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SEC Eliminates the Ban on General Solicitation and Disqualifies Participation by "Bad Actors" in Certain Private Securities Offerings

Gray Reed & McGraw Legal Alert

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The Securities and Exchange Commission (SEC) adopted new rules under the Jumpstart Our Business Startups Act (JOBS Act) to permit general solicitation and advertising of certain private securities offerings under certain circumstances. Under the new Rule 506(c), an issuer may generally solicit an offering so long as the issuer takes reasonable steps to verify that the purchasers are accredited investors. The SEC also adopted rules prohibiting issuers from relying on Rule 506 of Regulation D if certain "bad actors" are involved in the offering. These changes took effect September 23, 2013.

New Rule 506(c) and General Solicitation

Beginning September 23, 2013, an issuer may engage in general solicitation and advertising in a private offering under new Rule 506(c), provided that (1) each purchaser of securities in the offering must be an accredited investor (or is reasonably believed to be an accredited investor at the time of the sale); (2) the issuer must take reasonable steps to verify that each investor is an accredited investor; and (3) the offering complies with all other provisions of Regulation D, including Rule 502(a) (integration), and Rule 502(d) (restrictions on resale)

Whether the steps an issuer takes are reasonable or not will be determined by an objective analysis in the context of facts and circumstances of each issuer, investor and transaction. Under this principles-based method of verification, issuers should consider, among other factors, (1) the investor's nature and type of accredited investor the investor claims to be; (2) the amount and type of information the issuer has about the investor; and (3) the nature of the offering, the manner in which the issuer solicited the investor, and the offering terms, such as any minimum investment amount. For example, the SEC stated that if the offering terms have a high minimum investment amount and an investor can meet those terms, it is likely that the issuer will have to take fewer steps to verify accredited investor status. Further, the steps that may be reasonable to take to verify one type of investor's accredited investor status might be different from the steps that may be reasonable to take to verify a different type of investor's accredited investor status. Moreover, if an issuer advertises in a newspaper of general circulation, it will be required to take more steps than if it contacted names in a prescreened database.

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Along with the principles-based method, the SEC created a non-exclusive list of four methods that are deemed to be "reasonable steps" under Rule 506(c):

- First, for natural persons, an issuer may verify the person is an accredited investor based on income by reviewing any Internal Revenue Service (IRS) form that reports income for the two most recent years, including, but not limited to, Form W-2, Form 1099, Schedule K-1 of Form 1065, and a copy of a filed Form 1040. The issuer must also obtain from the person a written representation that the person has a reasonable expectation of reaching the necessary level of income to qualify as an accredited investor during the current year. In verifying whether the person is an accredited investor based on joint income, the issuer may review the forms for the two most recent years regarding the person and spouse along with written representations from both the person and the spouse.

- Second, for natural persons, an issuer may verify the person is an accredited investor based on net worth by reviewing (i) for assets: bank statements, brokerage statements, other securities holdings statements, certificates of deposit, tax assessments and appraisals from independent third parties; and (ii) for liabilities: a consumer report (or credit report) from at least one nationwide consumer reporting agency. The documentation must be dated within the three prior months. The issuer must also obtain along with the documentation a representation from the person that all liabilities necessary to calculate net worth have been disclosed to the issuer. In verifying whether the person is an accredited investor based on joint net worth, the issuer must review the documentation regarding both the person and spouse and obtain representations from the person and spouse.

- Third, an issuer may satisfy Rule 506(c) by obtaining from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant a written confirmation within the prior three months that the person has taken reasonable steps to verify the investor's accredited investor status and that the person determined that the investor is an accredited investor.

- Fourth, an issuer will be deemed to satisfy the Rule 506(c) verification requirement if a natural person who invested in an issuer's Rule 506(b) offering as an accredited investor before September 23, 2013, and remains an investor of the issuer, invests in the issuer's Rule 506(c) offering and the issuer obtains the person's certification at the time of sale that he or she qualifies as an accredited investor.

Issuers that do not rely on one of the foregoing methods must take other reasonable steps to verify the accredited investor status of investors. Whether the steps taken are reasonable will be based on an objective determination of the issuer's actions based on the particular facts and circumstances of the transaction

One thing is clear, however, the SEC stated it does not believe an issuer has taken reasonable steps to verify an investor is an accredited investor if the issuer merely required the investor to check a box or sign a form, without more. Thus, issuers considering general solicitation or advertisement should evaluate the types of investors they seek and which verification methods would likely satisfy Rule 506(c)'s requirements in light of the SEC's non-exclusive list. Because issuers bear the burden of demonstrating their entitlement to rely on Rule 506(c), issuers should engage in careful due diligence and retain adequate records establishing their reasonable steps taken to verify that each investor was an accredited investor. On the other hand, the SEC confirmed that the reasonable belief standard in the definition of accredited investor will apply to offerings conducted under Rule 506(c). As a result, issuers will lose the ability to rely on the exemption provided by Rule 506(c) if an investor turns out not to be an accredited investor so long as the issuer (i) took reasonable steps to verify that the investor was an accredited investor, and (ii) had a reasonable belief that such person was an accredited investor at the time of the sale.

The SEC has retained, without amendment, Rule 506(b), which gives issuers the ability to conduct Rule 506 offerings without the use of general solicitation. Thus, issuers may continue to utilize existing Rule 506(b) when raising capital, which may be important for these issuers not needing to make a general solicitation to conduct a successful offering that want to avoid the reasonable verification steps requirement of Rule 506(c) or want to sell securities to non-accredited investors meeting the rule's sophistication requirements. Issuers that are in the middle of a Rule 506(b) offering on September 23, 2013, the effective date of the new rules, may continue such offering and generally solicit investors. On the other hand, issuers should also keep in mind that once they have generally solicited, they may not be able to change a Rule 506(c) offering to a Rule 506(b) offering. An issuer that has generally solicited may have to wait six months so as to avoid integration between the unsuccessful Rule 506(c) offering and the same offering under Rule 506(b). Issuers should be sure in selecting which Rule 506 offering they choose well in advance of general solicitation.

