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SEC Relaxes Ban on Advertising and Solicitation for Private Placements to Accredited Investors

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In a watershed event reversing decades of private offering restrictions, on July 10, 2013, the Securities and Exchange Commission (SEC) approved final rules required by the Jumpstart Our Business Startups Act of 2012 (JOBS Act), eliminating the prohibition against "general solicitation and general advertising" in certain securities offerings conducted pursuant to Rule 506 of Regulation D and Rule 144A under the Securities Act.[i] The final rules, which arrived almost a year after the enactment of the JOBS Act and nine months after the deadline dictated by Congress, were politically controversial from the start, with business interests favoring minimal restrictions in order to facilitate capital raising, and securities regulators and shareholder watchdog groups favoring tighter restrictions in order to enhance investor protection.

One of the core legal underpinnings of the federal securities laws is the principle that issuers seeking to raise capital through the sale of securities must either register the securities with the SEC or rely on one of a number of enumerated exemptions from registration. Registration of an offering is time-consuming and expensive – an initial public offering can easily cost the issuer more than a million dollars in accounting, legal and other transaction expenses, not to mention the steep ongoing expenses of ongoing SEC reporting, financial statement audits and internal control audits.

The most frequently used exemptions from registration – so-called "private placements" – require the issuer to have a pre-existing business relationship with offerees and investors and prohibit issuers from engaging in general solicitation or general advertising in order to obtain investors. Regulation D, adopted in 1982, includes three separate exemptive provisions. Generally speaking, Rule 504 limits investment to $1 million in any 12-month period and Rule 505 limits investment to $5 million in any 12-month period, while Rule 506 has no limit on the amount of investment. Historically, Rule 506 has been available only for offers and sales to investors that are either accredited or that have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment. Rule 506 of Regulation D is the most widely-used exemption from registration.

General Solicitation and General Advertising for Private Placements to Accredited Investors

As mandated by the JOBS Act the SEC removed the prohibition on general solicitation or general advertising for securities sold to accredited investors through the adoption of new Rule 506(c), which allows general solicitation and general advertising, provided that:

- the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors, and
- all of the ultimate purchasers of the securities are accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors, or the issuer reasonably believes that they do, at the time of sale.

For purposes of Regulation D, an accredited investor is defined as, among other qualifications, an individual who has income of at least $200,000 in each year of the last two years (or $300,000 together with his or her spouse if married) and has the expectation to make the same amount in the current year, or a $1 million net worth excluding the value of his or her primary

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residence. In addition, various types of business entities, public charities, retirement plans and other large organizations with at least $5 million in assets qualify as accredited investors. By requiring the SEC to remove the prohibition against general solicitation and general advertising, Congress sought to make it easier for a company to find investors and thereby raise capital, and Congress sought to prevent any adverse impact on investors by limiting this relaxation of the rules to sales to accredited investors, who are considered to be able to "fend for themselves."[ii]

Although the securities laws do not define "general solicitation and general advertising," Regulation D includes examples of what types of activities would be included, such as 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. The SEC has also indicated that solicitation or advertising through an open Internet Web site also constitutes general solicitation or general advertising.

The new rules bifurcate Rule 506 into two exemptions. The legacy version of Rule 506 (now renumbered as Rule 506(b)), permits offers and sales to accredited investors or to non-accredited investors who are financially sophisticated, but does not permit general advertising or general solicitation. As under the current rules, if any sales are made to non-accredited investors under new Rule 506(b), a disclosure document must be provided to them. New Rule 506(c) permits general advertising or general solicitation and does not place any limits on who can receive offers of the securities, but requires that *sales* must only be made to accredited investors.[iii] Rule 506(c) does not limit the type or extent of general solicitation or general advertising permitted. One can imagine securities offerings being advertised on television, on Internet banner ads, on the sides of buses, and "on the subway walls and tenement halls."[iv]

Other than eliminating non-accredited, financially sophisticated investors from the possible pool of investors, the price of general advertising and general solicitation under Rule 506(c) is not steep. Although the JOBS Act's imposition of the requirement that an issuer take "reasonable steps to verify that the purchasers of the securities are accredited investors" created consternation among securities professionals, the fact is that Regulation D has always implicitly required issuers to ensure that accredited investors in a Rule 506 offering were indeed "accredited." The historical definition of accredited investor in Regulation D, which has not been changed as a result of the new rules, requires that the investor fall within any one of a number of enumerated categories, or that the issuer "reasonably" believe that the investor comes within one of such categories. Accordingly, issuers pursuing Rule 506 offerings have always been implicitly required to perform a certain amount of due diligence to establish the reasonableness of the issuer's belief that investors who claimed to be accredited were indeed so.

