

SEC Lifts the Ban on General Solicitation in Rule 506 Private Placement Offerings Under Special Circumstances

On July 10, 2013, the Securities and Exchange Commission ("SEC") approved certain changes to Rule 506 of Regulation D. Rule 506 is widely used by many issuers of securities in private placements. The changes were in response to Congressional mandates set forth in Section 201(a) of the Jumpstart Our Business Startups Act and Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Effective September 23, 2013, the new rules create Rule 506(c), a provision that allows issuers to use general solicitation to offer their securities. However, this new benefit comes with some additional duties for the issuer:

- Purchasers must be limited to accredited investors;
- The issuer must take reasonable steps as outlined in the rule to verify that the purchasers of the securities are accredited investors;
- The issuer must comply with new filing requirements, including new Form D requirements and submission of its advertising materials with proper legends to the SEC in advance of the solicitation;
- The issuer must satisfy the other safe harbor requirements under Rule 506, including the new "bad actor" rules.

Accredited Investors

Natural persons may be accredited investors based on either their net worth or their annual income. A natural person is considered an accredited investor if his or her individual net worth, or joint net worth with that person's spouse, exceeds \$1 million, excluding the value of the person's primary residence. Also, an investor is considered accredited if he or she has

individual income in excess of \$200,000 in each of the two most recent years, or joint income with their 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 accredited investor qualifications are important for an issuer to understand because, under the new rules, issuers will be required to verify the accredited status of its potential purchasers.

Verification of Accredited Status

The new Rule 506(c) requires issuers to verify the accredited status of potential purchasers. Verification cannot be accomplished simply by obtaining a signed written questionnaire from the investor. Rather, the new rules require issuers to take a more proactive approach to the verification process.

- **Accredited Based on Income.** The issuer is deemed to satisfy the verification requirement in Rule 506(c) based on income if the issuer reviews copies of any IRS form provided by the potential purchaser that reports income, including but not limited to, Form W-2, Form 1099, Schedule K-1 of Form 1065 or a copy of the filed Form 1040 for the two most recent years, along with obtaining a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.

- **Accredited Based on Net Worth.** The issuer is deemed to satisfy the verification requirement in Rule 506(c) based on net worth if the issuer

reviews the potential purchaser's bank statements, brokerage statements or other statements of securities holdings, certificates of deposit, tax assessments or appraisal reports issued by independent third parties and a credit report from at least one of the nationwide consumer reporting agencies.

- **Accredited Based on Written Confirmation.** The issuer may also verify the potential purchaser's accredited status by obtaining a written confirmation from a registered broker-dealer, a SEC-registered investment adviser, a licensed attorney or a certified public accountant that states that the confirming individual has taken reasonable steps to verify that the potential purchaser is an accredited investor. Other individuals may also be able to certify as to the accredited status of a potential purchaser, but that determination is based on the particular facts and circumstances as discussed in Rule 506(c).

- **Prior Investment Relationship.** A natural person who previously qualified in the issuer's prior Rule 506 offering as an accredited investor will be considered an accredited investor for purposes of a Rule 506(c) offering if the investor certifies that he or she still qualifies as an accredited investor at the time of the securities purchase under Rule 506(c).

The issuer has the burden of demonstrating that its offering is entitled to an exemption under Rule 506. Therefore, the issuer's failure to take reasonable efforts to verify a potential purchaser's accreditation status will jeopardize its entire securities offering.

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New Filing Requirements

Rule 506(c) also requires additional filing requirements. The issuer must do the following to comply with the new rules:

- File a Form D at least 15 calendar days before the issuer engages in general solicitation for a Rule 506(c) offering;
- File an amended Form D within 30 days after completing or terminating an offering to indicate that the offering has ended;
- Provide additional disclosure to enable the SEC to gather more information on the changes to the Rule 506 market that could occur now that the general solicitation ban has been lifted, such as information on the types of general solicitation used and the methods used to verify the accredited investor status of purchasers;
- Include legends and cautionary statements in any written general solicitation materials used in Rule 506(c) offering;
- Submit written general solicitation materials to the SEC via an online drop box for a period of two years after the effective date of the new rules.

Bad Actors Disqualification

The SEC also adopted new rules restricting certain issuers from relying on Rule 506 in the event the issuer or an affiliate has suffered a “disqualifying event” after the effective date of the new Rule 506. Any disqualifying event that takes place prior to the effective date will require written disclosure to investors.

A disqualifying event includes: (i) any criminal conviction arising from the purchase or sale of securities within the preceding 10 years; (ii) a court injunction or restraining order arising from the purchase or sale of securities within the preceding five years; (iii) any final order of an insurance, banking, commodities or

securities regulatory body that bars the issuer from participating in securities, insurance or banking activities or are based on fraud or manipulative conduct within the preceding 10 years; (iv) SEC disciplinary orders, cease-and-desist orders or stop orders; (v) suspension or expulsion from a self-regulatory organization; or, (vi) a U.S. Postal Services false representation order issued within the preceding five years.

Investors’ Privacy Concerns

The new rules require issuers to verify the accredited status of potential investors. Potential investors, therefore, must hand over their private financial information to an issuer for verification before any investment may be made.

Critics point out that financial information in the hands of a private issuer could be subject to far more abuse and fraud than what could emerge from the previous practice of self-certification for investors. Clearly, the new verification requirements are costly and burdensome for issuers. The question remains whether the verification requirements will be too invasive for potential investors.

Representing Clients Under the New Rules

Attorneys representing potential investors and issuers must be aware of the new rules.

• **Representing Potential Investors.** Potential investors should proceed with caution when responding to general solicitations for investment opportunities. The SEC does not approve the advertised offering for its merit, accuracy or completeness. Further, private placement offerings under Rule 506 do not require the full-blown disclosure

requirements that apply to a registered securities offering. Also, securities acquired under a Rule 506 offering are subject to transfer and resale restrictions. Thus, potential investors should not assume that they will be able to resell the securities if the investment is not performing as anticipated and should be able to bear the loss of their entire investment.

• **Representing Issuers.** It is not unusual for issuers to be unaware of securities regulations when they seek out investment funds for their business venture. However, with the passage of new rules allowing general solicitation, issuers will become more aware of investment capital and may not have an appreciation for the strict legal requirements. The new rules place a serious burden on issuers in terms of filing requirements and verification procedures. Failure to meet this burden will result in a denial of the registration exemption and potential other sanctions including, but not limited to, the inability to raise capital for a period of time.

Conclusion

The prospect of general solicitation is enticing to issuers who are looking to cast a wide net over their investment prospects. However, issuers will need to determine for themselves whether the additional burdens that accompany the new Rule 506(c) are worth the benefits of general solicitation. For those issuers who are not interested in general solicitation, the prior private placement requirements of Rule 506(b) remain intact.

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