

SEC Lifts Ban on General Solicitation in Rule 506 Offerings

On July 10, 2013, the SEC passed a long-awaited rule mandated by the JOBS Act to permit certain private offerings under Rule 506 of Regulation D to be conducted using general solicitation and advertising.¹ This rule as passed did not differ significantly from the SEC's proposed version of the rule issued in August 2012. In addition, the SEC issued two companion releases. One is a final rule to impose certain "bad actor" disqualifications on participants in Rule 506 offerings. The other is a proposed rule that would make significant amendments to Form D filing practices, impose legend and filing requirements for sales literature used in general solicitation offerings and extend certain antifraud rules to cover sales literature of private funds. This memorandum summarizes key provisions of these releases.

The New Rule 506(c) Exemption for General Solicitation Offerings

- **Effective Date:** The new Rule 506(c) exemption becomes effective on September 23, 2013. Until then, issuers conducting Rule 506 offerings should continue to comply with the old-style requirements, which include the prohibition on general solicitation.
- **Transition Offerings:** For offerings started as a conventional Rule 506 offering (now to be called a Rule 506(b) offering) that continue after the effective date of the new rules, an issuer may elect to start soliciting and advertising after the effective date without impairing the exempt status of offers and sales made prior to the effective date in accordance with the conventional Rule 506(b) requirements.
- **Issuers may choose between a 506(b) or 506(c) offering:** An issuer may still elect to conduct its Rule 506 offerings without general solicitation under Rule 506(b) and without having to comply with the heightened requirements for new Rule 506(c) offerings.
- **Private Funds May Conduct 506(c) Offerings without impairing exemptions under Section 3(c)(1) and 3(c)(7) of the Investment Company Act:** Most private equity, venture capital, hedge and other similar funds that are not publicly traded rely on one of two exclusions from the definition of "investment company" set forth in Section 3(c)(1) and 3(c)(7) of the Investment Company Act, both of which are conditioned on the issuer not making or proposing to make a public offering of its securities. The SEC affirmed that private funds may conduct 506(c) offerings without losing the benefit of these exclusions.
- **Primary Differences between Old-Style 506(b) Offerings and New 506(c) Solicitation Offerings**
 - Although unaccredited investors are rarely included in any Rule 506 offering because of the heightened information requirements triggered by their inclusion, an old-style

¹Eliminating the Prohibition Against General Solicitation and Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415; No. 34-69959; No. IA-3624, available at <http://www.sec.gov/rules/final/2013/33-9415.pdf>.

Rule 506(b) offering may include up to 35 unaccredited investors. All purchasers in Rule 506(c) offerings must be “accredited investors,” or “AIs.”

- In a Rule 506(c) offering, an issuer must take “**reasonable steps to verify**” that the purchasers are AIs. This requirement is separate from the requirement that all purchasers be AIs, and failure to comply with it can cause loss of the exemption, even if all purchasers turn out to be AIs.²
- The final rules implementing Rule 506(c) amend Form D to include separate check boxes in which an issuer must indicate whether it is relying on a Rule 506(b) exemption or Rule 506(c) exemption.
- Proposed rules, described below under “**Proposed Changes to Form D, Filing and Information Requirements for Rule 506(c) Offerings and Antifraud Guidance for Private Funds,**” would implement other significant changes regarding Form D filing practices, legend requirements on general solicitation materials, and a requirement that issuers file with the SEC all written general solicitation materials in Rule 506(c) offerings for the first two years after the effective date of the new rule.
- ***Satisfying the “Reasonable Steps to Verify” Requirement—Non-exclusive methods for Individuals:*** The rule provides a non-exclusive list of methods for verifying the AI status of individuals:³
 - For verification based on income, review of tax forms for the two most recent years (such as Form W-2, 1099, K-1, or 1040), along with a written representation that the individual (or couple, if relying on joint income) reasonably expects to reach the requisite income level during the current year.
 - For verification based on net worth, review of one or more of the following documents dated within the prior 3 months, along with a written a representation from the purchaser that all liabilities necessary to make a net worth determination have been disclosed:
 - **Assets:** one or more of the following: bank statements, brokerage statements and other statements of securities holdings, CDs, tax assessments and independent, third party appraisal reports.
 - **Liabilities:** a credit report from one of the nationwide consumer reporting agencies.

