

New General Solicitation Rules for Private Placements Go Into Effect

By Michael J. Gorback and Teresa V. Pahl



Hanson Bridgett Corporate Practice Group
HANSONBRIDGETT.COM

Introduction

On September 23, 2013, the SEC's recently adopted rules eliminating the prohibition on general solicitation and general advertising in securities offerings conducted pursuant to Rule 506 under the Securities Act of 1933, as amended, went into effect. The new rules were adopted pursuant to the JOBS Act, and are designed to make it easier for companies (such as startups) to access the capital markets by greatly increasing the universe of potential investors those companies can target in connection with fundraising activities.

Rule 506(c)

Rule 506 provides an exemption from the registration requirements of the Securities Act for issuances of securities not involving a public offering by permitting issuers to sell their securities in private placements to an unlimited number of accredited investors and up to 35 non-accredited investors. Prior to the new rules, Rule 506 was not available for issuers who offered or sold securities through general solicitation or general advertising, including print advertising, television and radio advertisements, or other publicly available media such as websites. New Rule 506(c), however, permits companies to engage in general solicitation and general advertising for their private placements, provided that (1) all purchasers in a Rule 506(c) offering must be accredited, (2) the company must take reasonable steps to ensure that the participating investors in a Rule 506(c) offering are, in fact, accredited, and (3) all of the other requirements relating to Rule 506 offerings must also be satisfied.

Whether a company has taken the requisite reasonable steps to determine the accredited status of investors under a Rule 506(c) offering will depend on the facts and circumstances of

a particular case. What constitutes reasonable steps to verify that a purchaser is an accredited investor will depend on the particular facts and circumstances of each case. While no specific checklist applies, the SEC has indicated that issuers should take into consideration such facts as (1) the nature of the purchaser (Eg: Is the investor an institutional investor or a natural person?); (2) the amount of information the issuer has about the purchaser (Eg: Is there ample public information concerning the investor's net worth or investment experience? Or has the investor's accredited status been confirmed by a reliable third party source?), and (3) the nature of the offering (Eg: Did the issuer solicit investments from its existing customer base or another pre-screened set of potential investors or did the issuer solicit investments through a website or mass email? Is the minimum investment amount sufficiently high to ensure a reasonably higher likelihood of accredited status?). Companies should be sure to retain records relating to their verification efforts, however, because it is the issuer, rather than the investor, that has the burden of demonstrating that the investors in a Rule 506(c) offering were in fact accredited. Importantly, simply requiring investors to submit a questionnaire checking an "accredited" box or to represent and warrant to the investor's accredited status will not be considered reasonable verification efforts.

In addition to the general "principles-based" considerations identified above, the SEC has identified the following four specific non-exclusive "safe harbor" methods of verifying accredited investor status for natural persons that, if used, are deemed to satisfy the verification requirement *unless* the issuer has actual knowledge that the purchaser is not an accredited investor: (1) reviewing the investor's filed Form 1040 for the two most recent years and obtaining a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year; (2) reviewing one or more of the following types of documentation, dated within the most recent three months: bank statements, brokerage statements, certificates of deposit, appraisal reports issued by independent third parties, and a credit report from at least one of the major consumer reporting agencies; (3) obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment advisor, a licensed attorney or a certified public accountant, that such person or entity has taken reasonable steps to verify, and has verified, that a purchaser is an accredited investor; and (4) with respect to any natural person who invests in a Rule 506(b) offering as an accredited investor prior to September 23, 2013 and remains an investor of the issuer, by obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor. An issuer must also indicate in its Form D filing whether it is relying on Rule 506(c). Because securities offered pursuant to Rule 506(c) are deemed to be "covered securities", state blue sky registration requirements will be preempted by Rule 506(c).

Bad Actor Disqualification

Pursuant to the Dodd-Frank Act, the SEC has further adopted new Rule 506(d), which disqualifies securities offerings involving "bad actors" from reliance on Rule 506 (both Rule 506(b) and 506(c)). Under Rule 506(d), the following persons are "covered persons": (1) directors and executive officers of the issuer and other officers who participate in the offering; (2) general partners and managing members of the issuer; (3) beneficial owners of at least 20 percent of the issuer's outstanding voting stock; (4) the issuer and any predecessor or affiliate of the issuer; (5) any promoter connected with the issuer in any capacity at the time of the sale; (6) any person that has been or will be paid, directly or indirectly, for solicitation of purchasers in connection with sales of the securities; and (6) directors, executive officers, other officers participating in the offering, general partners and

managing members of any person or entity covered by (5) above.

