

## SEC Allows Public Advertising and Raises Due Diligence Bar on Private Securities Offerings

July 17, 2013

### About the Authors



**Michael M. Sullivan**  
msullivan@taylorenghish.com  
770.434.1567

[Michael M. Sullivan](#) is a member of the firm's Corporate & Business practice group. He is a trusted advisor and helps clients grow their business and profits in a variety of transactions, including complex Non-Disclosure Agreements, Employment and Non-Compete Agreements, Buy-Sell Agreements, and all forms of business and commercial Agreements and Contracts.



**Jonathan B. Wilson**  
jwilson@taylorenghish.com  
678.336.7185

[Jonathan B. Wilson](#) is a member of the firm's Corporate & Business practice group and his practice includes corporate securities, corporate finance and governance, mergers and acquisitions and intellectual property. He has represented both Fortune 100, middle-market and start-up companies in transactional matters for more than 20 years.

On July 10, 2013, the Securities and Exchange Commission (SEC) issued final rules<sup>[1]</sup> (the "New Rules") that:

- Reverse its long standing ban on public advertising of private securities offerings,
- Implement new reporting, notice and disclosure requirements for private offerings, and
- Require issuers to perform due diligence for, and restrict the involvement of, felons and certain securities law violators ("bad actors") from being inside the issuer and part of its offering team, or lose their exemption from registration.

In addition, on the same day, the SEC issued proposed rules<sup>[2]</sup> (the "Proposed Rules") that would implement new reporting, notice and disclosure requirements for issuers in private offerings under Regulation D.

Both developments took place in light of legislative mandates under the JOBS Act and the Dodd-Frank Act. The New Rules make several important changes to the SEC rules applicable to the private sale of securities and take effect sixty days after the New Rules are published in the Federal Register (which will likely run into middle or late September). Consequently, issuers may not rely on the New Rules until they become effective. Parties are invited to comment on the Proposed Rules for sixty days after they are published in the Federal Register.

### **PUBLIC ADVERTISING**

#### *Legislative Background*

The Securities Act of 1933 (the "Securities Act") requires all offers and sales of securities to either be registered with the SEC or exempt from registration. The two main sources of statutory exemptions from registration are Sections 3 and 4 of the Securities Act. Most of the

Please contact Mr. Sullivan or Mr. Wilson for additional information on the new rules for Private Securities Offerings and how they may apply to your company or to your client.

## Other Contributors

### **Scott L. Duma**

sduma@taylorenghish.com  
770.434.4807

### **L. Kent Webb**

kwebb@taylorenghish.com  
678.336.7222

### **Melisa E. McMorries**

mmcmorries@taylorenghish.com  
678.336.7155

### **Emily Stuart Horn**

ehorn@taylorenghish.com  
678.336.7220

### **Jody Arogeti Brown**

jbrown@taylorenghish.com  
678.336.7259

exemptions from registration, however, prohibit issuers and their promoters from engaging in general solicitation or general advertising (including advertising in newspapers, on websites or using the Internet generally) when soliciting purchasers for exempt securities offerings.

Section 4(a)(2) of the Securities Act provides a statutory exemption for "transactions by an issuer not involving any public offering". More specifically, Regulation D ("Reg. D") of the Securities Act provides safe harbors for an issuer engaged in such an unregistered offering under Section 4(a)(2), with the vast majority of private, unregistered offerings of securities relying on the exemption in Reg. D's Rule 506(b). Prior to the New Rules, Rule 506(b) provided an exemption whereby an issuer could offer and sell an unlimited amount of securities to an unlimited number of accredited investors and to 35 non-accredited investors that are sophisticated investors as a part of a private, exempt offering.<sup>[3]</sup> However, such 506(b) issuer was prohibited from using "general solicitation or general advertising" in offering its securities. Utilizing "general solicitation or general advertising" would cause the offering to fall outside of the exemption providing for private sales under Rule 506(b).

#### *The JOBS Act and New Rule 506(c) Introduction*

Section 201(a) of the 2012 Jumpstart Our Business Startups Act (JOBS Act) directed the SEC to amend Rule 506 to permit general solicitation or general advertising in offerings of securities under Rule 506 but to retain the restriction limiting sales to accredited investors. In other words, Section 201(a) of the JOBS Act intended to permit issuers to publicly solicit purchasers for its securities, but the purchasers would still be required to meet all the requirements of an accredited investor.

