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SEC Gives Green Light to General Solicitation and Advertising in Rule 506 Private Placements: EB-5 project issuers should proceed with caution[1]

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The United States Securities and Exchange Commission (SEC) recently adopted amendments to Rule 506 of Regulation D under the Securities Act of 1933, as amended.[2] Rule 506 provides a safe harbor from registration with the SEC and is the exemption on which most issuers rely when conducting private placements of securities in the United States. Previously the availability of the exemption was conditioned on the absence of any general solicitation or advertising in connection with the offering.[3] As a result of the amendments, which go into effect on September 23, 2013, issuers and their selling agents will be permitted under new Rule 506(c) to engage in general solicitation activities without losing the benefit of the Rule 506 safe harbor. The elimination of the prohibition permits offering communications to be broadly disseminated in the traditional print as well as newer electronic media and has the potential to have a significant impact on the manner in which Rule 506 offerings can be conducted.

Rule 506(c) offers a new path for EB-5 project issuers to market their offering to potential investors in the United States and to third party advisors whose clients are interested in investment opportunities tied to the immigrant investor program. At the same time, it should be recognized that Rule 506(c) contains traps for those who engage in a general solicitation strategy without giving full consideration of the legal consequences of such activities. Certain consequences are evident from the text of the rule itself. Other consequences arise from laws whose potential application may not be readily apparent. The pointers below are addressed to EB-5 project issuers who are considering whether to take advantage of the liberalized solicitation rule to promote their projects and are intended to mitigate the risk that the strategy will create unexpected legal issues in the investment process. Of course, general guidance is not a substitute for particularized legal advice and issuers should consult with their own securities counsel before embarking on any general solicitation strategy.

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1 The term "EB-5 Project Issuer" is used herein to refer to any entity that is issuing securities to investors to fund a job creating project under the immigrant investor program created pursuant to Section 203(b)(5) of the Immigration and Nationality Act and administered by the United States Citizenship and Immigration Services ("USCIS").

2 Release No. 33-9415, July 10, 2013, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings.

3 It should be noted that issuers may continue to conduct their private placement under Rule 506 without engaging in any general solicitation. Issuers in such offerings are not subject to the requirements of Rule 506(c) to take reasonable steps to verify that the purchasers of the securities are accredited investors verify and may sell securities to up to 35 non-accredited investors.

Solicitations Not Exempt From Anti-Fraud Rules

Although Rule 506 provides a safe harbor from registration with the SEC, disclosures that are made in connection with the offering remain subject to the anti-fraud rule that governs all disclosures made to investors. In summary, it is unlawful to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or to engage in any act that would operate as a fraud or deceit upon any person.[4] The anti-fraud rule applies to all communications to investors, including disclosures outside what generally may be considered the formal offering documents such as the private placement memorandum and the subscription agreement. Accordingly, issuers that are promoting their projects in a general solicitation should avoid puffery and unsubstantiated claims so that such statements do not become part of the record on which investors rely in making their investment decisions. In particular, in the context of an EB-5 offering in which potential investors are interested primarily in the potential immigration benefits associated with the investment with an expectation of return of their capital, any claims concerning the issuance of a green card should be carefully scrutinized and any statements that could be construed as promoting the safety of the investment should be avoided.

It will be interesting to see how practices evolve once Rule 506(c) is effective. As a general matter, however, we believe that issuers should limit the content of any solicitation material to statements that are designed to convey general factual information about the offering and then refer interested parties to the formal offering document or personnel at the issuer or its placement agent for further information. For example, any advertisement should be limited to the name of the issuer and its general partner/or managing member, the amount of the offering and the title of the securities being offered, a brief factual description of the project in which the proceeds of the offering will be invested, the name of the regional center in which the project is located and the name and contact information of the person from whom additional information should be requested. It would also be advisable to include in the materials in prominent type meaningful cautionary language that highlights the material risks of the investment, the absence of any review by or approval of the offering by the SEC or the USCIS or any other regulatory authority, restrictions on transfers of the securities and the absence of guarantees as to any immigration or investment outcome.[5]

Third Party Agents Not Exempt From Securities Laws

The role of third parties retained by issuers to provide assistance in the promotion of projects to potential investors is a hot topic in the EB-5 industry and raises many complex issues. The fundamental question is the extent to which promotional and finder activities conducted by third parties requires them to register as broker-dealers under Section 15(b) of the Securities Exchange Act of 1934, as amended, on the basis that they are "engaged in the business of effecting transactions in securities for the account of others." The compensation of such third parties is often tied to an investment in the project. In the view of the SEC, this compensation structure is a hallmark of broker dealer activity since it gives the third party a salesman's

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[4] Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated by the SEC thereunder.

[5] See below "Form D and Other Fling Requirements" and accompanying footnotes.

stake in the enterprise. The elimination of the prohibition against general solicitation is likely to exacerbate the issue as it facilitates communications by such third parties with potential investors. Such communications are likely to be deemed in and of themselves to constitute engagement in the business of effecting transactions in securities for the account of others since they are a key step in the sales process. Accordingly, leaving aside the many other issues raised by the employment of third parties, if an issuer is retaining a third party to promote an EB-5 project it should ensure that the third party is properly registered as a broker dealer.

