

SEC Proposes Rules for Eliminating General Solicitation in Rule 506

On August 29, 2012, the SEC released its proposed rules for eliminating general solicitation and general advertising in Rule 506 and Rule 144A offerings. Here is a summary and our perspective.

1. The SEC left the current Rule 506 exemption intact. In other words, business as usual if you don't generally solicit. This section will be renamed as "506(b)." The SEC got this right.

2. For 506 offerings with general solicitation, to be called section "506(c)," all purchasers must be accredited and the issuer must "take reasonable steps to verify" that the purchaser is accredited, just as the JOBS Act requires.

3. The definition of "accredited investor" was not changed. Importantly, the SEC left in the escape valve in 501 that if the issuer "reasonably believes" the person comes within the categories, then that purchaser counts as accredited. More on this below.

4. The determination of what are "reasonable steps to verify" would be based on the particular facts and circumstances. Factors to consider would include: (1) nature of purchaser and type of accredited investor, (2) amount and type of information that issuer has about the purchaser, and (3) nature of the offering, such as manner of solicitation, and terms of the offering, such as minimum investment amount. Leaving what constitutes "reasonable steps" open as the SEC proposes is the right approach we believe as it makes room for advancements in verification methods over time.

5. The proposed rules contain a lengthy discussion on what type of evidence might, depending on circumstances, establish reasonable steps. The SEC stopped short, however, of proposing safe harbors for when reasonable steps would be deemed met. This is a mistake. Safe harbors are needed for companies to act with confidence out of the gate. Without safe harbors, issuers won't know when "enough is enough" until bad cases start making bad law. The uncertainty will

lead to conservative behavior and additional cost and investor hassle. The SEC invited comment on this point and we suggest a response that specific safe harbors should be implemented for at least private company offerings. These safe harbors could include an investment above \$25,000, third party verification (including verification from a funding platform that has a relationship with the purchaser), publicly available compensation information. Safe harbors based on annual figures should be presumed until the next cycle so that companies aren't burdened with repeating verification for interim investments.

6. The SEC reiterated that the issuer has the burden of showing it is entitled to the 506(c) exemption.

7. The proposed rules address the important question of whether the new 506(c) exemption is lost if a purchaser turns out not to be, in fact, accredited. The SEC proposed that if the issuer (1) took reasonable steps to verify the purchaser was accredited and (2) had a reasonable belief that the purchaser was accredited, then the exemption of 506(c) is not lost. The SEC's position is helpful but does not go far enough. Under the current Reg D rules, a "reasonable belief" that the purchaser is accredited is enough to maintain that treatment and thus 506. The SEC's formulation for 506(c) turns the inquiry into two standards, an objective test on whether "reasonable steps" were taken and the subjective "reasonable belief" test on accredited. With current Rule 506, issuers can rely on a Section 4(a)(2) exemption as a backstop if the 506 conditions aren't met. In the general solicitation context, however, there is no back stop. If an issuer blows 506(c), 4(a)(2) is not available and it's arguably had a public offering. In addition, a blown 506(c) exemption could remove a funding platform's broker-dealer exemption because that exemption under the JOBS Act requires the securities "be offered and sold in compliance with Rule 506." Thus the penalty for being wrong in the general solicitation context is far more significant than under current 506, and, like the absence of safe harbors, an objective facts and circumstances test measured in hindsight is scary and will lead

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issuers and portals to behave overly conservative, resulting in more expense and limiting who can be an investor. This subverts the purpose of the JOBS Act to open opportunities and encourage investment. The SEC specifically invited comment on the “reasonable belief” question, and we think the standard should be no higher than the current rule, specifically: if an issuer reasonably believes that (i) the purchaser is accredited and (ii) reasonable steps to verify were taken, then the exemption is not lost even though the purchaser does not meet the criteria for accredited investor.

8. The SEC noted it would be important for the issuer to retain adequate records to document the verification steps taken. Issuers using funding platforms will need to think through who holds and how to get access to purchaser verification information.

9. The information requirements in Rule 502(b), which describe financial and offering information required to be provided to unaccredited investors, would not apply to 506(c) offerings because (obviously) all the purchasers must be accredited.

10. Form D that gets filed with the SEC on a Regulation D offering would be changed to add a box to check for 506(c) offering, so that the SEC can collect data and monitor the offerings. Our only concern here is to make sure that by not checking the box, an issuer is not precluded from relying on 506(c) exemption (for example, if 506(b) didn't apply to an offering because it somehow tripped general solicitation but otherwise met the 506(c) conditions).

11. The actual language for new Rule 506(c) and related changes as proposed by the SEC are simple and merely recite the main wording, such as issuer must take reasonable steps to verify. The SEC's 60+ page discussion, including the facts and circumstances test, factors to consider, when the 506(c) exemption is lost, interpretation of Investment Company Act, and so on, are not in the rules themselves. Perhaps these will be added to the final rules or maybe advanced as an “interpretative” document. But not having some operative language in the actual rules is disconcerting. At a minimum, we think the standard for preserving the 506(c) exemp-

tion and safe harbors should be spelled out in the text.

12. Comment was invited on additional questions, including: (1) Are there other factors to consider? (2) Do some issuers (e.g., public shell companies) require heightened scrutiny on verification steps because of increased investor risk? (3) What other documentation could be used to verify accredited with less privacy concern? (4) Should Rule 508, which allows insignificant deviation from the Rules without losing the exemptions, be modified for 506(c)? Responding comments are due in 30 days.

13. Finally, SEC proposed similar changes to Rule 144A, an exemption used for sales to larger institutional investors.

14. As part of the proposed rules, the SEC expressed its view that investment funds are permitted to use general solicitation under new 506(c) offering without losing either of the exclusions under the Investment Company Act (i.e., the 100 beneficial owners and qualified purchasers exclusions). This was an open question because the Investment Company Act exclusions do not allow funds to make public offerings of securities. This is the right answer. Investment funds were excluded from using the new crowdfunding exemption in the JOBS Act, so the opportunity to generally solicit is a plus.

15. The SEC included some interesting data on 506 offerings: in 2011, Rule 506 offerings were estimated to be \$895 billion compared to \$984 billion raised in registered offerings. In 2010, the numbers were \$902 billion in 506 offerings versus \$1.07 trillion in registered offerings. Clearly Rule 506 offerings have a large impact on the US economy.

For more information about the JOBS Act or the proposed rules for Rule 506, please contact Dan Hansen at dhansen@mh-llp.com or at 650-331-7003.

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