Pursuant to Section 201(a) of the JOBS Act, in the New Rules adopted on July 10, the SEC added a new Subsection (c) to Rule 506 and created a new class of exemption.

New Rule 506(c) permits issuers to use general solicitation and general advertising to offer their securities. However, the issuer must take reasonable steps to verify that the investors are accredited investors and may not sell securities in the exempt offering to a purchaser it knows is not accredited. The SEC has never defined "general solicitation" or "general advertising" and does not do so in the New Rules.

The SEC does, however, give some examples of general solicitation and general advertising in Rule 502(c), which include ads in newspapers and magazines, communications broadcast over TV and

radio, and seminars where attendees have been invited by general solicitation. In the New Rules, the SEC confirms that other uses of publicly available media, such as unrestricted web sites, also are considered general solicitation and general advertising and may be used. It is fair to say that under new Rule 506(c) there are few, if any, restrictions on the medium that may be used to publicize a private offering using general solicitation and general advertising means.

*Taking Reasonable Steps to Qualify for Rule 506(c) Exemption*

Under new Rule 506(c), an issuer must take reasonable steps to verify the purchaser is an accredited investor. This verification requirement applies separate from and in addition to the requirement that the purchasers actually be accredited investors. Whether the steps taken by an issuer are "reasonable" will be an objective determination based on the particular facts and circumstances, including:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- The amount and type of information that the issuer has about the purchaser; and
- The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount. The SEC stated in its Release that it would not be reasonable for an issuer to require only that the prospective purchaser check a box in a questionnaire or sign a form certifying that the prospective purchaser is an accredited investor.

To provide greater certainty to issuers, as part of the New Rules the SEC adopted four specific, non-exclusive methods to satisfy the verification requirement. Those four methods are:

- Verifying accredited investor status on the basis of income by reviewing copies of IRS forms reporting income such as W-2, 1099, Schedule K-1 or 1040 for the two most recent years plus a written representation from the prospective purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.
- Verifying whether a natural person is an accredited investor on the basis of net worth by reviewing certain documents and obtaining written representation from the prospective purchaser that all liabilities necessary to make a determination of net worth have been disclosed. The documents referred to

by the SEC for verifying assets are bank statements, brokerage statements, certificates of deposit, tax assessments and appraisal reports issued by independent third parties with certain date requirements. The document for verifying liabilities is a consumer report from at least one of the nationwide consumer reporting agencies.

- Obtaining written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps within the prior three months to verify that the purchaser is an accredited investor.
- Obtaining a written certification from any natural person that he or she is an accredited investor if such natural person previously invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of the New Rules.

In the adopting release the SEC cautions issuers that, notwithstanding its use of any of the above verification methods, an issuer may not treat a prospective purchaser as an accredited investor if the issuer has actual knowledge that the prospective purchaser does not actually meet the all of the requirements to be an accredited investor. Issuers should maintain sufficient records of the process used to verify that each purchaser of its securities is an accredited investor.

#### *Continuation of Existing Exemption 506(b)*

Importantly, the New Rules do not remove Subsection (b) from Rule 506. Existing Rule 506(b) remains as a separate exemption not affected by new Rule 506(c). Consequently, issuers may still conduct a Rule 506(b) offering provided that they do so without using general solicitation or general advertising. Issuers who do comply with the tradition Rule 506(b) offering requirement are able to do so without having to comply with the new verification Rules under Rule 506(c).

#### *Other Changes*

In the New Rules the SEC also:

- Modified Form D to include a box to check if the issuer is relying on a Rule 506(c) exemption.
- Reaffirmed its view that Section 201(b) of the JOBS Act permits private funds to engage in general solicitation in compliance with new Rule 506(c) without losing either of the exclusions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.

- Amended Rule 144A under the Securities Act (and its related Regulation M) to implement Section 201(a)(2) of the JOBS Act to provide that securities sold under Rule 144A may be offered to persons other than Qualified Institutional Buyers ("QIB"), including by means of general solicitation, provided that securities are sold only to persons that the seller reasonably believes are a QIB.
- Reaffirmed its view that offshore offerings of securities made concurrently under Regulation S will not be integrated with domestic unregistered offerings conducted under Rule 506 or Rule 144A, as they are amended.

