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SEC Eliminates the Prohibition on General Solicitation for Rule 506 and Rule 144A Offerings

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On July 10, 2013, the SEC adopted the amendments required under the **JOBS Act** to Rule 506 that would permit issuers to use general solicitation and general advertising to offer their securities, subject to certain limitations. In addition, the SEC amended Rule 506, as required by the Dodd-Frank Act, to disqualify felons and other bad actors from being able to rely on Rule 506. The long-awaited new rules will allow issuers that are permitted to rely on Rule 506 to more widely solicit and advertise for potential investors, including on the Internet and through social media.

The SEC also adopted an amendment to Rule 144A that provides that securities may be offered pursuant to Rule 144A to persons other than qualified institutional buyers, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers.

For more background on the JOBS Act and Rule 506, please see our prior blog entry here.

What changes were made to Rule 506?

The final rule adds a new Rule 506(c), which permits issuers to use general solicitation and general advertising to offer their securities, provided that:

- All purchasers of the securities are accredited investors as defined under Rule 501; and
- The issuer takes “reasonable steps” to verify that the purchasers are all accredited investors.

What are reasonable steps to verify that an investor is accredited?

What steps 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.

The SEC indicates that among the factors that issuers should consider under this facts and circumstances analysis 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.

The final rule provides a *non-exclusive* list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons, including:

- For the income test, reviewing copies of any IRS form that reports the income of the purchaser for the two most recent years and obtaining a written representation that the purchaser will likely continue to earn the necessary income in the current year.
- For the net worth test, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:
    - With respect to 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
    - With respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies;
- As an alternative to either of the above, an issuer may receive a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that it has taken reasonable steps within the prior three months to verify the purchaser's accredited status.

Simply relying on a representation from the purchaser, or merely checking a box on an accredited investor questionnaire, will not meet the requirement for objective verification.

What actions must an issuer take to rely on the new exemption?

Issuers selling securities under Regulation D using general solicitation must file a Form D. The final rule amends the Form D to add a separate box for issuers to check if they are claiming the new Rule 506 exemption and engaging in general solicitation or general advertising. An issuer is currently required to file Form D within 15 days of the first sale of securities in an offering, but the SEC promulgated proposed rules to require an earlier filing. See "Are there any other changes contemplated for Rule 506?" below.

Will the new rule affect other Rule 506 offerings that do not use general solicitation?

Not directly. The existing provisions of Rule 506 remain available as an exemption. This means that an issuer conducting a Rule 506 offering without using general solicitation or advertising can conduct the offering in the same manner as in the past and will not be subject to the new verification rule.

However, under existing Rule 506, it is the issuer's obligation to satisfy all conditions of the

exemption, including the maximum number of non-accredited investors and the information and sophistication requirements for any non-accredited investors participating in the offering. We expect some issuers will decide to use more robust accredited investor verification procedures to assure compliance with the existing Rule 506 exemption.

Who is excluded from using the Rule 506 exemption?

Under the new rule regarding "bad actors" required by the Dodd-Frank Act, an issuer cannot rely on a Rule 506 exemption (including the existing Rule 506 exemption) if the issuer or any other person covered by the rule has had a "disqualifying event." The persons covered by the rule are the issuer, including its predecessors and affiliated issuers, as well as:

- Directors and certain officers, general partners, and managing members of the issuer;
- 20% beneficial owners of the issuer;
- Promoters;
- Investment managers and principals of pooled investment funds; and
- People compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor.

What is a "disqualifying event?"

A "disqualifying event" includes:

- Felony and misdemeanor criminal convictions in connection with the purchase or sale of a security, making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within 10 years of the proposed sale of securities (or five years in the case of the issuer and its predecessors and affiliated issuers).
- Court injunctions or restraining orders in connection with the purchase or sale of a security, making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The injunction or restraining order must have occurred within five years of the proposed sale of securities.
- Final orders from the Commodity Futures Trading Commission, federal banking agencies, the National Credit Union Administration, or state regulators of securities, insurance, banking, savings associations, or credit unions that:
    - bar the issuer from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or
    - are based on fraudulent, manipulative, or deceptive conduct and were issued within 10 years of the proposed sale of securities.
- Certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons.
- SEC cease-and-desist orders related to violations of certain anti-fraud provisions and registration requirements of the federal securities laws.
- SEC stop orders and orders suspending the Regulation A exemption issued within five years of the proposed sale of securities.
- Suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member.
- U.S. Postal Service false representation orders issued within five years before the proposed sale of securities.

What disqualifying events apply?

Only disqualifying events that occur after the effective date of the new rule will disqualify an issuer from relying on Rule 506. However, matters that existed before the effective date of the rule and would otherwise be disqualifying must be disclosed to investors.

Are there exceptions to the disqualification?

Yes. An exception from disqualification exists when the issuer can that show 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. The SEC can also grant a waiver of the disqualification upon a showing of good cause.

How do the new rules affect Rule 144A offerings?

Current Rule 144A permits resales of securities only to larger institutional investors known as qualified institutional buyers (QIBs). The new rules amend Rule 144A so that the exemption can apply when offers are made to investors who are not QIBs, including by means of general solicitation, as long as the securities are sold only to persons whom the seller reasonably believes are QIBs.

When do the new rules become effective?

Both rule amendments will become effective 60 days after publication in the Federal Register.

Are there any other changes contemplated for Rule 506?

In connection with the foregoing final rules, the SEC separately published for comment a proposed rule change intended to enhance the SEC's ability to assess developments in the private placement market based on the new rules regarding general solicitation. This proposal would require issuers to provide additional information to the SEC, including:

- identification of the issuer's website;
- expanded information about the issuer;
- information about the offered securities;
- the types of investors in the offering;
- the use of proceeds from the offering;
- information on the types of general solicitation used; and
- the methods used to verify the accredited investor status of investors.

The proposed rule would also require issuers that intend to engage in general solicitation as part of a Rule 506 offering to file the Form D at least 15 calendar days **before** engaging in general solicitation for the offering. Then, within 30 days of completing the offering, the issuer would be required to update the information contained in the Form D and indicate that the offering had ended.

The proposed rule has a 60-day comment period.

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