In order to take advantage of the liberalized advertising and solicitation permitted under Rule 506(c), it is no longer sufficient that the investors merely be accredited – now there is an affirmative requirement that the issuer take "reasonable steps to verify that the purchasers of the securities are accredited investors." The specific steps required to be taken are not dictated by the new rules; instead, the reasonableness of the steps taken turns on the objective assessment of the issuer. However, the final rules do set forth a non-exclusive and non-mandatory list of methods that are deemed to satisfy the verification requirement for purchasers who are natural persons,[v] including:

- documentation of income, such as through a review of the last two years' income tax returns
- documentation of net worth, such as through a review of bank and brokerage statements for assets and a credit report for liabilities
- third-party verification of accredited status from a broker-dealer, certified public accountant or attorney, and
- reliance on written verification from an existing investor who previously purchased securities in the issuer's Rule 506 private placement before the effectiveness of the new rules, where the investor continues to hold the previously purchased securities.[vi]

In addition to the foregoing, issuers may verify the accredited status of Rule 506(c) investors in any other reasonable manner that they select. The SEC discusses various other available methods, including a review of an SEC or other governmental filing listing the investor's annual compensation, or a review of pay stubs. Alternatively, if the amount of the investment is very high, such that only accredited investors would reasonably be expected to make such an investment, and the investor certifies that the investment is not being financed by a third party, this could be taken into account in determining that the investor is accredited. Conversely, merely having the investor check the "accredited

investor" box on a questionnaire would not alone be a sufficient basis to demonstrate that the issuer has taken "reasonable steps" to verify the investor's accredited status.

As a transition matter, the SEC has indicated that issuers that commenced a private placement under Rule 506 before the effectiveness of new Rule 506(c) may commence using general solicitation and general advertising in the same ongoing offering after the new rules take effect without affecting the validity of the exemption for prior offers and sales, even though the prior offers and sales may have been to non-accredited investors. Of course, any sales after commencement of general solicitation and general advertising must be made only to accredited investors.

Bad Actor Disqualification

The SEC also approved final rules to disqualify securities offerings involving certain felons and other "bad actors" from reliance on the exemption from Securities Act registration pursuant to Rule 506 as mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. If such "bad actors" (which, importantly, now include investment managers and principals of private investment funds) are the subject to certain "disqualifying events," then they will disqualify an issuer from relying on Rule 506. Disqualification will not arise as a result of triggering events that occurred before the effective date of the rule; however, matters that existed before the effective date of the rule and would otherwise be disqualifying are subject to a mandatory disclosure requirement to investors.

Proposed Form D Amendments

Finally, the SEC proposed certain amendments to Regulation D, Form D and Rule 156 under the Securities Act (Rule 156 prohibits fraudulent and misleading statements in investment company sales literature). The proposed amendments are intended to enhance the SEC's ability to evaluate changes in the market and to address the development of practices in Rule 506 offerings. The SEC proposed amendments to Form D that would require additional information from issuers, *i.e.*, the types of general solicitation used and the methods used to verify the accredited investor status of investors.

An issuer relying on new Rule 506(c) would also be required to file a Form D with the SEC no later than 15 days *prior* to commencing a Rule 506(c) offering – and an amended Form D within 30 days *following* the completion of the offering. The SEC also proposed disqualifying issuers from relying on Regulation D for one year if they fail to file Form D. Additional legends and disclosures would be required in all offering materials relying on Rule 506(c).

In addition, the SEC is proposing on a temporary basis (expiring two years after the effective date of the rule) that an issuer relying on Rule 506(c) would be required to file all general solicitation materials with the SEC. This echoes FINRA's new Rule 5123, which requires broker-dealers to report and upload offering materials after acting as placement agent for a private placement to individual investors.[vii] Under the proposed rules, guidance under Rule 156 under the Securities Act 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 would be extended to the sales literature of private funds. Importantly, this provision would apply to all private funds whether or not they are engaged in general solicitation activities.

Pepper Points

The final rules adopted July 10 become effective 60 days after their publication in the *Federal Register* (mid-September 2013). The proposed Form D amendments are now open for comment for 60 days.

- The new rules provide a wake-up call for issuers to take a close look at their accredited investor verification methods and related record retention processes. Robust due diligence in validating accredited investor status, and the ability to locate the records in the future when an investor or the SEC challenges the transaction, will be critical in Rule 506(c) offerings.
- Notwithstanding the "public" nature of the general advertising and general solicitation that may be used in Rule 506(c) offerings, the securities will still be considered "restricted securities" sold in a private offering and may not be sold absent a subsequent registration or exemption, such as Rule 144 under the Securities Act. Accordingly, such securities may not be resold publicly (such as on a stock exchange or in the over-the-counter market) for at least six months.
- Rule 506(c) has received a great amount of press coverage as the "hedge fund advertising rule" since hedge funds, private equity firms and other asset management firms and investment advisors rely on Regulation D for subscriptions. Look for some of these funds to be more aggressive in Web site development and client outreach.

