



Questions & Answers on the Lifting of the General Solicitation Ban under Rule 506

Andrew Hecht (July 13, 2013)

Private placements of securities are a primary source of capital to startups and emerging companies. As part of the JOBS Act, Congress instructed the Securities and Exchange Commission (“SEC”) to liberalize the private placement rules to permit general solicitation of purchasers of securities sold pursuant to Rule 506 of Regulation D under the Securities Act of 1933, as amended. On July 10, 2013, the SEC issued final rules (the “Final Rules”) lifting the ban on general solicitation under Rule 506, creating the potential for businesses seeking capital to reach a much larger audience of investors.

This Q&A briefly addresses some of the practical questions applicable to entrepreneurs and investors relating to the Final Rules. Note that the Final Rules do not become effective until 60 days after they are published in the Federal Register, and until that time issuers may not engage in general solicitation in reliance upon Rule 506. Also note that concurrently with the release of the Final Rules, the SEC issued rules prohibiting the use of the Rule 506 exemption for any securities offering in which certain felons and other bad actors are involved, and proposed additional rules to increase SEC supervision over offerings made using general solicitation. The bad actor rules and proposed rules are not discussed here, but they can be expected to further affect the Rule 506 exemption availability and offering process.

How are the Final Rules different from current Rule 506?

Under current Rule 506, an issuer may sell securities, without any limitation on the offering amount, to an unlimited number of accredited investors, and to no more than 35 non-accredited investors who meet certain sophistication requirements, but the issuer may not engage in any kind of general solicitation (offerings under the current rules are referred to as a “Rule 506(b) offerings”). The Final Rules permit an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, provided that (1) all purchasers of the securities are accredited investors and (2) the issuer takes reasonable steps to verify that such purchasers are accredited investors (offerings using general solicitation under the Final Rules are referred to as a “Rule 506(c) offerings”).

What is “general solicitation?”

General solicitation includes, for example, offerings made through unrestricted publicly available websites, widely disseminated email or social media solicitations, advertisements published in newspapers and magazines, communications broadcast over television and radio, and

seminars where attendees have been invited by general solicitation or general advertising.

Who is an “accredited investor” under the Final Rules?

The definition of “accredited investor” under Rule 501(a) has not been changed by the Final Rules. For natural persons, an accredited investor is 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”). There are other tests for accredited investor status for entities.

How will an issuer verify accredited investor status under the Final Rules?

As a condition of new Rule 506(c), issuers must take reasonable steps to verify that purchasers of the offered securities are accredited investors. This requirement is separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors. Whether the steps taken are reasonable will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. Among the factors that issuers should consider in forming this determination are:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

Are there any pre-approved methods of verifying accredited investor status?

Rule 506(c) includes four specific non-exclusive methods of verifying accredited investor status for natural persons that, if used, are deemed to satisfy the verification requirement in Rule 506(c). None of these methods will be deemed to satisfy the verification requirement if the issuer or its agent has knowledge that the purchaser is not an accredited investor.

(1) In verifying whether a natural person is an accredited investor *on the basis of income*, an issuer is deemed to satisfy the verification requirement by reviewing copies of any Internal Revenue Service form that reports income 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.

(2) In verifying whether a natural person is an accredited investor *on the basis of net worth*, an issuer is deemed to satisfy the verification requirement by reviewing one or more of the following types of documentation, dated within the prior three months, and by obtaining a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed. For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and for liabilities: a consumer credit report from at least one of the nationwide consumer reporting agencies.

(3) An issuer may satisfy the verification requirement by obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant, provided that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor.

(4) With respect to any natural person who invested in an issuer's Rule 506 offering as an accredited investor prior to the effective date of the Final Rules and remains an investor of the issuer, for any Rule 506(c) offering conducted by the same issuer, the issuer is deemed to satisfy the verification requirement with respect to such person by obtaining a self-certification at the time of sale that he or she qualifies as an accredited investor.

Is a standard "accredited investor questionnaire" alone sufficient to verify an investor's status?

No. The SEC has made clear that an issuer will not have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.

How are the investor information delivery requirements in a Rule 506(c) offering different from Rule 506(b)?

Offerings under Rule 506(c) will not be subject to the financial and other information requirements in Rule 502(b) for non-accredited investors, because all purchasers in Rule 506(c) offerings are required to be accredited investors.

What documents are filed with the SEC in a Rule 506(c) offering?

Issuers will be required to file a Form D with the SEC within 15 days of the first sale of securities under a Rule 506(c) offering. Note that the proposed rules issued concurrently with the Final Rules propose to significantly change and increase the filing requirements, including pre-filing of a Form D for use in Rule 506(c) offerings and filing of written general solicitation materials.

May an issuer rely on an alternative exemption from registration once it has commenced general solicitation?

Once general solicitation has commenced, an issuer is precluded from making a claim of reliance on Rule 506(b)

for that same offering. Similarly, the Final Rules only affect Rule 506, and not Section 4(a)(2) offerings in general, which means that an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering.

What resale restrictions are placed on securities issued under 506(c)?

Securities issued pursuant to a Rule 506(c) offering are deemed to be "restricted securities" for purposes of resale under Rule 144.

Why might an issuer choose to conduct a Rule 506(b) offering under the current rules?

Even after the Final Rules are effective, the continued availability of existing Rule 506(b) will be important for those issuers that either do not wish to engage in general solicitation in their Rule 506 offerings (and become subject to the requirement to take reasonable steps to verify the accredited investor status of purchasers) or wish to sell privately to non-accredited investors who meet Rule 506(b)'s sophistication requirements. Issuers should also expect that some accredited investors who would participate in Rule 506(b) offerings would decline to participate in Rule 506(c) offerings in light of the verification requirements.

Who has the burden of proof if accredited investor status is challenged?

The issuer has the burden of demonstrating that its offering is entitled to an exemption from registration. Issuers and their verification service providers should retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor. Given the sensitive personal information that may be contained in these records, issuers should be prepared to implement suitable data protection and privacy measures.

Is the safe harbor lost if a non-accredited investor purchases securities in a Rule 506(c) offering?

If a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, the issuer will not lose the ability to rely on Rule 506(c) for that offering, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale.

The full text of the Final Rules may be found here: <http://www.sec.gov/rules/final/2013/33-9415.pdf>

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