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Client Alert

Private Equity and Investment Management

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SEC Eliminates General Solicitation Prohibitions for Certain Private Offerings Solely to Accredited Investors

Overview

In a final rule approved yesterday, the Securities and Exchange Commission (SEC) amended Rule 506 of Regulation D to permit issuers utilizing the exemption from registration to engage in general solicitation and general advertising so long as all purchasers are accredited investors (or reasonably believed to be accredited) and the issuer has taken reasonable steps to verify accredited investor status. The final rule amendments allowing for general solicitation and advertising will be effective 60 days following publication in the Federal Register, which is likely to occur within three to ten days from today.

However, the impending elimination of the longstanding prohibition on general solicitation and advertising in Rule 506 offerings has caused many commentators and some of the SEC's commissioners to express concern that investors will no longer be sufficiently protected in such offerings. Therefore, in conjunction with yesterday's final rule, the SEC proposed additional rules that, if approved, would subject issuers that engage in general solicitation and advertising to additional disclosure requirements discussed below, which may discourage the use of general solicitation by some issuers.

Elimination of Prohibition on General Solicitation and General Advertising

From a regulatory perspective, issuers seeking to raise capital through the sale of securities must either register the securities offering with the SEC or rely on an exemption from registration. Historically, the exemptions from registration involving securities sold within the United States prohibited companies from engaging in general solicitation or general advertising. Among other things, general solicitation or advertising has been found by the SEC to include advertising in newspapers or magazines or on television, radio or the Internet and seminars where attendees have been invited by general solicitation or advertising.

According to the SEC, Rule 506 of Regulation D has been the most widely-used exemption from registration. Under the existing Rule 506 exemption, an issuer may raise an unlimited amount of capital from an unlimited number of "accredited investors" and up to 35 non-accredited investors who

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meet "sophistication" requirements so long as the securities are not offered or sold through any form of general solicitation or general advertising. The action taken by the SEC yesterday follows a Congressional mandate under the Jumpstart Our Business Startups Act (JOBS Act) that was enacted in April 2012, which directed the SEC to remove the prohibition on general solicitation and general advertising for securities offerings relying on Rule 506 if (1) sales are limited to accredited investors and (2) the issuer takes reasonable steps to verify that all purchasers are accredited investors.

Therefore, under the SEC's new Rule 506(c), an issuer is permitted to engage in general solicitation or general advertising if:

- the issuer takes reasonable steps to verify that the investors are "accredited investors"; and
- all purchasers of the securities in the offering are accredited investors or the issuer reasonably believes that the investors satisfy the accredited investor requirements at the time of the sale of the securities.

Under SEC rules, accredited investors are individuals who meet certain minimum income or net worth levels or institutions such as trusts, corporations, broker-dealers, charitable organizations and other entities that meet certain minimum asset levels.[1]

Required to Take Reasonable Steps to Verify Accredited Investor Status

While issuers will be able to widely solicit and advertise for potential investors, including through advertisements published in newspapers and magazines, communications broadcast over television and radio and postings on unrestricted websites, in accordance with the terms provided for in the JOBS Act, issuers will be required to take reasonable steps to verify that purchasers of the securities are accredited investors. In other words, there is no restriction on who an issuer may solicit, but an issuer faces restrictions on who is permitted to ultimately purchase its securities and must take reasonable steps to verify such purchasers' accredited investor status in order to comply with the new Rule 506(c). The amendments approved yesterday implement rules proposed by the SEC in August of 2012 to address the JOBS Act mandate, with limited changes arising out of the public comment period on the proposed rules.

For issuers that anticipate utilizing general solicitation and advertising under the new Rule 506(c), it will be critical to establish appropriate procedures to comply with the requirement to take reasonable steps to verify accredited investor status. According to the SEC, the determination of reasonableness of the steps taken to verify an accredited investor should be made by an issuer on a case by case basis in the context of the particular facts and circumstances of each purchaser and the transaction. For example, the SEC has stated that this principles-based approach would include consideration of:

