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

On August 29, the SEC in effect created an entirely new type of offering not subject to registration under the Securities Act of 1933.

The SEC voted to propose amendments to Regulation D under the Securities Act to add new Rule 506(c). Rule 506(c) offerings would technically be private placements, made only to "accredited" investors,[1] but they could be advertised widely – on television, in newspapers, and most importantly over the internet. The JOBS Act of 2012 required the SEC to remove the prohibition on "general solicitation or general advertising," which has been part of Regulation D since that regulation was adopted in 1982, so long as the purchasers in an offering were all accredited. The way the SEC is proposing to effect this legislative mandate means that there will be two different types of offering under Regulation D's Rule 506:

- Rule 506(b) offerings, which cannot use general solicitation but in which 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
- 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." The SEC declined to specify even a non-exclusive list of such methods, on the grounds that this would inhibit flexibility in the markets. Instead, the SEC is proposing that issuers be responsible for an objective determination of an investor's accredited status based on a facts and circumstances analysis that would take into account factors such as the nature of the purchase, the type of accreditation that a purchaser claims, the manner of the offering and the terms of the offering (including minimum investment amount). The SEC believes that this approach would give issuers the ability to use a variety of different approaches depending on their circumstances.

[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.

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, 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) will present opportunities and threats. Contacting a broader range of investors will become easier, and thus more offerings can be made. 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 PPM. More intermediaries (who must be registered broker-dealers) may enter the market. But, as the SEC points out in its Proposing Release:

> . . . 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 . . .

The increased opportunity for fraud may mean that companies will need to do more to establish their legitimacy and 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.

The SEC has established a short 30-day period for the public to comment on the proposed rules. After that, the SEC will adopt final rules and establish an "effective date" for new Rule 506(c). Rule 506(c) offerings will only be legal after that effective date.

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 rely on various methods to "verify" accredited status	
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 Memorandum typically used although not required if all investors are accredited	Disclosure driven by market demands and liability concerns	Disclosure (including reviewed or audited financial statements) mandated by statute; additional disclosure likely to be mandated by SEC
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; are likely to be designated "restricted" by SEC
Intermediaries: Intermediaries must be registered broker-dealers	Intermediaries must be registered broker-dealers	Intermediaries can be funding portals or broker-dealers

CrowdCheck provides due diligence and disclosure services tailored for the accredited-only Regulation D and investment-based crowdfunding offerings. We help platforms maintain compliance with statutory and regulatory requirements and provide their customers with a tool to avoid fraud and make informed investment decisions by creating a robust structured transparency regime for issuing companies. 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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