²The SEC affirmed its view that that the “reasonable belief” element of the definition of “accredited investor” in Rule 501(a) still applies in the context of all Rule 506 offerings. Thus, in a Rule 506(c) offering, if the issuer had taken “reasonable steps to verify,” and therefore established a “reasonable belief” that an investor was an AI, the issuer would not be denied an exemption if an investor who was not an AI provided false documentation supporting AI status that the issuer had no reason to believe was false.

³The SEC provided the non-exclusive list of verification methods for individuals because it believes “the potential for uncertainty and the risk of participation by non-accredited investors is highest in offerings involving natural persons as purchasers.”

- Obtaining written certification from a registered broker-dealer, SEC-registered investment adviser, a licensed attorney or a licensed CPA that such person or entity has taken reasonable steps to verify within the last 3 months that the investor is an AI and has determined that investor is an AI.
- With respect to subsequent sales by issuers under Rule 506(c) to any existing individual investor who purchased as an AI in a conventional Rule 506 offering of the issuer prior to September 23, 2013, a certification from the investor at the time of any additional of sale of securities under Rule 506(c) that the investor qualifies as an AI.
- **General Approach for Satisfying the “Reasonable Steps to Verify” Requirement for Non-Individuals:** Although the “reasonable steps to verify” requirement applies to all purchasers in a Rule 506(c) offering, the SEC provided little specific guidance as to how this requirement will be met for non-individual investors. As to all purchasers, including individuals (subject to the option to use one of the non-exclusive listed methods of verification), the SEC states that the reasonableness of the verification approach will be an “objective determination” based on facts and circumstances of the purchaser and transaction and suggests that verification should be a principles-based approach in light of considerations such as:
 - the nature of the purchaser and type of accredited investor the purchaser claims to be;
 - the amount of information the issuer has about the purchaser; and
 - the nature of the offering, such as the manner in which the purchaser was solicited and the terms of the offering, such as a minimum investment amount.

Using factors such as those described above, the SEC suggests a sliding scale-type approach, where the more information the issuer has about the investor or the offering that would support the reasonable belief that an investor was an AI (e.g., purchaser is an institutional investor, or the minimum investment amount is so high that only accredited investors would likely be to be able to participate), the less the issuer would have to do in order to satisfy the “reasonable steps to verify” requirement.

- **Mere Check-Off Insufficient:** The SEC retained language from the proposing release stating its view that, absent additional information about the purchaser indicating AI status, merely having the purchaser check a box on a questionnaire regarding its status would not constitute reasonable steps to verify. It remains to be seen how market practices will evolve in this regard given the prevalence of the check-box questionnaire as a common method of substantiating AI status.
- **No New Guidance on What Constitutes General Solicitation and Advertising:** The SEC provided no new guidance on what constitutes “general solicitation or general advertising.” The release simply referred to the existing list of examples in Rule 502(c) under Regulation D (e.g., advertisements in newspapers and magazines, radio and TV communications) and subsequent SEC guidance discussing certain uses of electronic media that constitute general solicitation, such as unrestricted websites.⁴ Because of the need for an issuer to know

⁴ See Release No. 33-9415 at pp. 6-7 and footnotes referenced therein.

whether it will be required to comply with the more stringent Rule 506(c) requirements, and because of proposed changes to Form D discussed below that would require issuers utilizing a Rule 506(c) offering to file a Form D no later than 15 days *in advance* of the first use of general solicitation in a Rule 506(c), it will be important for issuers and their advisors to analyze what types of marketing activities constitute general solicitation and coordinate the commencement of these activities so as not to run afoul of any filing or compliance requirements.

Final Rules Disqualifying Exemption under Rule 506 for Offerings involving “Bad Actors”

In a related release,⁵ the SEC issued final rules mandated by Dodd-Frank to exclude an issuer from relying on Rule 506 if the issuer or various affiliated parties and offering participants⁶ have been subject to various specified disqualifying events, such as criminal convictions, securities-related felonies and misdemeanors, injunctions, regulatory suspensions or bars and similar events.⁷ In a significant change from the proposed version of these rules, the disqualification will apply only to triggering events that occur after the effective date of the rule (September 23, 2013). However, pre-existing triggering events will be subject to mandatory disclosure. This rule will likely necessitate new diligence requirements for some issuers in advance of a Rule 506 offering, such as the distribution of D&O-type questionnaires to affiliates and offering participants to confirm that it is not disqualified from using Rule 506.

