



Adoption of New Rule 506(c): General Solicitation in Regulation D Offerings

On July 10 the SEC complied with a mandate in the JOBS Act of 2012 to permit “general solicitation” in private securities offerings. In doing so, the SEC created an entirely new type of securities offering not required to be registered under the Securities Act of 1933. The SEC also adopted rules preventing “bad actors” from participating in private offerings, and proposed for public comment changes to Regulation D and Form D under the Securities Act that are intended to increase investor protection.

Offerings of securities in the United States must be registered with the SEC under the Securities Act or made in compliance with an exemption from registration. Rule 506, part of Regulation D under the Securities Act, is the most used exemption from registration of securities in the United States. The SEC estimates that in 2012 \$899 billion was raised in transactions claiming the Rule 506 exemption.

New Rule 506(c) Adopted

The SEC voted to adopt amendments to Regulation D under the Securities Act to add new Rule 506(c). Rule 506(c) offerings are technically private placements, made only to “accredited” investors.¹ In the past this has meant not just that accredited investors only could buy the securities, but also that the issuer could offer them to accredited investors only.

Under the new rule, small companies and private investment funds and their intermediaries will be able to use “general solicitation” to reach accredited investors, which means they may advertise or publicize an offering on television, in newspapers, and most importantly over the internet. They may talk about the offering on talk shows and webinars, and they may promote the offering on social media. In doing

¹ Accredited investors include, in general, people with a net worth (excluding their residence) of \$1 million, income of \$200,000 a year (or \$300,000 with their spouse), officers and directors of the issuer and various institutions that have more than \$5 million in assets. The SEC is considering revising these standards, although it cannot make any revisions until July 2014.

so, however, they will be subject to the anti-fraud provisions of the federal securities laws, which prohibit misleading statements. If the proposals discussed below are adopted, the materials used in general solicitation (which is a very broadly defined concept, including most attempts to condition market interest in an offering) will also be subject to legending requirements.

The JOBS Act required the SEC to remove the prohibition on “general solicitation or general advertising,” which has been part of Regulation D since its adoption in 1982, so long as the purchasers in an offering were all accredited. The way the SEC has implemented this legislative mandate means that there will now be two different types of offering under Regulation D’s Rule 506:

- Traditional Rule 506(b) offerings, which cannot use general solicitation, but in which up to 35 non-accredited investors can participate so long as they are provided with extensive information about the issuer of the securities, usually in the form of a private placement memorandum or PPM; and
- New Rule 506(c) offerings, which can use general solicitation, but must be sold to accredited investors only, in which the market will let investors dictate the type of information that they need in order to make informed investment decisions.

The JOBS Act directed the SEC to lift the prohibition on general solicitation provided that all purchasers of the securities were accredited investors and the issuer took “reasonable steps to verify” that the purchasers were accredited, “using such methods as determined by the Commission.” In its initial proposal the SEC declined to specify even a non-exclusive list of such methods, on the grounds that this would inhibit flexibility in the markets. However, in the final rule the SEC provided more clarity and established a principles-based method of verification that expects issuers to look at, among other things:

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

The SEC makes clear that the issuer should look to the facts and circumstances surrounding the offer and the issuer’s relationship with the investor, and that what will be required to constitute “reasonable steps” will change based on the circumstances. For example, offerings with high minimum cash

investments might require less additional investigation than offerings with lower minimums, provided there are no facts to indicate that a third party is financing the purchase.

The SEC also provided a non-exclusive list of methods the issuer could use to verify that a natural person meets the accredited investor requirements of 506(c). These methods are:

- If verifying whether a purchaser qualifies on the basis of income, the issuer may use IRS records that report income (e.g., a Form W-2, Form 1099, etc.) for the purchaser for the two most recent years, along with written representation from the purchaser that they have a reasonable expectation that they will meet the income requirement this year as well.
- If verifying whether a purchaser qualifies on the basis of net worth, the issuer may use bank statements, brokerage statements, other statements of security holdings, certificates of deposit, tax assessments and appraisals provided by independent third parties, provided the records are no more than three months old. The issuer must also use a credit report to assess the purchaser's liabilities. The issuer must also get written representation from the purchaser that all liabilities necessary to make a net worth determination have been disclosed.
- The issuer may rely on written confirmation from a third party that the third party has taken reasonable steps to verify the purchaser's accredited status. The SEC specifically named broker-dealers, CPAs, attorneys, and SEC-registered investment advisers as acceptable third parties, but also stipulated that other third parties could be acceptable provided they take reasonable steps to verify that purchasers are accredited and the issuer has a reasonable basis to rely on that verification.
- Finally, purchasers who invested in the issuer in a previous 506(b) offering as an accredited investor and remains an investor in the issuer's 506(c) raise is deemed to satisfy the verification requirements if the issuer obtains certification from the purchaser that they qualify as an accredited investor at the time of sale.