### **"BAD ACTORS" DISQUALIFIED UNDER NEW RULE 506**

#### *Legislative Background*

Prior to the New Rules, Rule 506 did not prohibit felons and other "bad actors" from taking part in Rule 506 offerings. As part of the New Rules on July 10, 2013 the SEC implemented Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") by issuing new Rule 506(d) which disqualifies issuers and other market participants from relying on Rule 506 if a "Covered Person" that has experienced a "Disqualifying Event" is involved with the solicitation.

#### *"Covered Persons"*

Under new Rule 506(d), the following categories of natural persons and entities are "Covered Persons":

- The issuer, including its predecessors and affiliated issuers;
- Directors and executive officers, general partners, and managing members of the issuer;
- 20 percent beneficial owners of the issuer;
- Promoters;
- Investment managers and principals of pooled investment funds; and
- Persons compensated for soliciting investors, as well as the general partners, directors, officer and managing members of any compensated solicitor.

#### *"Disqualifying Events"*

Under Rule 506(d), if a Covered Person has experienced any of the following events (a "Disqualifying Event") it will disqualify the Rule 506 exemption for the issuer:

- Criminal conviction in connection with purchase or sale of a security, making a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries that occurred within 10 years of the proposed sale of securities, or 5 years for the issuer and its predecessors and affiliated issuers. The criminal conviction must have occurred within the past 5 years of the proposed sale of securities for the issuer, its predecessors and affiliated issuers or within the past 10 years for all other Covered Persons;
- Court injunctions and restraining orders in connection with purchase or sale of a security, making a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries that occurred within 5 years of the proposed sale of securities;
- Final orders from the CFTC, federal banking agencies, the National Credit Union Administration, or state regulators of securities, insurance, banking, savings associations, or credit unions that:
  - Bar the issuer from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings associations or credit union activities, or
  - Are based on fraudulent, manipulative, or deceptive conduct;
- Certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons;
- SEC cease-and-desist orders related to violations of certain anti-fraud provisions and registration requirements of the federal securities laws;
- SEC stop order and order suspending a Regulation A offering issued within 5 years of the proposed sale of securities;
- Suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member; or
- U.S. Postal Service false representation order issued within 5 years before the proposed sale of securities.

#### *Consequence and Action*

Rule 506(d) makes the sale of any securities involving the existence of a Disqualifying Event with regard to a Covered Person ineligible for exemption under Rule 506. Importantly, the discovery of a "Disqualifying Event" by a "Covered Person" can have a retroactive

effect, causing an issuer to lose its Rule 506 exemption and becoming subject to penalties for selling securities without registration if the disqualification is discovered after the offering has been completed. Consequently, issuers should take great care to exercise a significant level of internal due diligence with respect to the issuers Covered Persons as the failure to uncover a Disqualifying Event could have significant repercussions.

#### *Reasonable Care Exception*

Rule 506(d) does provide for a "reasonable care" exception from disqualification when the issuer can show it did not know and, in the exercise of reasonable care, could not have known that a Covered Person with a Disqualifying Event participated in the offering. However, the issuer cannot establish that it exercised reasonable care unless it made a factual inquiry into whether any disqualification existed. Due to the diversity of facts behind every offering, the SEC rejected proposals to prescribe specific steps necessary or sufficient to establish reasonable care. Rather, the steps an issuer should take to exercise reasonable care will vary according to the particular facts and circumstances of each securities offering. Factual inquiry by questionnaires or certifications may be sufficient in some circumstances, particularly if there is no information or other indications suggesting bad actor involvement. However, in the case where government records exist or in the case of a registered broker-dealer and other similar regulated intermediaries publish reports that are available to the public, it may be additionally expected that issuers make sufficient inquiry of the background of Covered Person by having searched such publicly available databases for past disciplinary history.

When seeking to meet the reasonable care exception, the time frame for the disqualification inquiry should also be reasonable in relation to the circumstances of the offering and the participants. The inquiry should be sufficiently close to the offering without unreasonably overburdening the issuer. For continuous and long-lived offerings, depending on the circumstances, the issuer may be required to make periodic inquiries of disqualifying events to update its factual database. The frequency and degree of updating will depend on the circumstances of the issuer and the offering and participants involved.

#### *Disqualification Waiver*

The SEC granted authority to the SEC's Director of the Division of Corporation Finance to grant waivers to the "Bad Actor" disqualification provisions. However, the SEC declined to issue

guidance on circumstances which justify grant of a disqualification waiver. On the other hand, the SEC did identify a number of circumstances that could be relevant to the evaluation of a waiver request --- a change in control, change in supervisory personnel, absence of notice and opportunity for hearing, and relief from a permanent bar for a person who does not intend to apply to re-associate with a regulated entity.