Changes to Form D

The SEC also made changes to Form D to reflect the addition of Rule 506(c) to Regulation D offerings. The new Form D will have a check box for an issuer to select if the issuer is relying on Rule 506(c) for its registration exemption. Issuers that wish to rely on Rule 506(b) will check a box marked "506(b)" instead of the former "506" to indicate such reliance. An issuer may not rely on both Rule 506(b) and (c) at the same time for the same offering.

Rule 506 "Bad Actor" Disqualifications

The bad actor rules, under new Rule 506(d), apply to both Rules 506(b) and (c) offerings and took effect September 23, 2013. These bad actor disqualifications prohibit issuers from

relying on Rule 506 if the issuer or certain other persons or entities (referred to as "covered persons") is or has been subject to certain "disqualifying events." These disqualifications apply only for events occurring after September 23, 2013, but prior events are subject to mandatory disclosure. Covered persons under the disqualification provisions of Rule 506(d) include:

- The issuer, its predecessor, and affiliated issuers;
- Any director, executive officer, other officer participating in the offering, general partner, and managing member of an issuer;
- Any beneficial owner of at least 20% of an issuer's voting stock;
- An investment manager of an issuer that is a pooled investment fund;
- A promoter connected with the issuer in any capacity at the time of the offering;
- Any person paid (directly or indirectly) remuneration for solicitation of investors in connection with such sale of securities (a "compensated solicitor");
- Any general partner or managing member of any such investment manager or solicitor; and
- Any director, executive officer, or other officer participating in the offering of such investment manager or solicitor or general partner or managing member of such investment manager or solicitor.

If a covered person commits one of the disqualifying acts, the offering is prohibited from a Rule 506 registration exemption. The disqualification acts, in general, include:

- Felony or misdemeanor securities law convictions within ten years of the offering (or five years, in the case of issuers, their predecessors, and affiliated issuers);
- Being subject to an order, judgment, or decree of a court within five years of the offering that bars a person from doing anything in connection with the sale of a security, making a false SEC filing, or arising out of the conduct of an underwriter, broker, dealer, investment adviser, or paid securities solicitor;
- Being subject to a state or federal securities or financial agency final order that prevents the person or entity from engaging in the securities or financial business;

- Being subject to an SEC order within five years of the offering that orders the person or entity to cease and desist from committing or causing a violation of an anti-fraud provision or Section 5 of the Securities Act of 1933;

- Being suspended, expelled, or barred from a national securities exchange or affiliated securities association for an act inconsistent with just and equitable principles of trade;

- Having filed as an issuer or registrant a registration statement or Regulation A offering statement that, within five years of the current offering, was the subject of a stop order, refusal order, or order suspending the exemption under Regulation A; and

- Being subject to a United States Postal Service false representation order entered within five years of the offering or being currently subject to a temporary restraining order or preliminary injunction for receiving money through mail by false representations.

The look-back periods in the rule are measured from the date of the disqualifying event (i.e. the issuance of the injunction), not the date of the underlying conduct that led to the disqualifying event.

It is also important to note that only events that occur after September 23, 2013 will disqualify an issuer from a Rule 506 exemption. An issuer must disclose events that have occurred before September 23, 2013 that would have been a disqualifying event to each investor within a reasonable time before the sale.

The SEC provided several exceptions to the disqualification provisions. The SEC may determine that it is not necessary under particular circumstances that a Rule 506 exemption be denied, upon the issuer showing good cause. Prior to the sale, the relevant court or regulatory body that entered an order disqualifying the issuer from exemption may advise the SEC that disqualification should not arise as a result of the order. The court or regulatory body may include this advisement in the relevant judgment or order or advise the SEC separately.

The issuer may establish that it did not know and, in exercising reasonable care, could not have known that it was disqualified under Rule 506(d). The issuer must have made a factual inquiry, in light of the circumstances, into whether a disqualification existed. The scope of this inquiry will vary depending on the facts and circumstances concerning the issuer and other offering participants. For example, the SEC stated that issuers will likely have in-depth knowledge of their own officers gained through the hiring process and in the course of employment such that further inquiry into potential disqualification events may not be necessary. However, issuers should be aware of any employment law implications related to criminal history inquiries. In other circumstances, questionnaires and certifications, along with contractual representations and covenants, may be sufficient to establish reasonable

care. If the circumstances give an issuer reason to question responses to its inquiries, then reasonable care may require the issuer to take further steps to ensure a disqualification event does not apply to a covered person.

Moreover, events relating to an affiliated issuer that occurred before the affiliation arose are not considered disqualifying events, so long as the affiliate is not (1) in control of the issuer or (2) under common control with the issuer by a third party that controlled the affiliate at the time of the event.

On September 19, 2013, the SEC published a Small Entity Compliance Guide. The Guide sets forth a useful summary of Rule 506(d) and contains guidance as to the interpretation of certain key terms and concepts used in Rule 506(d).

Given these changes to Rule 506 registration exemptions, issuers should consider implementing procedures to discover any disqualifying events of any covered persons. These bad actor provisions not only apply to new Rule 506(c) offerings but also to existing Rule 506(b) offerings. Issuers not intending to generally solicit or advertise should, nevertheless, be aware of these new requirements because they are subject to these requirements.

If you have any questions, please feel free to contact Gray Reed attorney Mark Wigder.