While the SEC provided these four methods as a non-exclusive safe-harbor, the Commission was clear that these methods would not satisfy the verification requirement if the issuer or its agent has knowledge that the purchaser is not an accredited investor.

Proponents of Rule 506(c) offerings believe that they will increase transparency, make it easier for small companies to raise capital and decrease companies' administrative costs. Opponents argue that Regulation D was already a successful capital-raising mechanism (a recent study by the SEC showed a

vibrant Regulation D market raising up to a trillion dollars in over 15,000 offerings a year, mostly in offering sizes under \$1 million). They also worry that, in the words of Commissioner Aguilar at the meeting at which the new rules were first proposed, removal of the prohibition on general solicitation would be “a boon to boiler room operators, Ponzi schemers, bucket shops, and garden variety fraudsters, by enabling them to cast a wider net, and making securities law enforcement much more difficult.”

Rule 506(c) presents opportunities and threats. Contacting a broader range of investors will become easier, and thus more offerings can be made and more investors can enter the market. This will combine with the opportunities already presented by the internet to present investment opportunities on a more cost-effective basis, without using an extensive (and expensive) PPM. More intermediaries may enter the market. But as the SEC pointed out in the release proposing the rules:

. . . eliminating the prohibition against general solicitation could make it easier for promoters of fraudulent schemes to reach potential investors through public solicitation and other methods not previously allowed. This could result in an increase in the level of due diligence conducted by investors in assessing proposed Rule 506(c) offerings and, in the event of fraud, would likely lead to costly lawsuits . . .

This increased awareness of potential fraud may mean that companies need to do more to establish their legitimacy and that intermediaries will seek to provide meaningful due diligence to distinguish themselves from their competitors. Moreover, liability under the securities laws for misstatements, both for issuers and their intermediaries, has not changed. Any person who makes an untrue statement of a material fact, or omits to state a material fact necessary in order to make the statements that are made not misleading, violates the anti-fraud provisions of securities law. This is true whether the statement is intentional or made recklessly. It is easy to imagine how an entrepreneur might make a thoughtless or overoptimistic statement with respect to his or her company in the informal context of social media. Space-constrained media like Twitter will pose particular challenges to presenting a balanced picture of the investment opportunity.

Will the rule change mean that we see hedge funds advertising on late-night TV or Twitter campaigns for investments in startups? The impact of the new rule is likely to be more limited in that respect than some have predicted. Public registered mutual funds do advertise, but those advertisements tend to be staid and contain lots of “fine print” disclaimers prescribed by law; private funds will likely be just as

constrained. Broker-dealers putting together Regulation D deals are already subject to FINRA rules with respect to their advertising and social media use, and these requirements have not changed. The anti-fraud laws discussed above should have a tempering effect on any overly-exuberant publicity attempts in either paid or social media.

And the SEC will be watching. The SEC has established a “Rule 506(c) Work Plan” involving staff from all across the SEC, who will monitor the new Rule 506(c) market for fraud and compliance and to coordinate with state regulators.

The effective date for the new rule will be in mid-September, 2013.² Rule 506(c) offerings will only be legal after that effective date. The SEC views “gun-jumping” very harshly.

Proposed Changes to Regulation D, Form D and Rule 156

In the interests of investor protection, the SEC proposed the following changes:

- Requiring the filing of a Form D in Rule 506(c) offerings at least 15 days before the issuer engages in general solicitation (an Advance Form D). Form D is currently filed no more than 15 days after the first sale of securities in a Regulation D offering.
- Requiring a closing amendment to Form D within 30 days after the termination (final sale or abandonment) of any Rule 506 offering.
- Expanding the content of Form D to include website address, information about controlling persons of the issuer, the issuer’s type of business, issuer size, whether the filing is an Advance Form D or a closing amendment, securities identifier, information about the type of investor, and use of proceeds. New items would be added to the form to cover number and types of accredited investor, trading venue, whether a broker-dealer filed general solicitation materials with FINRA, identity of investment adviser (for pooled investment vehicles), the types of general solicitation to be used in 506(c) offerings, and the methods to be used for determining accredited status in 506(c) offerings.
- Requiring written general solicitation material used in Rule 506(c) offerings to include specified legends and other disclosures. Private investment funds would need to use a special legend disclosing that the investors are not provided the protection of the Investment Company Act of

² 60 days after publication in the Federal Register, which has not yet occurred.