Proposed Changes to Form D, Filing and Information Requirements for Rule 506(c) Offerings and Antifraud Guidance for Private Funds⁸

- ***Significant changes to timing, content and disqualification requirements regarding Form D filings:*** In a tandem *proposed* rule release,⁹ the SEC proposed significant changes to Form D filing practices in light of the new final rules permitting general solicitation offerings under Rule 506(c). Specifically, the proposals would require:
 - ***New “Advance Form D” Filing for 506(c) Offerings:*** An issuer intending to use Rule 506(c) would file an Advance Form D 15 calendar days prior to the first general

⁵ Disqualification of Felons and other “Bad Actors” From Rule 506 Offerings, Release No. 33-9414, available at <http://www.sec.gov/rules/final/2013/33-9414.pdf>.

⁶ The actors who can trigger the disqualification include the issuer; any predecessor of the issuer; any affiliated issuer; any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer’s outstanding voting equity securities, calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of such sale; any investment manager of an issuer that is a pooled investment fund; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; any general partner or managing member of any such investment manager or solicitor; or any director, executive officer or other officer participating in the offering of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor.

⁷ The full list of disqualifying events is specified in new Rule 506(d) at pp. 142-145 of the release.

⁸ For purposes of these proposals, a “private fund” is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for the exclusions from the definition of “investment company” in Section 3(c)(1) or Section 3(c)(7) of that Act. Most private equity, venture capital, hedge and other similar funds that are not publicly traded rely on these exclusions and are thus “private funds” under these proposals.

⁹ Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Release No. 33-9416; Release No. 34-69960; Release No. IC-30595, available at <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>.

solicitation in the offering. The existing rule requires applicable Form D filings be made within 15 calendar days after the first sale of securities in the offering. The existing 15-day post-sale filing requirement would be retained for Rule 506(b) offerings and 506(c) offerings in which all the required information was not provided in an earlier Form D filing.

- ***New “Closing Amendment” Filing for all 506 Offerings:*** A closing amendment to a Form D would be filed within 30 calendar days after termination (meaning either the last sale in or abandonment of an offering) of a Rule 506 offering, whether conducted under Rule 506(b) or (c).¹⁰
- ***More Extensive Information in Form D filings:*** More extensive information about the offering and in some cases, offering participants and their affiliated parties, would be required in new Form D items. These new items would include, among others: (1) a listing in Rule 506(c) offerings of each person who directly or indirectly controls the issuer; (2) a breakdown in all Rule 506 offerings of the number of purchasers who qualify as AIs based on the particular category in Rule 501(a) in which the purchaser qualifies (e.g., income, net worth, etc.); (3) a listing in Rule 506(c) offerings of all types of general solicitation used or to be used; and (4) a listing in Rule 506(c) offerings of the methods used or to be used to verify the AI status of purchasers.
- ***Stricter Disqualification Standards based on Form D Noncompliance:*** An issuer would be disqualified from relying on Rule 506 for one year if the issuer, any predecessor or an affiliate of the issuer did not comply with all applicable Form D filing requirements. Unlike existing Rule 507, which imposes disqualification only if the issuer has been subject to court action for failure to comply, the new disqualification would be self-executing and apply simply based on the issuer’s failure to comply. Only non-compliance after effectiveness of the proposed rules would trigger a disqualification, so that an issuer would not have to look back past that effective date to assess compliance.¹¹ The disqualification would also be subject to a single 30-calendar day cure period per offering in which the issuer could file one delinquent Form D or amendment required for a particular offering without becoming subject to the disqualification. The SEC would also retain provisions permitting issuers to seek waiver of the disqualification upon showing of good cause. Like current Rule 507, the disqualification would apply only to future offerings and not affect the exemption for the offering in which the non-compliance occurred. The one-year disqualification period begins to run only after the issuer has caught up on all delinquent Form D filings.
- ***Legend and Filing Requirements for Sales Literature:*** The proposed rules would also require all issuers to include certain legends on all written materials used in Rule 506(c)

¹⁰The closing amendment would not be required if a previously filed Form D contained all information required to be included in the closing amendment and indicated that it was the closing amendment.

