Rule 506 Offerings: Advertising and General Solicitation Permitted, "Bad Actors" Disqualified - Advance Notice Requirement Proposed

July 23, 2013

On July 10, 2013, the Securities and Exchange Commission (SEC) implemented key provisions of the Jumpstart Our Business Startups (JOBS) Act, lifting an 80-year old ban on general solicitation and general advertising as it relates to private placements under Rule 506 and Rule 144A offerings. Elimination of such ban has been controversial within the SEC and securities law communities since the JOBS Act's enactment in April 2012.

Responding to investor protection and industry concerns, the SEC established safe-harbor guidelines issuers can follow to ensure compliance with requirements to verify that investors are accredited or qualified to participate in Rule 506 and Rule 144A offerings, and proposed a new advance notice requirement designed to deter and help police potential fraud and abuse.

The amendments are expected to significantly change how private placement securities offerings are conducted, and may accomplish the JOBS Act goal of broadening access to the capital markets. Absent any prohibition against general solicitation and advertising, issuers are now free to employ a number of previously-unavailable solicitation and advertising methods to reach out to potential investors, so long as they screen potential investors adequately for accredited investor status before accepting their investments.

The rule amendments are expected to become effective in September 2013, 60 days after the rule's Federal Register publication date.

Removal of Prohibition on General Solicitation and General Advertising

Rule 506

Rule 506 has become the mainstay of private offerings under Regulation D because it entails no limitations on the total number of investors or the amount raised, so long as all of the investors involved are accredited investors. Regulation D also pre-empts state securities law offering restrictions. Regulation D offerings under Rule 506 had, however, been subject to the long-standing prohibition against general solicitation and general advertising, which limited the ability of issuers and placement agents to publicize such offerings and create general interest in them. Adopted in the wake of the 2008 financial crisis, which had paralyzed the capital markets generally, JOBS Act Section 201(a)(1) directed the SEC to remove the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506, so long as the sales are limited to accredited investors and the issuer has taken "reasonable steps" to verify that purchasers of the securities are accredited investors. The new rules implement this mandate.

The “accredited investor” definition remains unchanged. A person is an “accredited investor” if he or she has either (i) an individual net worth, or joint net worth with a spouse, of at least $1 million (excluding the value of a primary residence); (ii) an individual annual income exceeding $200,000 in each of the past two years and a reasonable expectation of the same income level in the current year or (iii) an annual joint income with a spouse exceeding $300,000 in each of the past two years and a reasonable expectation of the same income level in the current year. (According to the General Accounting Office, adjusting these thresholds for inflation since the rule’s adoption would have increased these amounts by a factor of 2.3x and reduced the number of households eligible for accredited investor treatment from 8.5 million to 3.7 million.)[1]

The issuer must take “reasonable steps” to verify the investor’s accredited status. Those steps may include factors such as the nature of the investor, the amount and type of information about the investor known to the issuer, and the nature of the offering. In addition, issuers may rely upon the “safe harbors” established under the amended rule described below.

Safe Harbors

Amended Rule 506 establishes several non-mandatory “safe harbor” verification options issuers may employ to be deemed to have satisfied the requirement that they take “reasonable steps” to verify that a purchaser of the securities is an accredited investor.

1. *Income Test*: (a) review copies of any IRS forms that report the investor’s income (such as income tax returns, Forms W-2 and 1099, and Schedule K-1) over the two most recent years and (b) obtain the investor’s written confirmation that he or she reasonably expects sufficient income to qualify as an accredited investor during the current year;

2. *Net Worth Test*: (a) review financial institution or similar third-party statements from the prior three months (e.g. a credit agency report) that show the investor’s assets and liabilities, and (b) obtain the investor’s written representation that all liabilities necessary to make a determination of net worth have been disclosed.

3. *Professional Verification*: Obtain a written representation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant that such person or entity has, within the last three months, verified that the investor qualifies as an accredited investor; or

4. *Grandfathering*: With respect to an investor who invested in an issuer’s Rule 506(b) offering as an accredited investor prior to the Rule 506(c) effective date and remains an investor of the issuer, the issuer need only obtain a certification that the investor remains qualified as an accredited investor.

Rule 144A

The newly-adopted rules also permit issuers to advertise offerings under Securities Act Rule 144A. Rule 144A is a safe harbor exemption for non-issuers to resell unlisted securities to qualified institutional buyers (QIBs). Registered broker-dealers perform the functional equivalent of underwriting when they act as “initial purchases” in offerings of debt securities to QIBs under Rule 144A. As always, those offerings may only be sold to qualified institutional buyers (QIBs) or persons the seller reasonably believes to be QIBs. Given the limited market for Rule 144A offerings, it is unclear how much the lifting of the ban on general solicitation and general advertising will change industry practices in this market segment.