Accredited Investor Status Must Be Verified

If an issuer engages in general solicitation in a Rule 506 offering, Rule 506(c) requires that the issuer take reasonable steps to verify that the purchasers of the securities are accredited investors.[6] The exact method of verification depends on the particular facts and circumstances of each purchaser and transaction. Since the minimum investment for most projects under the EB-5 program is US$500,000 based on their location in a targeted employment area, the issuer would not be able to rely on the terms of the offering itself to establish that the investor satisfied the net worth test. It is clear, however, that the determination cannot be based simply on a representation in a subscription agreement that the investor is accredited.

The SEC has provided a non-exclusive list of methods that issuers may use to satisfy the verification requirement that include (a) reviewing copies of any IRS form that reports the income of the purchaser for the two most recent years and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the necessary income level in the current year, (b) reviewing documentation dated within the prior three months that the purchaser has sufficient net worth (such as bank statements and a consumer report) and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed, and (c) receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney or certified public accountant that such entity or person has taken reasonable steps to verify the purchaser's accredited status within the prior three months.

It should be emphasized that the issuer must complete this inquiry prior to the sale of securities to the investor. Accordingly, issuers that are considering a general solicitation strategy should review their subscription procedures to ensure that they include the delivery of documentation evidencing an investor's income or net worth prior to acceptance of an investor's subscription and should retain such documentation in their compliance files.

No Sales to Unaccredited Investors

If an issuer engages in general solicitation in a Rule 506 offering, Rule 506(c) requires that sales of securities be limited to accredited investors (including persons that the issuer reasonably believes to be accredited after satisfying the verification requirement discussed above). This restriction effectively

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[6] An accredited investor includes (a) any natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person; and (b) any natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.

precludes admission of investors in the United States who do not satisfy either the income or net worth accredited investor test. Accordingly, issuers must make a determination early in the marketing process whether the benefits of a general solicitation strategy in the United States outweigh the loss of such potential investors. In principle, the issuer may continue to sell to unaccredited investors that are not U.S. persons in a concurrent offering outside of the United States in reliance on the Regulation S exemption. In that case, however, records must be created that detail exactly how such non U.S. persons were solicited outside the United States and that the conditions of the Regulation S exemption were satisfied with respect to such investors.[7]

Form D and Other Filing Requirements

Issuers that have sold securities in reliance on any of Regulation D exemptions must file a notice of offering on Form D with the SEC no later than 15 calendar days after the date of first sale of securities in the offering. Many states impose a similar filing requirement based on the first sale of securities in the state. This rule has not changed. However, when it adopted the new rules the SEC also revised the Form D to provide that issuers that conduct a general solicitation in a Rule 506 offering must check a box to indicate that they are relying on Rule 506(c).

More significantly, the SEC has also issued for public comment proposed rules that, if adopted, would require an issuer that is conducting general solicitation in reliance on Rule 506(c): (1) to file a Form D no later than 15 calendar days prior to the first use of general solicitation or general advertising for such offering; (2) to include in a prominent manner certain legends and cautionary statements in written general solicitation materials used in connection with the offering;[8] (3) to provide additional information in amended Form D concerning the issuer, the offered securities, the use of proceeds of the offering, the types of general solicitation that were used, and the methods used to verify investor status; and (4) to submit to the SEC no later than the date of first use of any general solicitation materials (as proposed this requirement would be on a temporary basis only for a period of two years). More generally the proposed rules would also require the filing of a closing amendment to Form D no later than 30 calendar days after the termination of any Rule 506 offering (not just Rule 506(c) offerings that used general solicitation) and disqualify any issuer from relying on Rule 506 for one year if the issuer or any of its predecessors or affiliates did not timely file a Form D (subject to a 30 day cure period) in any Rule 506 offering within the last five years.[9]

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[7] In the adopting release, the SEC states that, consistent with the historic treatment of concurrent Regulation S and Rule 506 offerings, concurrent offshore offerings under Regulation S would not be integrated with domestic unregistered "advertised" offerings.

[8] These legends are to the effect that: (1) the securities may be sold only to "accredited investors," which for natural persons are investors who meet certain minimum annual income or net worth thresholds; (2) the securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act; (3) the SEC has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials; (4) the securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and (5) investing in securities involves risk, and investors should be able to bear the loss of their investment. .

[9] Release No. 33-9416, July 10, 2013, Amendments to Regulation D, Form D and Rule 156.

The proposed rules are subject to a period of public comment and may not become effective in their current form or at all. However, they are instructive on two counts. First, they signal that the SEC is concerned at the potential for abuse of general solicitation in Rule 506(c) offerings and considers that the area requires greater oversight. EB-5 project issuers should therefore assume as a practical matter that the SEC is closely monitoring advertisements in Rule 506(c) offerings and should craft their communications accordingly. Secondly, the proposed rules provide an indication of the type of cautionary language which the SEC believes it is appropriate to include in these advertisements. EB-5 project issuers should give careful consideration to including such disclosures in their communications as a matter of best practices without waiting for the SEC to take final action.

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