1940. Failure to use the proposed legends would lead to a disqualification from future Rule 506 offerings.

- On a temporary basis, requiring issuers to submit written general solicitation materials used in Rule 506(c) offerings to the SEC for the SEC to monitor what sort of communications are being used. The SEC will not make a formal review of these materials, and submission is not a condition to the validity of the offering but non-compliance might lead to unavailability of Rule 506 for future offerings. The materials are not formally “filed” with the SEC and will not be available to the public. Submission would be via an “intake page” on the SEC website.
- Disqualifying an issuer from relying on Rule 506 for one year if it has not complied, within the last five years, with the Form D filing requirements in a Rule 506 offering.
- Amending Rule 156, which interprets the anti-fraud provisions of the securities laws in connection with sales communications used by investment companies, to apply to private funds and to mandate additional manner and content restrictions on general solicitation materials used by private funds. The SEC states that private funds “should now be considering the principles underlying Rule 156 to avoid making fraudulent statements in their sales literature” and that private funds are just as much subject to the anti-fraud provisions of the law as investment companies are.

Two points that might not be evident to non-securities lawyers:

- “Written communications” under the securities law include videos, TV appearances, webcasts, website content, Tweets, Facebook posts and recorded songs about the offering. Anything digital or broadcast. (Rule 405 under the Securities Act.)
- “General solicitation” is very broad concept and includes any attempt to create a market for the securities being offered.

The SEC stated that it needed further consideration following experience with offerings under the new rule before imposing any content restrictions on general solicitation materials, which several commentators had urged the SEC to adopt.

The additional filing requirements are not particularly burdensome, and the legending requirements would reflect best practices even if they were not proposed to be compulsory. Likewise, the changes to Rule 156 reflect the SEC’s interpretation of the law as it stands now.

The temporary requirement to submit general solicitation materials could fast become unwieldy both for issuers and for the SEC itself. Current practice in online Rule 506 offerings is to use various media in presenting an investment opportunity to investors, including videos, slide decks, graphic-heavy offering memoranda, due diligence reports and other supporting data. These items are prepared in many different formats. Add to these social media postings and other solicitation items (and it is not clear in what format these are to be submitted) and the opportunity for chaos is limitless. Unless the "intake page" uses a robust document-handling system able to handle many extremely large files in every format in which it is possible to create documents (and the intake page feeds documents to an equally robust database), failed uploads, long loading wait times and garbled data files are inevitable. The intake page is apparently going to be available for voluntary submissions by the time Rule 506(c) is effective. It is quite possible that the SEC's experience with voluntary submissions will cause it to rethink this proposal.

One striking issue in light of the combination of rules that are adopted and rules that are merely proposed is that in September, companies and funds will be able to generally solicit with fewer restrictions, and then additional restrictions (legends, slightly stricter Form D filing requirements and information submission requirements) will kick in after the proposed rule changes are adopted.

The SEC also asks whether the definition of accredited investor should be changed when the SEC is permitted to make such changes, which would not be until July 2014.

The proposed changes are now open for a period of public comment, which ends in mid-September.

"Bad Actor" Rules Adopted

The SEC also adopted its final rules disqualifying "felons and other 'bad actors'" from taking part in securities offerings made in reliance on Rule 506. The new rules were required by the Dodd-Frank Act of 2010, and the SEC first proposed these rules in May 2011.

Prior to this rulemaking, Rule 506 did not impose any bad actor disqualification requirements. In contrast, the bad actor disqualification provisions under Rule 262 of the Regulation A exemption from registration has existed for decades. The new rules are based on the established Rule 262 bad actor disqualification provisions, modified to account for the statutory requirements of Section 926 of the Dodd-Frank Act and how the Rule 506 exemption differs from the Regulation A exemption in practice.

The SEC's new rules are set out in new paragraph (d) of Rule 506. The rules state that the Rule 506 exemption — including both "traditional" Rule 506(b) and new Rule 506(c) offerings — will not be available if the “covered persons” in an offering have triggered a disqualifying event.

