

GET CREATIVE: SOON YOU MAY BE ABLE TO ADVERTISE THE SALE OF PRIVATE SECURITIES

By lifting the ban on general solicitation and advertisement for certain exempt private securities, the U.S. Securities and Exchange Commission (SEC) has expanded the pool of investors for companies trying to raise money by selling private securities. This article discusses some of the ways the new Rule 506 has changed the landscape for companies considering the sale of equity and some of the considerations which should be kept in mind in doing so.

Under the previous Rule 506, a company, or issuer, could sell securities, without any limitation on the offering amount, to an unlimited number of “accredited investors” as defined by Rule 501 and to 35 or fewer non-accredited investors who met the “sophistication” requirements. However, an issuer could not engage in general solicitation, such as advertising through a newspaper or magazine, a television or radio broadcast, the Internet or a seminar to find investors. As such, issuers had to rely on relatives, friends or business acquaintances to purchase private securities or pay an intermediary broker to get access to a list of accredited investors.

This changed, as of July 10, 2013, when the SEC approved changes to Rule 506 of Regulation D under the Securities Act of 1933 implementing the elimination, mandated by the Jumpstart Our Business Startups (JOBS) Act, of the prohibition against general solicitation or advertising in the offer and sale of securities under Rule 506, provided that all of the purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that status.

In order to comply with the JOBS Act, the SEC removed the prohibition on general solicitation and advertisement for certain securities offerings, such that companies which qualify for the Rule 506 exemption have the option to use newspapers, the Internet and other modes to solicit the general public for the securities they are selling, subject to:

- Buyers of the securities have to be accredited investors as defined by Rule 501.
- The issuer has to take reasonable steps to verify that the buyers are accredited investors.
- The issuer and certain related parties cannot be felons or other “bad actors.”

The SEC has offered some guidance on how to satisfy these requirements. An accredited investor is:

- Someone who comes within the categories of Rule 501,

- Someone who the seller reasonably believes to be accredited investor at the time of the sale or
- A natural person with a certain net worth or income may qualify as an accredited investor.

In verifying whether the prospective purchaser is an accredited investor, the issuer should go beyond a “check the box” type of approach and should take certain factors into consideration such as:

- The nature of the prospective investor (e.g., institutional investor vs. an individual),
- The amount and type of information the seller knows about the buyer (e.g., bank or brokerage statements, tax returns, and credit reports),
- The manner in which the buyer was solicited, and
- The minimum investment amount required.

While the issuer may use other methods to satisfy the verification requirement, the elaboration of the above may make these considerations into a *de facto* safe harbor for prospective issuers.

The foregoing constitutes a critical change, removing the requirement of investors having to have a substantial pre-existing relationship with the issuer or relying on intermediaries to get access to “accredited” investors. The content of the issuer’s solicitation and advertisement is still, of course, subject to other federal laws such as anti-fraud, misrepresentation, advertising and recordkeeping rules. Potential issuers should also keep in mind the following:

- The definition of "accredited investor" has not changed.
- Securities sold in a Rule 506(c) private offering remain "restricted securities."
- "Old Rule 506" (now Rule 506(b)) remains unchanged and is available for use by issuers that, for example, (i) do not need or want to engage in general solicitation in conducting their private offerings, (ii) do not want to subject themselves to the affirmative verification requirements of Rule 506(c), or (iii) want to include non-accredited investors in their offering (up to 35 are permitted under Rule 506(b) if additional disclosure standards are met). Conversely, the Rule 506(c) requirement requiring reasonable steps to verify accredited investor status is separate from the requirement that sales be limited to accredited investors and cannot be satisfied simply because all purchasers in the offering are, in fact, accredited.
- An issuer relying, outside of Regulation D, on the statutory private placement exemption provided by Section 4(a)(2) of the Securities Act is still prohibited from using general solicitation.
- Securities offered under Rule 506(c) will continue to be deemed "covered securities" for purposes of state securities law preemption.

For questions about this or other corporate issues, please contact **Peter D. Feinberg**.

The Fine Print.

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