

## MEMORANDUM

To: Our Clients and Colleagues

Date: July 2013

Re: Final SEC Rules Regarding Rule 506 Offerings – General Solicitation and other matters

The 2012 Jumpstart Our Business Startups Act (JOBS Act) called on the SEC to adopt rules removing the prohibition on general solicitation or general advertising for securities offerings relying on the exemption from registration contained in Rule 506 of Regulation D.

On July 10, 2013, in response to the JOBS Act directives, the SEC adopted two rules relating to Rule 506 transactions and proposed another rule regarding private offerings.

### **1. Final Rule regarding Offerings by General Solicitation**

Under new Rule 506(c), which will be effective September 23, 2013, issuers can make Rule 506 offerings using general solicitation or general advertising provided that (1) the issuer takes “reasonable steps” to verify that all purchasers<sup>1</sup> are accredited investors and (2) all purchasers are accredited investors or the issuer “reasonably believes that the investors” qualify as accredited investors at the time of the sale.

The rule does not change the existing definitions of “accredited investor,” which vary depending on whether the investor is a natural person or a particular type of entity. But, unlike Rule 506 transactions until now, which allowed up to 35 non-accredited investors, offerings using general solicitation can have no non-accredited investors. (In the SEC’s own words, for this type of transaction, “there is no restriction on who an issuer can solicit” as long as each purchaser is an accredited investor.)

The rule provides that the “determination of the reasonableness of the steps taken to verify an accredited investor is an objective assessment by the issuer.” This requires the issuer to consider the facts and circumstances of each purchaser and the transaction. The rule, however, provides a *non-exclusive* list of methods that issuers can use to satisfy the verification requirement for each purchaser.

---

<sup>1</sup>Although the rule specifically cites the standards for determining if a natural person is an accredited investor, it would appear that the term “purchaser” applies to natural persons or entities, so that, whatever the nature of any purchaser, he/she/it must fall within at least one of the appropriate qualifications for being an “accredited investor.”

## **KRIEGER & PRAGER, LLP**

The non-exclusive methods include, as may be relevant, (1) reviewing IRS forms showing income of the purchaser and obtaining a written representation that the purchaser will likely earn the necessary income in the coming year or (2) receiving confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney or CPA that such entity or person has taken reasonable steps to verify the purchaser's accredited investor status.<sup>2</sup>

In other words, if an offering is being made by general solicitation, the issuer will need to actively attempt to verify the purchaser's status; the purchaser's self-determination that he/she/it is an accredited investor will not suffice.

The SEC specifically provides, however, that if the general solicitation approach is not being used, it would seem that the existing provisions of Rule 506, which allow for up to 35 non-accredited purchasers in addition to unlimited accredited investors, could still be used without being subject to the verification rule.

The rule also provides that Rule 144A offerings can be offered by means of general solicitation provided that the securities are sold only to qualified institutional buyers (QIBs) or to persons whom the seller and any person acting on behalf of the seller "reasonably believe" to be QIBs.

Form D, which is the notice that issuers have to file with the SEC when they sell securities under Regulation D, is being revised to include reference to this new Rule 506 exemption.

### **2. Final Rule on Disqualification of "Bad Actors"**

The SEC has adopted a rule, also effective September 23, 2013, which denies the availability of the Rule 506 exemption (not just the new Rule 506(c) exemption) under Regulation D to an issuer if the issuer or any other person covered by the rule had a "disqualifying event."<sup>3</sup>

---

<sup>2</sup> Comment: Time will tell whether investors will be ready to provide copies of their tax returns to issuers or whether BDs or investment advisers or attorneys for that matter will be ready to certify the accredited investor status of their clients to issuers in transactions in which they are not involved or compensated. Perhaps certification from CPAs might be the most likely route, but that assumes that CPAs will be willing to "verify the purchaser's accredited [investor] status."

<sup>3</sup> Certain other SEC offering mechanisms, such as Regulation A, have similar provisions.

## KRIEGER & PRAGER, LLP

Besides the issuer, the rule covers its predecessors (!) and affiliated issuers, as well as (1) directors and certain officers, general partners and managing members of the issuer, (2) 20% beneficial owners of the issuer, (3) promoters, (4) investment managers and principals of pooled investment funds and (5) persons compensated for soliciting investors (even unlicensed finders?), as well as the general partners, directors, officers and managing members of any compensated solicitor.<sup>4</sup>

The combination of the list of persons covered by the rule *and* the list of disqualifying events means that greater care (due diligence) will be necessary by an issuer, placement agent and their counsel when an issuer takes any of the following actions: elects a director, elects an executive officer, identifies a shareholder which has become a 20% beneficial owner (and all the more so if the issuer itself issues securities resulting in the purchaser becoming a 20% beneficial owner), merges with or acquires another entity, retains a placement agent for a Rule 506 transaction or retains a promoter.