The new rules apply to a range of people (the “covered persons”) in an exempt offering made under Rule 506(b) or 506(c). On the issuer side, the covered persons under the rules include:

- The issuer itself, its predecessors, and affiliated issuers;
- Any director, executive officer, or other officer participating in the sale of securities (or the counterparts for such persons if the issuer is a partnership or LLC);
- Any beneficial owner of twenty percent or more of outstanding voting equity securities; and
- Any promoter connected to the issuer company at the time of sale.

With regard to intermediaries, the rule applies to:

- Any investment manager of a pooled investment fund;
- Any person who has been or will be paid remuneration for solicitation of investors; and
- Any director and executive officer (along with the partnership and LLC counterparts) of the investment manager or solicitor.

The “disqualifying events” that will prevent a person from being involved in offerings made in reliance on Rule 506(b) or Rule 506(c) include:

- Any felony or misdemeanor convictions, within the past ten years (five years for the issuer), in connection with the purchase or sale of any security, involving making a false filing with the SEC, or arising out actions as an intermediary, advisor, or solicitor. The felony or misdemeanor convictions must relate to prior involvement with the offer or sale of a security, interactions with the SEC, or conduct as a securities intermediary. The disqualifying convictions do not include all criminal convictions involving fraud or deceit.
- Any court order, within the past five years, which, at the time of the sale of securities under Rule 506(b) or Rule 506(c), restrains or enjoins a person from engaging in practices in connection with a securities transactions, making false filings with the SEC, or acting as an

intermediary, advisor, or solicitor. For disqualification under this item, the person must be subject to the court order; that is, specifically named in the order. Other people who may come under the scope of an order, but are not specifically named, will not trigger the disqualification.

- Any final order of a federal or state financial regulator that, at the time of the sale of securities, bars the person engaging in the business, or associating with an entity, regulated by that regulator. Additionally, the disqualification is triggered by a final order, within the past ten years, based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct. The applicable financial regulators include a state securities commission, state banking or thrift regulator, state insurance commission, federal banking regulator, the U.S. Commodity Futures Trading Commission, and the National Credit Union Administration.
- Any SEC disciplinary order suspending or limiting the activities of a person at the time of the sale of securities. These could be suspensions or revocations of a person's registration as a broker, dealer, or investment advisor, or limitation on those activities, or a bar from being associated with the offering of penny stock.
- Any SEC cease-and-desist order, within the past five years, that at the time of the sale orders a person to cease and desist from committing, or committing in the future, a violation of federal securities laws. These cease-and-desist orders arise out of the commission of securities fraud (i.e., knowingly misrepresenting a fact or omitting a fact necessary to make a previous statement not misleading) or making an unregistered, non-exempt offer of securities in violation of Section 5 of the Securities Act.
- Any suspension or expulsion from a securities self-regulatory organization for any act or omission to act that constitutes conduct inconsistent with just and equitable principles of trade. Securities self-regulatory organizations include registered national securities exchanges, and national securities associations. The rules do not make clear whether a suspension results in a permanent disqualification or only operates during the period of the suspension.
- Any order to stop or suspend a registration statement or Regulation A offering statement within the past five years. The disqualification applies to any filer or named underwriter, and extends to parties that are under investigation by the commission at the time of the Rule 506(b) or Rule 506(c) securities offering.

- Any Postal Service false representation order within the past five years, or temporary restraining order or preliminary injunction at the time of the sale of securities.

A covered person that is subject to a disqualifying event has the ability to petition the SEC and show good cause as to why the disqualification should not apply. The SEC notes specific situations where this may occur, such as a demonstration that a court order was entered without the person having an opportunity to challenge the order. Additionally, the disqualification event will not apply if the relevant court or regulatory authority indicates that the judgment or order should not bar the person from participating in a Rule 506(b) or Rule 506(c) securities offering.

The rules also create a reasonable care exception for the issuer. Under that exception, the issuer may establish that it did not know, and even in the exercise of reasonable care, could not have known that a covered person triggered a disqualifying event. The standard for reasonable care includes the issuer's factual inquiry into whether any covered person triggers a disqualifying event. The requirements for a factual inquiry vary according to the issuer's situation. An issuer with only a few executive officers and directors may be expected to have knowledge of its own covered persons. Factual inquiries on intermediaries may be done by questionnaires, certifications, and background investigations, accompanied by contractual representations and covenants.

