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SEC's Amendment to Rule 506 Allows for General Solicitations (with Some New Requirements)

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On July 10, the SEC announced an amendment to Rule 506, allowing issuers to rely on Rule 506's safe harbor from registration requirements in offerings in which the issuer engages in a general solicitation or general advertising. An issuer may rely on this new exemption if (1) all of the purchasers in that offering are accredited investors, and (2) the issuer takes "reasonable steps" to determine that all of the purchasers are accredited investors. The issuer must also satisfy other the requirements contained in Regulation D in order to avail itself of the exemption. The amendment will become effective sixty days following its publication in the Federal Register.

While the amendment, contained in new Rule 506(c), potentially provides issuers with a wider array of options in raising capital, issuers should be cautious in taking advantage of this new exemption. It is not yet clear what will constitute "reasonable steps" in many situations, and straying from the SEC's prescribed methods of verifying accredited investor status could cause issuers to lose the protection of Rule 506's safe harbor.

What constitutes "reasonable steps" to verify a purchaser's status as an accredited investor?

The requirement that issuers take "reasonable steps" to confirm accredited investor status is unique to offerings under new Rule 506(c), and is independent from the requirement that all of the purchasers are accredited investors. In other words, even if all of the purchasers are actually accredited investors, an issuer will not have complied with the requirements of Section 506(c) unless the issuer took reasonable steps to confirm this fact.

The SEC has explained that what constitutes "reasonable steps" will vary according to the facts and circumstances of any given offering, based on such factors as the nature of the offering, the nature of the investor, and the information that the issuer has regarding the investor.

The SEC did codify in Rule 506(c)(2)(ii) certain methods by which an issuer can verify that an investor that is a natural person qualifies as an accredited investor. While these methods are neither necessary nor exclusive, they do provide an issuer certainty that it is using "reasonable steps" to verify that an investor is accredited, absent knowledge to the contrary. For natural persons that seek to qualify as accredited investors based on annual income, an issuer can rely on certain tax forms from prior years, and a written representation that the purchaser has a reasonable expectation of reaching the required income threshold in the current year. For natural persons that seek to qualify as accredited investors based on net worth, the issuer can rely on bank statements, brokerage statements or other specified documents with respect to assets, and a consumer report from a consumer reporting agency with respect to liabilities. An issuer can also rely on a confirmation of a natural person's accredited investor status from certain third parties, (such as a CPA or a licensed attorney). With respect to current security holders who previously purchased securities as accredited investors in a "traditional" private offering under Rule 506(b) not involving a general solicitation or general advertising, a certification from that investor that he or she is still an accredited investor will suffice.

The SEC was explicit in its adopting release that having an investor simply sign a form or check a box in a questionnaire will *not* constitute "reasonable steps" under Rule 506(c), unless the issuer has other information to verify accredited investor status. This

is an important contrast with “traditional” offerings under Rule 506(b) not involving any general solicitation or general advertising, in which it is common for investors to establish their accredited status by completing an investor questionnaire.

The SEC did not codify methods by which an issuer can take “reasonable steps” to confirm the accredited status of entity investors.

Additional Guidance Regarding Use of Rule 506(c)

Issuers should use caution if engaging in general solicitations under Section 506(c), particularly if they stray from the “reasonable steps” that the SEC has specifically codified as being acceptable. While other verification methods may be reasonable depending on the case, it is often difficult to predict the results of a “facts and circumstances” analysis, and the burden of proof is on the issuer to show that its methods were reasonable. Furthermore, hindsight is 20/20 and, if an investor is later revealed not to be an accredited investor, it may be difficult for the issuer to show that its method of verifying accredited status was reasonable. Once the issuer is in the position of having to demonstrate reasonableness in an unpredictable “facts and circumstances” analysis, one of the major benefits of a “safe harbor” like Rule 506 – the certainty that an issuer who follows certain prescribed requirements will be exempt from registration requirements – is lost.

Issuers should also be advised that the “reasonable steps” listed in Rule 506(c)(2)(ii) only apply to the accredited investor criteria for natural persons, and not for trusts, corporations, and other entity investors. Any issuer that includes entity investors in an offering under Rule 506(c) is therefore acting with some uncertainty. Issuers should also understand that it is not always easy to control whether its investors will be natural persons or entities; for example, it is not uncommon for an issuer selling securities to a high net worth individual to assume it is selling securities to that person directly, only to find out – often shortly before closing the investment – that the investor has decided to purchase securities through a trust or other investment vehicle.

An issuer who chooses to engage in a Rule 506(c) offering, should, in any case, carefully and comprehensively document its verification of the accredited investor status of its offerees. Issuers should also be aware that the SEC may soon provide requirements associated with new Rule 506(c); for example, the SEC has proposed, on a temporary basis, requiring issuers to submit to the SEC written general solicitation materials used in Rule 506(c) offerings. Finally, issuers should also note that the exemption for “traditional” private offerings under Rule 506(b) remains in effect, and may be the better option for many issuers.

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