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

The SEC has been clear that there is no uniform or prescriptive way an issuer must establish that it has taken "reasonable" steps, but that the above factors are intended to help issuers assess the likelihood that the purchaser is an accredited investor, which in turn impacts the types of steps that would be necessary to verify accredited investor status. Therefore, the more likely it appears that the purchaser qualifies as an accredited investor, the fewer steps the issuer should have to take to verify status, and vice versa. For example, the SEC has stated that a high minimum investment amount in an offering is likely to lead to a high probability that any potential purchaser that is able to meet the requirement is an accredited investor and fewer, and in some cases no, additional steps to verify accredited investor status may be necessary beyond confirming that the investment is not being financed by a third party. Other types of information that may in and of themselves be considered reasonable verification according to the SEC include:

- confirming accredited investor status by virtue of being a registered broker-dealer by checking FINRA's BrokerCheck website;
- reviewing publicly available information regarding an individual's compensation in regulatory filings (e.g. named executive officer compensation disclosure filed with the SEC in a proxy statement); and
- verification by a third party if the issuer has a reasonable basis to rely on such third party verification.

The SEC has, however, stated that other than as set forth below with respect to prior investors, an issuer will not have taken reasonable steps if the purchaser solely checks a box on a questionnaire stating that it is an accredited investor, absent other information.

Since the verification of accredited investor status for individual investors is likely to provide the most difficulty to issuers given concerns regarding privacy and the disclosure of personal financial information, the SEC has provided a non-exclusive and non-mandatory list of methods that issuers may use to satisfy the verification requirements for individual investors. Therefore, issuers will be deemed to have satisfied the reasonableness requirement with respect to accredited investor status of an individual by using one of the following methods, so long as the issuer has no knowledge that the individual is in fact not accredited:

- *On the basis of income* - reviewing copies of IRS forms for the two previous years that report the income of the purchaser and obtaining a written representation from the purchaser to the effect that it will likely continue to earn income in the current year necessary to satisfy these thresholds;
- *On the basis of net worth* - reviewing (1) one or more of bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties, dated within three months and (2) a credit report from at least one of the nationwide consumer reporting agencies, as well as obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed;
- *Third-party verification* - receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that such entity or person has taken reasonable steps to verify the purchaser's accredited status; and
- *Prior investors* - obtaining a certification by the purchaser at the time of the sale that he or she qualifies as an accredited investor, but only if the individual (1) had previously invested as an accredited investor in a Rule 506

offering of the issuer conducted prior to the effective date of these new rules and (2) remains an investor of the issuer.

The above non-exclusive list, however, is not meant by the SEC to imply that one of these methods must be used, only that if one is used, it will automatically be deemed to be a reasonable verification.

Issuers should be sure to remember that the requirement to take reasonable steps to verify accredited investor status is separate from the requirement that sales be limited to accredited investors and must be satisfied even if all purchasers happen to be accredited investors. Therefore, even if all investors are found to be accredited investors, if the issuer did not take reasonable steps to verify such status, then the offering would not qualify under the new Rule 506(c). Given that it is the issuer's burden to demonstrate it is entitled to an exemption from registration, issuers should retain adequate records regarding the steps they have taken to establish a reasonable basis for an accredited investor determination. Yesterday's rules also amend Form D, which is the notice that issuers must file with the SEC when they sell securities under Regulation D. The revised form adds a separate box for issuers to check if they are claiming the new Rule 506(c) exemption permitting general solicitation or general advertising.

Impact on Rule 506 Offerings Conducted without General Solicitation and on Private Funds

It is important to note, that the existing provisions of Rule 506 will remain available as a separate exemption and are not affected by these amended rules. Issuers conducting Rule 506 offerings without the use of general solicitation or general advertising can continue to conduct securities offerings in the same manner Rule 506 offerings were previously conducted (i.e. unlimited accredited investors and up to 35 non-accredited investors) and are not subject to the new accredited investor verification rule. Furthermore, the SEC has stated that private funds are permitted to engage in general solicitation in compliance with the new Rule 506(c) without losing either of their Section 3(c)(1) or 3(c)(7) exclusions under the Investment Company Act of 1940.

Rule 144A

Furthermore, in addition to the changes made to Rule 506 described above, the SEC also amended Rule 144A so that offers of securities may be made to investors who are not qualified institutional buyers (QIBs) so long as the securities are sold only to persons whom the seller reasonably believes are QIBs. This change, therefore, eliminates the previous requirement that "offers" in a Rule 144A offering only be made to QIBs and allows for general solicitation and advertisement in Rule 144A sales so long as the ultimate purchaser of the security is a QIB.