A “covered person” would disqualify an offering under Rule 506 in the event that such covered person:

- Has been convicted, within 10 years before the offering in question (or five years, in the case of issuers, their predecessors and affiliated issuers), of a felony or misdemeanor: (i) in connection with the purchase or sale of securities; (ii) involving the making of a false filing with the SEC; or (iii) arising out of the conduct of business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Is subject to an order, judgment or decree of a court of competent jurisdiction, entered into within five years before the offering: (i) that, at the time of the sale, restrains or enjoins the covered person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of securities; (ii) involving the making of a false filing with the SEC; or (iii) arising out of the conduct of business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Is subject to a final order of any state or federal regulatory authority that: (i) at the time of the sale in the offering bars the person from: (a) association with an entity regulated by such regulatory authority; (b) engaging in the business of securities, insurance or banking; or (c) engaging in any savings association or credit union activities; or (ii) constitutes a final order entered within 10 years before such sale based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct;
- Is subject to an order of the SEC that, at the time of the offering: (i) suspends or revokes such person's registration as a broker, dealer, municipal dealer or investment adviser; (ii) places limitations on the activities, functions or operations of such person; or (iii) bars such person from being associated with any entity or from participating in the offering of any penny stock;
- Is subject to an order of the SEC entered within five years before the offering that, at the time of the sale, orders the person to cease and desist from committing or causing a violation or future violation of any scienter-based anti-fraud provision of the federal securities laws or Section 5 of the Securities Act;
- Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for certain acts or omissions; or
- Has filed (as a registrant or issuer), or was named as an underwriter in certain offerings that: (i) were the subject of a refusal order, stop order or suspension order; or (ii) are the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.

While disqualification will apply only in connection with triggering events that occur after the effective date of Rule 506(d), prior triggering events must nonetheless be disclosed to purchasers a reasonable time prior to any sale in an offering made pursuant to Rule 506. Rule 506(d) also will not apply to offerings in which the issuer establishes

that it did not know, and, in the exercise of reasonable care, could not have known, that a disqualification existed because of the presence or participation of a covered person.

Future Developments

Also in the works at the SEC are proposed rules relating to legends that will need to be affixed to offering materials under Rule 506(c), how and when offering materials will need to be submitted to the SEC for review, and revisions to Form D in connection with Rule 506(c) offerings. Until those rules become final, however, it is sufficient for issuers to understand that it has finally become easier to raise money in the capital markets via general solicitation of investments. Doing so is not without its traps, however, and companies interested in taking advantage of Rule 506(c) to raise funds are advised to do so in consultation with counsel in order to minimize the likelihood of running afoul of the prohibitions that remain.

If you have any additional questions, please contact:



Michael J. Gorback
 Direct Phone: 650-358-1367
mgorback@hansonbridgett.com



Teresa V. Pahl
 Direct Phone: 415-995-5079
tpahl@hansonbridgett.com

SAN FRANCISCO

425 Market Street, 26th floor
 San Francisco, CA 94105
 TEL 415-777-3200
 FAX 415-541-9366

NORTH BAY

Wood Island
 80 E. Sir Francis Drake Blvd., Ste. 3E
 Larkspur, CA 94939
 TEL 415-925-8400
 TEL 707-546-9000
 FAX 415-925-8409

SACRAMENTO

500 Capitol Mall, Ste. 1500
 Sacramento, CA 95814
 TEL 916-442-3333
 FAX 916-442-2348

SILICON VALLEY

950 Tower Lane, Ste. 925
 Foster City, CA 94404
 TEL 650-349-4440
 FAX 650-349-4443

EAST BAY

1676 N. California Blvd., Ste. 620
 Walnut Creek, CA 94596
 TEL 925-746-8460
 FAX 925-746-8490