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Reinvigorating Accredited Investor Only Offerings – Proposed New Rule 506(c) Permits General Solicitation and Advertising

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Much has been written about the JOBS Act, including its "on-ramp" provisions for emerging growth companies and its crowd-funding provisions. This article focuses on the JOBS Act's mandate to eliminate the prohibitions on general solicitation and advertising from offerings of securities to accredited investors.

One of the more exciting provisions of the JOBS Act for businesses that raise capital privately (i.e., through unregistered offerings of securities) is Section 201(a), which requires the Securities and Exchange Commission ("SEC") to remove the restrictions on general solicitation and advertising in offerings in which securities are sold only to "accredited investors." The prohibition on general solicitation and advertising has always severely limited the ability of private capital raisers to find new prospective investors, and this limitation became even more painful following the Internet's exponential growth as a medium of social interaction and product and service advertising. Upon implementation, the benefits will be felt at the state as well as the federal level because the Section 201(a) mandate applies to Rule 506 of Regulation D, making securities issued under this new provision "covered securities" and thus exempt from the application of state "blue sky" laws (other than notice requirements). Almost as exciting as the substance of the provision is the further mandate that Section 201(a) be implemented by SEC rule making within 90 days after the JOBS Act signature into law on April 5, 2012. Unfortunately, the SEC has not met the rule making schedule.

On August 29, 2012, the SEC proposed a new subsection (c) to Rule 506; however, as of this writing new subsection (c) has not yet been adopted, and the prohibition on general solicitation and advertising in Regulation D offerings remains in place. Although commentators and practitioners are hopeful that it will be coming soon, the SEC yet to provide guidance on when the final rule will be adopted.

Elisse Walter and others at the SEC have suggested that certain additional conditions may be imposed, such as filing Form D in advance of any sales as a condition to the exemption, and expansion of the Form D itself to gather additional information. However, none of these conditions are found in proposed Rule 506(c), so for now it appears likely that whenever the final rule does come out, it will be substantially similar to the following, contained in proposing Release No. 33-9354:

§ 230.506 Exemption for limited offers and sales without regard to dollar amount of offering.

(c) Conditions to be met in offerings using general solicitation or general advertising.

(1) *General conditions.* To qualify for exemption under this section, sales must satisfy all the terms and conditions of §§ 230.501 and 230.502(a) and (d).

(2) *Specific conditions.*

(i) *Nature of purchasers.* All purchasers of securities sold in any offering under this § 230.506(c) are accredited investors.

(ii) *Verification of accredited investor status.* The issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under this § 230.506(c) are accredited investors.

Because the definition of "accredited investor" in Rule 501(a) of Regulation D already includes a caveat that the issuer of securities must have a reasonable belief that the purchaser fits within one of the accredited investor categories, the effect of proposed Rule 506(c)(2)(ii) is that, in an offering where general solicitation and/or advertising is used, the issuer must take "reasonable steps" to form a "reasonable belief" as to each investor's accreditation. In proposing Release No. 33-9354, the SEC staff specifically declined to provide any safe harbors for what constitutes "reasonable steps," stating instead that, in their view, "Whether the steps taken are 'reasonable' would be an objective determination, based on the particular facts and circumstances of each transaction." Thus, it is not clear at this point exactly what "reasonable steps" might be, nor is it clear what the SEC intended to add by providing for "reasonable steps" in addition to a "reasonable belief."

The staff did, however, suggest several factors that should be considered by issuers, including:

- Nature of the purchaser/type of accredited investor;
- Information the issuer already has about the purchaser; and
- Nature and terms of offering (including minimum investment).

As an example, an issuer might not need to perform any additional investigation if it were issuing securities to CALPERS or a similar organization/entity for which there is publicly available information about its level of assets, or to a named executive officer of a public company for whom several years of income information were likewise available. Another example where limited investigation might be acceptable would be in the case of an offering with a very high minimum investment, where it would be highly unlikely that any non-accredited investor could afford to invest.

Although no bright lines have been drawn as to what will constitute "reasonable steps," it seems clear from the SEC's proposing release that mere reliance on a representation, written or otherwise, of a prospective investor as to his, her or its accredited investor status will be insufficient. While completion of a detailed financial questionnaire will probably be helpful, reliance on a prospective investor's questionnaire answers, with no back-up data, will also likely not be sufficient. As a consequence, issuers using general solicitation and/or advertising and relying on Rule 506(c) should request that, unless the prospective investor falls into a category of person or entity similar to those described in the previous paragraph, the prospective investor provide additional information that the issuer can use to verify the questionnaire answers and/or subscription agreement representations. For example, issuers may request audited, reviewed or compiled financial statements from an outside accounting firm, tax returns, bank or brokerage statements, real property appraisals, confirmatory letters from estate planning attorneys or financial advisors, or other information from independent sources that confirms the answers provided by the prospective investor.

Issuers considering Rule 506(c) should note that nothing in proposed Rule 506(c) changes the general anti-fraud prohibitions of the securities laws. Offerings in which general solicitation or advertising is used will be to accredited investors only, so there is no specifically mandated disclosure as would be the case if there were sales to non-accredited investors; however, the anti-fraud disclosure requirement must be observed, i.e., all information about the issuer and its business that would be material to a reasonable investor's investment decision must be provided, and no material information may be omitted.

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