

## SEC Removes Ban on General Solicitation in Rule 506 and Rule 144A, But Problems Remain

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### New Rule 506(c) Permits General Solicitation Under Regulation D

The Securities Exchange Commission has adopted final rules to remove the prohibition on general advertising and solicitation in securities offerings conducted in accordance with Rule 506 of Regulation D or Rule 144A under the Securities Act of 1933. When the rules become effective 60 days after publication in the Federal Register, new Rule 506(c) will permit general solicitation and advertising in connection with such offerings so long as the issuer takes “reasonable steps to verify” that the purchases are made by accredited investors.

### Safe Harbors For What Constitutes “Reasonable Steps to Verify”

Oddly, the most controversial part of the new rules isn’t even binding. The final rules – which otherwise predictably follow the proposed rules (see our September 2012 alert here) – include a list of non-exclusive, non-mandatory safe harbor standards concerning the types of evidence that an issuer can review that would constitute “reasonable steps to verify” accredited investor status under Rule 506(c).

- With respect to **income**, the issuer can review any IRS Form (e.g., Form W-2, Form 1099, Schedule K-1, Form 1040) that reports the investor’s income for the two most recent years *and* obtain from the investor a written representation that s/he has a reasonable expectation of reaching the income level needed to qualify for accredited investor status in the current year.
- With respect to **net worth**, the issuer can review any of the following types of documentation *dated within the prior three months* and obtain a written representation from the investor that all liabilities needed to make a determination of net worth have been disclosed:
  - ▶ Assets – bank or brokerage statements, statements of securities holdings, certificates of deposit, tax assessments and appraisal reports prepared by independent third parties.
  - ▶ Liabilities – a consumer report from at least one of the nationwide consumer reporting agencies.
- With respect to accredited investor status generally, **obtaining a written “confirmation”** from one of the following persons or entities that such person or entity has taken “reasonable steps to verify” that the investor is an accredited investor *within the past three months* and has in fact determined that such investor is accredited:
  - ▶ A registered broker-dealer
  - ▶ A registered investment adviser
  - ▶ A licensed attorney in good standing in the jurisdiction where s/he is licensed
  - ▶ A certified public accountant in good standing in the jurisdiction where s/he is licensed
- With respect to an investor who purchased securities from an issuer under Rule 506(b) (that is, in a Regulation D transaction without general solicitation) as an accredited investor prior to the adoption of Rule 506(c), and continues to hold such securities, the same issuer can **obtain a certification from the investor that s/he continues to be an accredited investor** for purposes of a subsequent Rule 506(c) offering by that issuer.

## Negative Reaction in the Angel Investment Community

At least part of the investment community has already reacted negatively to the safe harbors, fearing that they will become the *de facto* standard for verification of accredited investor status under Rule 506(c). They contrast this with the long-standing practice of investor self certification, pursuant to which, most practitioners agree, the issuer may form a reasonable belief of accredited investor status for purposes of Rule 506(b). The Angel Capital Association (ACA) stated in a press release:

FINAL RULES ENDING THE BAN ON GENERAL SOLICITATION FOR COMPANIES SEEKING INVESTMENT FROM ACCREDITED INVESTORS ELIMINATES THE ABILITY OF ANGELS TO SELF-CERTIFY THEIR STATUS, AND WILL RESULT IN MANY ANGELS REFUSING TO PARTICIPATE IN THIS TYPE OF INVESTING.

“WITH THOUSANDS FEWER ANGELS PARTICIPATING IN THIS MARKET, STARTUPS WILL HAVE FAR LESS ACCESS TO CAPITAL, THE MILLIONS OF JOBS THEY CREATE EACH YEAR WILL DISAPPEAR, AND THE ECONOMY WILL SUFFER,” SAID MARIANNE HUDSON, EXECUTIVE DIRECTOR OF ACA. “THIS IS THE EXACT OPPOSITE OF CONGRESS’ INTENT IN ITS NEAR-UNANIMOUS PASSAGE OF THE JOBS ACT.”

“ANGEL INVESTORS PROVIDE THE FUNDAMENTAL SOURCE OF START-UP CAPITAL IN OUR ECONOMY,” HUDSON SAID. “NOT A SINGLE ANGEL I HAVE SPOKEN WITH IS WILLING TO PROVIDE PERSONAL FINANCIAL INFORMATION TO AN ISSUER WHO IS ASKING THEM FOR INVESTMENT. THIS VIOLATION OF PRIVACY IS UNTENABLE, ESPECIALLY FOR THE ANGELS WHO DO MULTIPLE DEALS A YEAR.”

## What Could Go Wrong with Rule 506?

A major problem with Rule 506(c) is that failure to take reasonable steps to verify accredited investor status might result in an unregistered public offering, the remedy for which would at a minimum involve rescission. Fear of this outcome could actually discourage issuers from making a general solicitation in reliance on Rule 506(c).

Also problematic is whether the use of the Rule 506(c) verification standard will be interpreted to impose an equivalent verification standard upon the “reasonable belief” standard – including self-certification – that has prevailed for many years under Rule 506(b). The SEC has offered some comfort on this issue, though we should not assume that courts will agree if faced with a messy set of facts. In its Fact Sheet on the meeting of the Commission at which the final rules were adopted, the SEC said:

THE EXISTING PROVISIONS OF RULE 506 AS A SEPARATE EXEMPTION ARE NOT AFFECTED BY THE FINAL RULE. ISSUERS CONDUCTING RULE 506 OFFERINGS WITHOUT THE USE OF GENERAL SOLICITATION OR GENERAL ADVERTISING CAN CONTINUE TO CONDUCT SECURITIES OFFERINGS IN THE SAME MANNER AND AREN'T SUBJECT TO THE NEW VERIFICATION RULE.

It’s worth remembering that Rule 506(b) offerings may include up to 35 non-accredited purchasers (if certain information delivery requirements are met), perhaps resulting in a strong enough distinction between Rules 506(b) and 506(c) to provide a basis for maintaining the differences in the nature of the determination of “accredited” status.

## New Rule 144A Permits General Solicitation

Under the final rule, securities sold pursuant to Rule 144A can be offered to persons other than qualified institutional buyers, or QIBs, including by means of general solicitation, provided that the securities are sold only to persons whom the seller and any person acting on behalf of the seller reasonably believe to be QIBs.

## Form D Modified to Show Rule 506(c) Election

The final rule amends Form D, which is the notice that issuers must file with the SEC when they sell securities under Regulation D. The revised form adds a separate box for issuers to check if they are claiming the new Rule 506(c) exemption that would permit general solicitation or general advertising.

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