The rule, however, does provide an exception from the disqualification provided in the rule when the issuer can show that 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.<sup>5</sup>

The SEC specifically provides that the disqualification applies only for disqualifying events that occur after the September 23, 2013 effective date of the rule. However, if something that occurred earlier would have been a disqualifying event for a covered person had the rule been in effect earlier, the event must be disclosed to investors.

---

<sup>4</sup> The list of “disqualifying events” includes (1) criminal convictions in certain securities related activities which occurred with 10 years of the proposed sale (or 5 years in the case of the issuer and its predecessors or affiliated issuers), (2) court injunctions and restraining orders in certain securities related activities which were issued within 5 years of the proposed sale, (3) final orders from CFTC, state securities regulators or certain other agencies or associations that (a) bar the issuer engaging in the business of securities, insurance or banking or associating with a regulated entity or (b) are based on fraudulent, manipulative or deceptive conduct and are issued within 10 years of the proposed sale, (4) certain SEC disciplinary orders relating to brokers, dealers and others, (5) SEC cease-and desist orders relating to certain anti-fraud provisions, (6) SEC stop orders and orders suspending the Regulation A exemption issued within 5 years of the proposed sale, (7) suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member, and (8) US Postal Service false representation orders issued within 5 years of the proposed sale.

<sup>5</sup> From this provision it would seem that the disqualification from the Rule 506 exemption provided in this rule only applies if the covered person “participate[s]” in the offering.

### **3. Proposed Rule regarding Private Offerings**

Of special interest to the utility of revised Rule 506 are the SEC's proposed rules "intended to enhance the SEC's ability to assess developments in the private placement market now that the rule to lift the ban on general solicitation has been adopted." The SEC is seeking comments on the proposed rules. The final rules which may be adopted may be more or less restrictive than the ones summarized below. If adopted, the additional regulatory and filing requirements will affect the usefulness of the new general solicitation rules.

#### *Form D filings*

- Issuers who intend to engage in general solicitation as part of a Rule 506 offering would be required to file a Form D at least 15 calendar days before engaging in general solicitation for the offering. (Note: Currently, Form D is generally filed after the first closing. That post-first sale filing would still be required, as well.)
- Besides the information called for in the current Form D, issuers would be required to provide additional information about the issuer's website, expanded information about the issuer, the securities being offered, the types of investors in the offering, the use of proceeds, the types of general solicitation used and the methods used to verify the accredited status of investors. All of this is ostensibly "to enable the SEC to gather more information on the changes to the Rule 506 market."
- Form D would need to be updated within 30 days of completing the offering. That filing would have to indicate that the offering had ended. It may require additional information not previously provided in the Form D filings for the particular transaction.
- An issuer which does not comply with the Form D filings in a Rule 506 offering made within the last 5 years (but not before the effectiveness of this rule) will be disqualified from using the Rule 506 exemption (not just the Rule 506(c) "general solicitation" exemption) for one year after the required filings are made. (The SEC notes that issuers could rely on cure periods for a late Form D filing and recognizes that issuers could, in certain circumstances, request a waiver from the SEC staff.) The SEC proposal specifies that this disqualification would apply to subsequent offerings, not to any on-going offering at the time of the filing non-compliance.

#### *Solicitation Materials*

- Issuers would be required to include certain legends and cautionary statements in any written general solicitation materials. The legends would inform potential investors that only accredited investors will be allowed to purchase the securities and that certain potential risks may be associated with the offering.

## **KRIEGER & PRAGER, LLP**

- If the issuer is a private fund and the material includes information about past performance, the issuer will be required to provide certain additional information and cautionary language.
- If the issuer is using written material in the general solicitation, the material will have to be submitted to the SEC. The submission would be done via a process where it would *not* be available to the general public. (The proposal notes that this requirement is intended to be temporary, expiring after two years.)
- The SEC's guidance in Rule 156 on when information in sales literature by an investment company registered with the SEC could be fraudulent or misleading for purposes of the federal securities laws will be extended to sales literature of private funds, whether or not they are engaged in general solicitation. The SEC "would express its view that private funds should now begin considering the principles underlying Rule 156."

### **4. Request for Comments on Definition of "Accredited Investor"**

While it is not proposing any particular changes at the moment, the SEC invited comments on the potential revision of the definition of "accredited investor," which has not changed in a few decades.

### **5. Conclusion**

Clearly the newly adopted amendments to Rule 506 are a step in the right direction. However, their usefulness will have to await the outcome of possible SEC staff interpretations, new industry "due diligence" practices, workable and accepted avenues for verification of "accredited investor" status of parties interested in being purchasers and other regulatory developments – including possible adoption of the additional SEC Rule 506 proposals, in whole or in part, and the anticipated revision of the Regulation A offering rules.

If we can be of any further assistance, please feel free to contact our office.

#####