year.

- *Net Worth Verification* would consist of collecting and reviewing bank-, brokerage-, and other financial statements, along with a recent credit report (dated up to three months prior to the application) to verify potential liabilities of a potential investor. Moreover, the potential investor also needs to represent that he disclosed all liabilities, as required, for the issuer to conduct the net worth test.

- *Third Party Confirmation* by a registered broker-dealer or investment advisor, a licensed attorney, or certified public accountant to the effect that they have taken reasonable steps to verify a potential investor's Accredited Investor status during the last three months.

[5] The definition of the term "Accredited Investor" that is applicable to Rule 506 is set forth in Rule 501(a) of Regulation D. For natural persons, Rule 502(a) defines an accredited investor as a person: (1) whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence (the "net worth test"); or (2) who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year (the "income test").

- *Grandfathering of Accredited Investors* in an issuer's previous Rule 506 (now Rule 506(b)) Offering is also suitable to qualify a potential investor as an Accredited Investor, as they would only need to represent that they remain qualified as an Accredited Investor.

If issuers, in fact, will be able to collect sensitive personal and financial information from potential investors for the purpose of qualifying them as Accredited Investors, especially if issuers don't have a prior and trust-based relationship with these investors, remains to be seen, but appears to be unlikely.

Of course, this list of SEC endorsed verification procedures is neither mandatory nor all-inclusive. Hence, issuers may rely on other methods to verify a potential investor's Accredited Investor status, including by relying on:

- The nature and the type of Accredited Investor the potential investor claims to be (e.g. registered broker-dealer, bank, insurance company, registered investment company, including small business investment companies (SBICs), etc.).

- Information that the issuer has on file already.

- Nature and terms of the offering; whether the offering requires a substantial minimum investment, which typically can only be met by an Accredited Investor; and the circumstances under which the potential investor was solicited to participate in the offering (potential investors that were solicited using an ad on a website or responded to a promotional email will likely require more extensive verification measures than a potential investor that was referred to the issuer by his financial advisor, bank, or accountant).

- Publicly available information, such as state, federal, or regulatory filings, which may offer a reasonable and objective basis for qualifying a potential investor as an Accredited Investor.

Whether implementing any of the above-mentioned verification procedures will be feasible, especially for small issuers without an existing network of legal and financial resources, will ultimately be determined as time goes by and small issuers move to adopt new Rule 506(c) for their offerings. Doing so, however, may prove to be a faithful decision for an issuer, because (i) any failure to comply with the required investor verification process can result in Rule 506(c) becoming unavailable to the issuer and entail an SEC enforcement action, even if all investors in the respective offering qualify as Accredited Investors. (ii) Issuers can't go back and adopt another rule, since they likely engaged in general solicitation and general advertising, and Rules 504, 505, and 506(b) strictly prohibit any marketing to the general public (again, with a very narrow exception under Regulation D, Rule 504).

It will therefore be essential to an issuer's compliance with new Rule 506(c) to carefully design and implement a dynamic, yet meaningful, investor verification process and document as many details as possible about steps that were taken, including supporting information, to qualify a potential investor as an Accredited Investor.

Changes to Form D

Changes to Form D will be effected in two stages. As of September 23, 2013, when new Rule 506(c) will go into effect, issuers will be required to clearly indicate whether they are relying on Rule 506(b) (formerly Rule 506 Safe Harbor) or new Rule 506(c) when filing Form D with the Securities & Exchange Commission following the first sale of securities under their offering. This will be a pivotal moment for issuers, as they will only be able to adopt one rule or the other[6] and after selecting new Rule 506(c), they likely will not be able to revert back to a traditional offering under Safe Harbor Rule 506(b) or any other rule of Regulation D.

In separate proposed amendments to Regulation D and Form D (Rule 503), the SEC is currently contemplating to impose far more substantial disclosure requirements in connection with the required filing of Form D:

- Issuers would then be required to file an Advance Notice Form D not later than 15 days prior to commencing an offering under Regulation D (or engaging in general solicitation and general advertising, if they adopted new Rule 506(c)), unless a standard Notice of Sale Form D has already been filed with the SEC. Within the Advance Notice Form D, issuers would need to disclose (i) general information on the issuer, (ii) details about people involved with the offering, (iii) the exemption that is being claimed, (iv) the planned use of proceeds, (v) details about the securities to be sold in the offering, and (vi) planned solicitation and advertising activities, if the issuer relies on new Rule 506(c).

- Moreover, issuers would also be required to file an amended Advance Notice Form D, if they were unable to provide substantially all of the information required at the time they first filed their Advance Notice Form D.

- The requirement to file a standard Notice of Sale Form D, not later than 15 days after the first sale of securities, continues to apply.

- Furthermore, issuers would need to file an amended Termination Notice Form D, not later than 30 days, after the issuer terminated or completed an offering under either Rule 506(b) or new Rule 506(c). Information to be provided in this Termination Notice Form D would include (i) the total

[6] SEC Release "We are of the view that an issuer will not be permitted to check both boxes at the same time for the same offering"

amount of securities sold, (ii) information about general solicitation and general advertising techniques used to promote the offering, and (iii) details about the verification process(es) and method(s) used by the issuer to verify an investor's Accredited Investor status.