- It remains to be seen how the SEC envisions equity crowdfunding co-existing in a Rule 506(c) world. Crowdfunding, which was authorized by Congress under the JOBS Act and which awaits implementing rulemaking by the SEC, is separate and distinct from the private placement / Regulation D world. Theoretically, one could advertise under Rule 506(c) while engaging in a contemporaneous crowdfunding offering, and then select the exemption that best suits the transaction. If all prospective investors are accredited, the issuer could complete the offering under Rule 506(c). If some prospective investors are not accredited, the issuer could complete the offering as crowdfunding offering. Nevertheless, this flexibility does have its limits. Under the JOBS Act, crowdfunding would permit an issuer to sell up to $1 million in securities per year, and the amount invested by each investor would be limited based on the investor's annual income and net worth, ranging from a maximum investment of $2,000 to a maximum investment of $100,000. A crowdfunded capital raise has several additional requirements as well, including the filing of a disclosure document with the SEC, the furnishing of the disclosure document to investors at least 21 days prior to first sale, and the requirement to use a broker-dealer or funding portal. As a result of these procedural requirements, it would be impractical for an issuer to run a Rule 506(c) private placement and crowdfunding round concurrently. See our prior Client Alert, "*The Trouble With Crowdfunding*," at http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2615.
- The SEC has yet to publish rules regarding another JOBS Act darling, commonly dubbed "Regulation A+," which increases the "small offering exemption" from $5 million to $50 million. Depending on the complexity and expense involved in a Regulation A+ offering, as will be revealed when the SEC eventually completes its rulemaking on this topic, issuers may prefer to pursue a Regulation A+ offering than a Rule 506(c) offering. The benefits of a Regulation A+ offering are that the securities sold will not be restricted securities and may be freely resold, and the offering will be preempted from substantive review under state securities laws (also known as "blue sky laws") if the securities will be listed on a national securities exchange.
- As a consequence of the new rules, an issuer that commences a Rule 506(c) offering using general solicitation or general advertising may, without any delay, subsequently file a registration statement with the SEC to convert the offering to a registered public offering to accredited investors only, if the issuer decides that market conditions are ripe for such a public offering. Time will tell if the SEC will consider amending existing rules to permit an analogous conversion of an abandoned registered public offering to a Rule 506(c) private placement offering to accredited investors without delay.[viii]
- In the final version of the bad actor disqualification rule, the SEC limited the scope of bad actors to the executive officers of the issuer and of any compensated solicitor of purchasers of securities and any officers of those entities participating in the offering. This significantly reduces the work of the investment banking compliance community, which had been concerned that the previous formulation of "any officer" would require the polling of personal data of thousands of bank employees who have officer titles (*e.g.*, Vice President, Director, Managing Director), most of whom would not be working on or even be aware of the private placement. As a practical matter, any registered representative of a FINRA-regulated broker-dealer who has committed any disqualifying act would most likely have such act as disclosed on their Central Registration Depository, or CRD. CRD records can be obtained from the FINRA brokercheck website, http://brokercheck.finra.org. The SEC did address the *ex post facto* argument by disqualifying only those bad actors who commit *future* bad acts, but the disclosure of past disqualifying acts effectively punishes the bad actor for past transgressions in the same manner as if the SEC had set an outright ban.
- The list of disqualifying acts in the bad actor disqualification is limited to "financial" bad acts. Violent non-financial bad acts and felonies (*e.g.*, murder, rape) do not exclude someone from participating in a Rule 506 private placement, it turns out.

Endnotes

i Rule 144A is an exemption permitting the resale of securities by existing securityholders to large financial institutions, including institutions owning more than $100 million in investment securities, which are defined as "Qualified Institutional Buyers," or "QIBs." The SEC amended Rule 144A by permitting offers to be made to anyone, such as through general solicitation and general advertising, provided that only QIBs purchase securities in the offering.

ii *SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S. Ct. 981 (1953). This hallmark U.S. Supreme Court case established that wealthy or financially sophisticated investors are considered to be less vulnerable in making investment decisions and thus qualify to participate in private placement offerings.

iii If a broker-dealer or placement agent is involved in the offering, it will remain subject to applicable FINRA regulations requiring that all public advertising concerning a securities offering must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. FINRA Rule 2210.

iv Paul Simon and Art Garfunkel, *The Sound of Silence* (Columbia Records 1965).

v The new rules do not provide any examples of verification procedures for investors that are entities.

vi Current Rule 506 private placements will continue under new Rule 506(b), which permits an unlimited amount of proceeds to be raised from an unlimited number of accredited investors and up to 35 non-accredited investors, provided that if any sales are made to non-accredited investors, a disclosure document must be provided to them.

vii See our prior Client Alert, *Investment Banks and Other Broker-Dealers Required to Make Private Placement Filings Under New FINRA Rule 5123*, http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2529.

viii Rule 155 under the Securities Act provides for a public-to-private and private-to-public integration safe harbor which includes a 30 day cooling-off period as well as additional procedural requirements.

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