Disqualification of “Bad Actors”

The SEC also implemented a Dodd-Frank Act requirement to add a so-called “bad actor” disqualification for issuers seeking to make private placement securities offerings in reliance on Rule 506. The disqualification applies if the issuer or certain covered persons had a “disqualifying event”, which includes securities-related criminal convictions, injunctions and restraining orders, as well as disciplinary and other orders issued by the SEC and other regulatory and government agencies. The time periods for disqualification generally address conduct between five and 10 years prior to the date of the Rule 506 securities issuance.

In addition to the issuer itself, the following persons are also covered by the “bad actor” disqualification:

- directors and certain officers, general partners, and managing members of the issuer;
- twenty percent (20%) and greater beneficial owners of the issuer;
- promoters of the issuer;
- investment managers and principals of pooled investment funds promoting the issuer; and
- persons compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor.

This new rule has exceptions, such as a “reasonable care” exception if the issuer did not know (or in the exercise of “reasonable care” could not have known) of the disqualifying event. The issuer is expected to conduct a “factual inquiry” specific to the facts and circumstances of the sale.

The bad actor disqualification is also expected to become effective in September, 60 days after the rule’s Federal Register publication date.

Proposed Advance Notice Requirement for Issuers

The SEC has proposed a new 15-day advance notice requirement before issuers engage in general solicitation in connection with a private offer under Rule 506(c), in response to concerns of potential fraud and abuse under the new rules. The proposal would require issuers to file a Form D with the SEC 15 calendar days *before* they engage in general solicitation. (The current rule only requires issuers to file their Form D within 15 calendar days *after* the date of the first securities sale.) This advance notice requirement is not currently effective, permitting issuers to rely upon the lifted ban on solicitation and advertising without any waiting period, at least for now.

In addition to the 15-day advance notice requirement, the proposed rule also would require issuers to file an amended Form D within 30 calendar days of the successful conclusion or any other termination of the offering to update the information contained in the initial Form D and to announce that the offering has ended.

The SEC stated that this proposal was an effort to improve its ability to evaluate and assess developments in the private placement market and to enhance the SEC’s ability to monitor market practices under Rule 506 offerings and address certain investor concerns regarding general solicitations.

SEC Commissioner Daniel M. Gallagher, who did not support the proposed rule, questioned the timing of issuing proposed restrictions on a new rule before that rule has taken effect. He stated that

“It is not normal for the Commission to propose rules designed to mitigate perceived problems with Congressional mandates before those mandates have been effectuated”. Conversely, it is equally unusual to adopt rules with a known potential for abuse ahead of measures designed to mitigate that potential.

Additional Information Requirement

Issuers would also have to provide additional identifying information in the Form D, including:

- identification of the issuer’s website;
- expanded information on the issuer;
- information on the type of securities to be offered;
- details as to the types of investors in the offering;
- the use of proceeds from the offering;
- information on the types of general solicitation used; and
- the methods used to verify investors’ accredited investor status.

The above requirements would be in addition to all existing Form D filing requirements, although they would only apply to private offerings of by issuers that engage in general solicitation.

Penalty for Non-Compliance

The proposed rule would automatically disqualify an issuer from using Rule 506 in any new offering if the issuer failed to comply with applicable Form D filing requirements in a Rule 506 offering within five years of such new offering. The length of any such disqualification would extend from the date of non-compliance to one year from when the issuer remedied the non-compliance by making the required Form D filings (or, if the offering has been terminated, one year after filing a closing amendment).

The proposed disqualification would apply only to an issuer’s future offerings and not its ongoing offerings at the time of the filing non-compliance, including the offering for which the issuer failed to make a required filing. In addition, the five-year look-back period would not extend to prior to the effective date of the proposed amended rule.

The proposed rule would provide for a limited 30-day cure period for late filings (available only for an issuer’s first failure to timely file a Form D or Form D amendment in connection with a particular offering) and would permit issuers to request a waiver from disqualification.

General Solicitation Materials

Issuers also would be required to include certain legends in their general solicitation materials and, for the first two years that the rule is in effect, submit copies of general solicitation materials to the SEC that would then be publicly available.

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[1] See http://www.gao.gov/assets/660/655963.pdf.