Additional Proposed Rules

In light of the number of concerns that have been expressed regarding the potential lack of investor protections due to the elimination of the prohibition on general solicitation, concurrently with the approval of the new more lenient general solicitation rules described above, the SEC also proposed additional rules intended to address such concerns and enhance the SEC's ability to assess developments in the private placement market now that the general solicitation prohibition has been lifted. These proposals include:

- requiring issuers to file an advance notice of sale on Form D 15 days before a sale under Rule 506 that utilizes general solicitation;

- requiring an issuer to provide additional information about itself and the offering in the Form D, including the types of investors in the offering, the types of general solicitation used and the methods used to verify accredited investor status;
- disqualifying issuers from using Rule 506 in any new offering for a period of one year if they fail to timely comply with the current Form D filing requirements and those described above;
- requiring issuers to include legends and cautionary statements on any written general solicitation materials, and if the issuer is a private fund and includes information about past performance in its written general solicitation materials, requiring additional information to highlight the limitations on the usefulness of the information and the difficulty in comparing the information to that of other funds;
- a temporary requirement for a period of two years to submit *written* general solicitation materials prepared by or on behalf of the issuer to the SEC by the date of first use (as proposed, such materials would not be available to the general public and would not be commented on by the SEC); and
- extending the guidance contained in Rule 156 under the Securities Act of 1933 regarding when information in sales literature could be fraudulent or misleading for purposes of the federal securities laws to all private funds whether or not they are engaged in general solicitation activities.[2]

Importantly, not only did the SEC propose that Rule 156 regarding fraudulent statements apply to private funds if these rules are adopted, but it stated that its view is that private funds should *now* be considering the principles underlying Rule 156 to avoid making fraudulent statements in their sales literature.

The practical implications of these proposed rules remain to be seen, as the SEC has solicited public comment on a number of items, including, among other things, the appropriateness of the additional requirements described above and whether there are other restrictions on the conduct of offerings and content of solicitation materials that should apply to written general solicitation materials used by private funds.

While there is no guarantee that any of these proposals will be implemented, many of the SEC commissioners have indicated a strong desire to employ additional restrictions to remediate what they believe is a lack of investor protections now that the general solicitation and advertising bans have been lifted. These proposals will now be subject to an initial 60-day public comment period, which could result in substantial changes prior to the adoption of any final rules approved by a vote of the five SEC commissioners.

Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings

At the same meeting, the SEC also approved a "bad actor" rule with respect to Rule 506 offerings that was originally required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. Under the new rule, an issuer is disqualified from relying on a Rule 506 exemption if the issuer or certain covered persons, including, among others, directors, certain officers, general partners, managing members, investment managers, promoters and 20% beneficial owners of the issuer, had a "disqualifying event." The types of events that are considered "disqualifying" include criminal convictions, court injunctions, SEC orders and self-regulatory organization actions that relate to activities such as the purchase or sale of securities, fraudulent or deceptive conduct and false filings. The issuer, however, will not be disqualified if it can show it did not know and, in the exercise of reasonable care, could not have known that a person with a disqualifying event participated in the offering. Disqualification only applies for events that occur after the

effective date of the new rule, but events that occurred before the rule are subject to disclosure to investors. As with the rule amendments relating to general solicitation, the final rule will be effective 60 days following publication in the Federal Register.

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[1] The definition of the term "accredited investor" that is applicable to Rule 506 is set forth in Rule 501(a) of Regulation D and includes any person who comes within one of the definition's enumerated categories of persons, or whom the issuer "reasonably believes" comes within any of the enumerated categories, at the time of the sale of the securities to that person. For entities, the definition includes, among others, banks, broker-dealers, insurance companies, investment companies, employee benefit plans with assets in excess of $5 million and 501(c)(3) organizations with assets in excess of $5 million. For natural persons, Rule 501(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").

[2] Rule 156 prevents registered investment companies from using sales literature that is materially misleading in connection with the offer and sale of securities. The rule provides that sales literature is considered misleading if it (i) contains an untrue statement of a material fact; or (ii) it omits to state a material fact necessary in order to make a statement, in light of the circumstances of its use, not misleading. Rule 156 also provides specific examples of the types of statements in sales literature that could be considered misleading.