*Transition - Pre-Existing Disqualifying Events*

New Rule 506(d) will become effective 60 days after the New Rules are published in the Federal Register. Disqualification under 506(d) will apply only for disqualifying events occurring after the effective date of the New Rules. However, matters that existed before the effective date that would otherwise be disqualifying are subject to a mandatory disclosure requirement to investors.

Summary of Regulation D Rules

<b>Reg. D Rule</b>	<b>Amount of Offering</b>	<b>Solicitation</b>	<b>Purchasers</b>	<b>Applicability of Rule 506(d)</b>	<b>Comments</b>
504	\$1Million	Privately, to known investors; no general solicitation or general advertising	Unlimited Number of Accredited Investors only	Applicable	Intra-state offerings
505	\$5Million	Privately, to known investors; no general solicitation or general advertising	Unlimited Number of Accredited Investors, and up to 35 non-accredited but sophisticated investors	Applicable	
506(b)	Unlimited	Privately, to known investors; no general solicitation or general advertig	Unlimited Number of Accredited Investors, and up to 35 non-accredited but sophisticated investors	Applicable	
506(c)	Unlimited	Public advertising - general solicitation or general advertising	Unlimited Number of Accredited Investors only	Applicable	

### **Links to Original Source Documents**

- Release No. 33-9415 (File No. S7-07-012) Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (July 10, 2013) <http://www.sec.gov/rules/final/2013/33-9415.pdf>
- Release No., 33-9414 (File No. S7-21-11) Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings (July 10, 2013) <http://www.sec.gov/rules/final/2013/33-9414.pdf>
- Release No. 33-9416 (File No. S7-06-13) Amendments to Regulation D, Form D and Rule 156 under the Securities Act (July 10, 2013) <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>

### **THE SEC'S PROPOSED CHANGES TO FORM D AND RULE 506**

In its proposed amendments to Regulation D on July 10, 2013, the SEC proposed the following changes:

- Form D filings for Rule 506 exempt offerings must be filed 15 days prior to the offering rather than the current 15 days after commencement;
- Expanding the information required on Form D, including a description of the use of proceeds;
- Disqualifying an issuer from the use of the Rule 506 exemption if the issuer fails to file a Form D;
- Including certain legends and cautionary statements in written general solicitation material; and
- A requirement, valid for 2 years, for issuers to file their general solicitation materials with the SEC for informational purposes (not approval). □

The SEC is accepting comments within sixty days after the publication of the Proposed Rules in the Federal Register.

[\[1\]](#) Release No. 33-9415 (File No. S7-07-012) Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (July 10, 2013), and Release No., 33-9414 (File No. S7-21-11) Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings (July 10, 2013).

[\[2\]](#) Release No. 33-9416 (File No. S7-06-13) Amendments to Regulation D, Form D and Rule 156 under the Securities Act (July 10, 2013).

[\[3\]](#) The term "accredited investor" is defined in Rule 501 under the Securities Act, in general terms, as a natural person with either (a) a net worth of \$1 million or more, excluding the person's primary residence, or (b) adjusted gross income of \$200,000 or more (\$300,000 if married filing jointly) in each of the past two years and with the reasonable expectation of earning at least such amount in the current year. The term may also include partnerships, all of whose individual partners are accredited investors, corporations with net assets of \$5 million or more and other entities.

Taylor English Duma LLP is a full-service law firm composed of experienced and results-driven lawyers. Our model is purpose-built around our clients and designed to seek new opportunities for them.

*Law Alert* is published solely for the friends and clients of Taylor English Duma LLP and should in no way be relied upon or construed as legal advice. For specific information on recent developments or particular factual situations, a reader should obtain the advice of an attorney. Taylor English Duma LLP is a limited liability partnership.

You have received this email because you are on the firm's e-distribution list. If you received this transmission in error, please notify the sender by reply email and delete the message and any attachments. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Prior results do not guarantee a similar outcome.

IRS CIRCULAR 230 Disclosure: Under U.S. Treasury regulations, we are required to inform you that any advice contained in this e-mail or any attachment hereto is not intended to be used, and cannot be used, to avoid penalties imposed under the Internal Revenue Code. Copyright © 2013 Taylor English Duma LLP.