The factual inquiry should be done at a time that allows the issuer to have a complete and accurate understanding of the absence of disqualifying events at the time of the securities offering. As such, the inquiry should be done as close to the offering as possible without being unduly burdensome. Further, ongoing or long-lived offerings may require additional factual inquiries done on a reasonable basis.

The rule is designed to phase in after it becomes effective in mid-September, 2013. Disqualification will only result from disqualifying events that occur after the effective date of the new rules. Nevertheless, any disqualifying events triggered by an issuer or covered person that occurred prior to the effective date are subject to mandatory disclosure to potential investors. It is conceivable that failure to disclose a past disqualifying event could result in the finding of securities fraud, which would then trigger the disqualification from reliance on Rule 506(b) or Rule 506(c) in future securities offerings.

These new rules impose substantial requirements on issuers and intermediaries relying on the Rule 506(b) or Rule 506(c) exemptions from registration of securities. Principally, issuers must establish that they have exercised reasonable care to discover whether any of the parties to a securities offering

disqualify the issuer from utilizing the exemptions. If a covered person triggers a disqualifying event, and the issuer fails to exercise reasonable care, that could lead to further securities law violations, triggering additional disqualifying events for the issuer, and thereby severely limiting access to the capital markets.

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The following table compares the principal attributes of traditional placements under Rule 506, new Rule 506(c) offerings and offerings made under Rule 506(c)'s cousin, crowdfunding. The SEC has not yet proposed its rules for crowdfunding, so additional restrictions are likely.

Rule 506(b) offerings (traditional Regulation D)	New Rule 506(c) offerings	Crowdfunding (when legal)
Solicitation: Marketed directly to known investors without "general solicitation"; no internet solicitation	Marketed over the internet; TV, advertisements and solicitation on social media permitted	Marketed over the internet, but primary solicitation and disclosure happens on "funding portal"; publicity anywhere else (including social media) is restricted
Eligible issuers: Both SEC-registered and private companies can use exemption	Both SEC-registered and private companies can use exemption	Only companies not registered with the SEC can issue
Eligible investors: Up to 35 non-accredited investors permitted; no limits on accredited investors	Only accredited investors may buy	No restrictions on type of investors but they must show they understand their investment and are limited in dollar amount
Ascertaining investors' status: Accredited investors typically self-certify	Issuer may use various methods to "verify" accredited status; non-exclusive list of methods that may be relied on as meeting requirements	Proposals to come
Offering size: No dollar limit on offering size	No dollar limit on offering size	\$1m limit on offering size; SEC may decide not to include sales to accredited investors in that limit
Disclosure: Private Placement	Disclosure driven by market	Disclosure (including reviewed or

Memorandum typically used although not required if all investors are accredited	demands and liability concerns	audited financial statements) mandated by statute; additional disclosure likely to be mandated
Filing Requirements: Form D (very short form with issuer and intermediary identity and offering description but no substantive disclosure) filed after offering starts	Proposals would require earlier filing of Form D and additional amendment after closing; general solicitation materials proposed to be submitted informally to SEC	Filing required with SEC; form to be determined
Liability: Liability under general Rule 10b-5 anti-fraud provisions for any person making untrue statements	Liability under general Rule 10b-5 anti-fraud provisions for any person making untrue statements	Rule 10b-5 liability plus Section 12(a)(2)-type liability for issuer, its officers and directors and anyone “selling” (including promoting) the offering
Resales: Securities are “restricted”; cannot be freely resold	Securities are “restricted”; cannot be freely resold	Very limited resales permitted for one year; may be designated “restricted” by SEC
Intermediaries: Intermediaries not required; any intermediaries used must be registered broker-dealers or entities exempt from B/D registration (such as VC Funds)	Intermediaries not required; any used must be registered broker-dealers or exempt	Intermediaries are compulsory; can be funding portals or broker-dealers

CrowdCheck provides due diligence and disclosure services for online investments, including Regulation D offerings. We help platforms and issuers ensure that their offering satisfies legal and industry requirements, including the new “Bad Actor” rules and ensuring that issuer statements are accurate and not misleading. CrowdCheck also provides investors with the tools they need to avoid fraud and make an informed investment decision. We combine “hands on” and high tech to create a right-sized yet powerful product that works with the reality of small businesses and needs of investors. For more information please contact us at info@crowdcheck.com or visit us at www.crowdcheck.com.

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