

# Rule 506(c) Private Offerings General Solicitation and Advertising Provisions

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## *General Background*

"Regulation D" allows for certain securities offerings to be exempt from the registration requirements of Section 5 of the Jumpstart Our Business Startups Act ("JOBS Act"). Regulation D's Rule 506 is the provision most commonly used because (i) Rule 506 offerings are exempt from pre-offering filing and review requirements of state securities laws and (ii) there are no limitations on the amount of money that may be raised or the number of investors, provided sales are limited to the types of investors described in the Rule.

One condition imposed on offerings by prior versions of Regulation D was that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or advertising." The JOBS Act required the Securities and Exchange Commission ("SEC") to revise Rule 506 to eliminate this solicitation and advertising restriction if the issuer reasonably determined that all purchasers are "Accredited Investors." The SEC was also required to adopt rules for what steps an issuer must take to reasonably determine that an investor is an Accredited Investor.

The term "Accredited Investor" includes certain entities. It also includes individuals with (i) an individual or joint marital net worth exceeding \$1,000,000, or (ii) individual income of \$200,000 in the two prior years (or \$300,000 jointly with a spouse), and an expectation of that level of income in the current year. Fairly recent changes to the Accredited Investor definition exclude an individual's primary residence from the net worth calculation, and also exclude debt owed on the primary residence except debt (i) incurred within 60 days prior to purchase of the securities, or (ii) in excess of the property's estimated fair market value.

The Private Offerings Advertising portion of the JOBS Act also required the SEC to issue rules allowing advertising of resales of Rule 144A securities, provided all purchasers are sophisticated institutions that meet the definition of "Qualified Institutional Buyers."

## *Verification of Accredited Investors - General Solicitation and Advertising Final Rules*

New Rule 506(c) allows an issuer to conduct a general solicitation or to advertise a private offering, if all investors are Accredited Investors **and** the issuer takes "reasonable steps to verify" that all purchasers are "Accredited Investors." Someone can be an "Accredited Investor," but if the issuer does not take reasonable steps to verify the investor's status, the issuer does not qualify for the Rule 506(c) exemption. The price the issuer pays for being able to advertise and conduct general solicitations is that it must go through the reasonable verification process. The SEC rule suggests a non-exclusive list of reasonable steps including:

- For the annual income test, reviewing copies of an IRS form that reports income and obtaining a written

representation from the purchaser that the purchaser will likely continue to earn the necessary income; and,

- For the net assets test, reviewing a bank, broker, or other financial statement that shows assets in excess of \$1 million and a credit report to determine liabilities that might reduce net assets below the \$1 million level.

Of course, few people want to give private tax and financial records to complete strangers. Instead, under the rule, an issuer can provide a verification from a registered broker-dealer, SEC-registered investment advisor, licensed attorney, or certified public accountant that the latter reviewed the documents and that the investor is an "Accredited Investor." The third-party verification will constitute the taking of reasonable steps by the issuer for purposes of the safe harbor. These professionals can work for either the issuer or the investor or can be hired specifically to verify all investors for the deal.

Initial opposition to the Accredited Investor verification rules from angel investor groups created a false impression that the verification rules were onerous. But the reality is different. Many technology platforms conducting Rule 506(c) offerings are automating the verification process. The ability of investors to have their own advisors sign a verification form minimizes privacy concerns. Most Accredited Investors have advisors who already possess the information that has to be verified.

The most significant effect of the verification rules has been that some angel investors and angel investor groups who cannot verify their accredited investor status can no longer participate in attractive deals. Knocking out some existing angel groups might initially hurt the flow of capital, but this problem is likely to decrease substantially over time as angel investor groups police their own membership.

Rule 506(c)'s benefits include the fact that lone angels have better access to deals. Also, some "super" angels are able to form their own investment syndicates comprised of followers who want to piggy-back on their successful investment track record.

Issuers can also market to unaccredited investors (who cannot make purchases) through social media and motivate them to involve Accredited Investors. This provides cost-effective marketing for many issuers who are able to identify online groups interested in promoting their product or service. People who share common hobbies or other interests frequently share information through social media. These groups form communities that can be motivated to help sell securities offerings for businesses that capture their imagination even if none of the community is accredited and, thus, unable to invest financially.

Finally, Rule 506(c) allows issuers to go around traditional money gatekeepers (like venture fund managers) and sell directly to investors who invest in such funds. In turn, this provides the investors with the ability to negotiate better prices and more flexible deal structures because they are not paying the fees charged by fund managers and can accept deal structures that fund managers would avoid.

Therefore, although the world of investing is changing, technology advances permitted by Rule 506(c) are making individual investors a more dynamic force.

### ***The General Advertising Proposed Rules***

Although the SEC's initial Rule 506 rules were balanced and reasonable, its proposed new rules for Rule 506 offerings that intend to use general advertising would impose many additional burdens including:

- An advance filing of SEC Form D 15 days before engaging in general advertising;
- Requiring additional information on a revised SEC Form D, which one Congressman has called a "wildly expanded" Form D;

- Use of lengthy specific legends on written general solicitation materials;
- Submission of advertising materials to the SEC prior to use;
- Imposition of specific time deadlines and a disqualification period for a failure to use Form D; and,
- The requirement for an updated Form D filing at the close of an offering.

The SEC does not like general advertising and solicitation in private offerings, and these rule proposals are an attempt to impose registration-like requirements on these offerings and take away the benefits intended by the JOBS Act. However, there is a small window of time for Rule 506 offerings to be made without complying with the new proposed rules.

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