Issuers should be aware that any failure to timely file Form D for either Rule 506 offering, beyond a one-time 30-day cure period, could result in the issuer being barred from conducting an offering under Rule 506 for at least one year. If adopted, the amended rule would also include a 5-year look back period and apply to issuers, their predecessors and affiliates.

Other Proposed Disclosure Requirements – New Rule 509 and 510T

Under proposed new Rule 509, issuers relying on new Rule 506(c) would be required to add legends to all offering documents and general solicitation materials that reflect that (i) only Accredited Investors can participate in the offering, (ii) the offering is exempt from registration under the U.S. Securities Act, (iii) that the SEC has neither approved nor disapproved the offering, the securities to be sold in the offering, and any disclosure materials supplied in connection with the offering, and (iv) that the securities offered are subject to restrictions on resale and thus, that investors must be able to hold these securities for an indefinite period of time, and be able to withstand a total loss of their investment. Such cautionary notes are already standard in most private placement memoranda; hence, implementing this requirement should be fairly straightforward for most issuers.

Private Funds relying on new Rule 506(c) would be required to include a similar legend in all disclosure documents and general solicitation materials. Such legend would likely need to include cautionary notes such as (i) that securities offered would not qualify for protection of the Investment Company Act of 1940, and (ii) that past performance is not necessarily indicative of future results. Moreover, such a legend would need to include the fund's phone number, email address, or URL where potential investors could find additional information, including the fund's most recent performance data.

Proposed temporary Rule 510T extends regulatory requirements for issuers relying on new Rule 506(c) even further by requiring them to submit all disclosure documents and documents used in general solicitation and general advertising to the SEC – even though just for an initial period of 2 years. This proposed rule is designed to help the SEC monitor new Rule 506(c) in the marketplace and to address concerns that general solicitation and general advertising in an offering under Regulation D may result in a sharp increase in fraudulent activities and unlawful sales to non-Accredited Investors. Disclosure documents and materials used in general solicitation and general advertising in connection with an offering pursuant to new Rule 506(c) would be due to be submitted prior to being disseminated; however, it is important to note that such submissions to the SEC will

not be viewed as a formal "filing" or even "registration" under the Securities Act or Exchange Act.

The SEC is currently seeking comments on these proposed amendments until September 23, 2013.

Impact of New Rule 506 (c) on Private Funds

New Rule 506(c) will also be accessible to private funds, such as hedge funds, private equity funds, and venture capital funds and thus, play a material role in helping them broaden their investor base. Moreover, private funds will still be able to rely on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, which exempts such private funds from having to register under the Investment Company Act.

However, private funds will remain subject to federal "truth in securities" and anti-fraud provisions. Registered investment advisors will also have to comply with anti-fraud provisions of the Investment Advisor Act and refrain from using testimonials, past recommendations, and past performance data in connection with an offering of a private fund.

Moreover, Rule 156, in its current form, prohibits registered investment companies from using sales literature that is misleading because (i) it contains untrue statements, or (ii) omits to state a material fact necessary in order to make a statement not misleading. If adopted, the proposed amendment would also subject new Rule 506(c) offerings of private funds to Rule 156.

Conclusion

Pending the release of the final regulatory framework for new Rule 506(c), it is too early to determine whether or not this new rule will help to "Jumpstart Our Business Startups" and facilitate their access to new capital resources. While easing the restrictions on general solicitation and general advertising in connection with a Regulation D offering may be a step in the right direction, it will take time to penetrate new Rule 506(c) to the extent where issuers and their advisors can make an educated decision about the benefits and drawbacks of adopting this new rule. Issuers will need to be aware that, once they adopted new Rule 506(c) and engaged in general solicitation and general advertising, there is no turning back to standard Safe Harbor Rule 506(b) or any other exemption under Regulation D. Moreover, heightened Accredited Investor verification requirements will create substantial challenges for issuers, as they will have to walk a thin line when they require potential investors to disclose very sensitive personal and financial information and address their concerns over their privacy at the same time. Issuers should also consider that, if approved, extended requirements to file an advance notice, notice of sale, and termination notice Form D, along with the required submission of all disclosure documents and general solicitation materials to the SEC, would enable

more stringent regulatory oversight and hence, likely result in more enforcement actions.

Issuers who contemplate an offering under Regulation D and consider adopting new Rule 506(c) should take their time and carefully explore the regulatory framework for this new rule, including all possible ramifications, before making an educated decision. Especially during the very early stages where this new rule can be adopted and implemented, it will be advisable to do so only with the help of a seasoned attorney or financial advisor.

We will continue to monitor any new developments in connection with the Jumpstart Our Startup Businesses Act ("JOBS Act") and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and publish our comments here on JacksonSteiner.com.

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