¹¹Under the proposed rule, the issuer would eventually be subject to disqualification based on filing noncompliance that occurred during the preceding 5 years. However, in light of the transition aspect of the rule that imposes disqualification for noncompliance that occurs only after the effective date of the new rules, the 5-year look back will be prospective starting with the effective date of the new rules.

general solicitations¹² and additional legends and disclosures in any private fund written general solicitation materials that include performance data.¹³

- ***Filing of Rule 506(c) Written General Solicitation Materials with the SEC:*** The proposals would also require, for the first 2 years following the effective date of the proposed rule, that all issuers conducting a Rule 506(c) offering submit to the SEC, prior to their first use, any “written communication that constitutes a general solicitation or general advertising.” Although not entirely clear, the wording of the proposed rule suggests that underlying sales materials, such as private placement memoranda, which are privately provided to prospective investors who indicate interest after being generally solicited, would not have to be filed, provided that this literature is not so broadly disseminated as to itself constitute a general solicitation. The general solicitation materials would be submitted through a newly established SEC intake portal and would not be available publicly through the SEC’s EDGAR filing system. These materials also would not be deemed “filed” or “furnished” for purposes of Securities Act and Exchange Act liabilities. An open question is whether these materials could be obtained through a Freedom of Information Act request. The SEC’s stated purpose in proposing this requirement is to allow it to assess market developments and practices following the effectiveness of new Rule 506(c).
- ***Amendments to Rule 156 to Apply to Sales Literature of Private Funds:*** Current rule 156 is an elaboration on the general antifraud rules under the Securities Act and Exchange Act, including Rule 10b-5, that applies to sales literature of investment companies and contains various examples of statements and representations in such sales literature that could be deemed misleading, such as unqualified representations regarding past or future performance, portrayals of past results that may expressly or impliedly convey misleading inferences about past or future results, exaggerated or unsubstantiated claims about management skills or techniques and similar statements. Proposed amendments to Rule

¹²The general legend required on any written Rule 506(c) general solicitation literature would have to include the following statements: (1) The securities may be sold only to “accredited investors,” which for natural persons are investors who meet certain minimum annual income or net worth thresholds; (2) The securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act; (3) The Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials; (4) The securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and (5) Investing in securities involves risk, and investors should be able to bear the loss of their investment.

¹³ Private funds relying on Rule 506(c) would have to provide a legend disclosing that the securities offered are not subject to the protections of the Investment Company Act. If the solicitation includes performance data, the following additional disclosure requirements would apply: (1) a legend disclosing that the performance data represents past performance; that past performance does not guarantee future results; that current performance may be lower or higher than the performance data presented; that the private fund is not required by law to follow any standard methodology when calculating and representing performance data; and that the performance of the private fund may not be directly comparable to the performance of other funds. The legend should also identify either a telephone number or a website where an investor may obtain current performance data; (2) all performance data must be as of the most recent practicable date considering the type of private fund and the media through which the data will be conveyed, and the private fund must disclose the period for which performance is presented; and (3) if the performance presentation does not include the deduction of fees and expenses, the private fund must disclose that the presentation does not reflect the deduction of fees and expenses and that if such fees and expenses had been deducted, performance may be lower than presented.

156 would extend the coverage of these antifraud guidelines to sales literature of private funds, whether or not used in a Rule 506(c) general solicitation.

- ***Coordination issues with Final Rules Authorizing Rule 506(c) Offerings:*** It remains to be seen how market practices with regard to Rule 506(c) offerings may develop during the interim period between September 23, 2013, when Rule 506(c) offerings will technically be permissible under the final rules, and finalization of the proposed rules regarding Form D filings and other informational requirements relating to Rule 506(c) offerings, for which the comment period will expire on September 23, 2013. Given the implicit and explicit statements in the proposed release that the Form D and related informational reforms are intended to monitor and curb potential abuses arising from the liberalization of offering practices under Rule 506(c), issuers may be best served by proceeding cautiously during this interim period until additional guidance is provided regarding the coordination and potential application of these proposed requirements to Rule 506(c) offerings conducted prior to finalization of the proposed rules.

Observations

Although removal of the ban on general solicitation in Rule 506 offerings may dramatically alter market practices, these rules, along with related rule proposals, may impose significant complexities, uncertainties and compliance responsibilities on issuers, such as the proposed requirements to file a Form D 15 calendar days prior to a contemplated general solicitation, provide more extensive information in Form D and file all written general solicitation materials with the SEC prior to first use. Satisfying these requirements will require discipline and foresight and may prove incompatible to some extent with the certainty, spontaneity and relative privacy associated with current private offering practices. Each issuer will need to carefully assess whether availing itself of a general solicitation offering is worth these costs and the heightened profile an issuer may assume on federal and state securities regulators' radar as the result of these requirements. Because general solicitation offerings will not be permitted until September 23, 2013 at the earliest, and because old-style Rule 506 offerings are still available using familiar practices, issuers may want to see how developments, final rules and interpretations and market practices unfold before embarking on a general solicitation offering.

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July 24, 2013

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