

SEC Adopts Final Rules Lifting Ban Against General Advertising in Private Capital Raises

July 18, 2013

Summary

In a significant move, on July 10, 2013, the Securities and Exchange Commission voted 4 to 1 to eliminate the 80 year old ban on general advertising and general solicitation for capital raise transactions. This action is predicted to be a "game changer" with respect to the way hedge funds, venture funds, businesses and entrepreneurs raise capital. The new rules impose obligations on companies and individuals who are raising capital to take "reasonable steps" to verify that the investors fall into one or more categories of "accredited investors." According to the SEC, based on 2010 census data, there are 8.7 million households that qualify as "accredited investors."

Exempt offerings play a significant role in capital formation in the United States. In 2012, the estimated amount of capital reported as being raised in private exempt offerings (including both equity and debt) was \$898 billion, compared to \$1.2 trillion raised in registered public offerings. Of this \$898 billion, operating companies (issuers that are not investment funds) reported raising \$173 billion, while investment funds reported raising \$725 billion. In 2012, approximately 153,000 investors participated in private exempt offerings by operating companies, while approximately 81,000 investors invested in private exempt offerings by investment funds.

New Rule 506(c)

The "New Rules"^[1] were promulgated by the SEC pursuant to the Jump Start Our Business Startups Act ("JOBS Act"), which was signed into law on April 5, 2012.^[2] The purpose of the New Rules is to permit general solicitation or general advertising in capital raise transactions, provided that all purchasers of the securities are "accredited investors."

SEC regulations do not define "general solicitation" or "general advertising" but they do give examples, including newspaper and magazine ads, TV and radio communications, and seminars where attendees have been invited by general solicitation or general advertising. The SEC staff has taken the position that unrestricted websites and other uses of publicly available media also constitute general solicitation or general advertising.

An "accredited investor" is one whom the recipient of the capital reasonably believes has: 1) a net worth or joint net worth with that person's spouse in excess of \$1,000,000, excluding the value of the person's primary residence ("net worth test"), or 2) an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person's spouse of \$300,000 in each of those years, and a reasonable expectation of reaching the same income level in the current year ("income test").

Who can avail themselves of the New Rules?

- Hedge funds, private equity funds and buy-out firms
- Venture capital funds
- Start-up and other companies
- Entrepreneurs/Individuals

What is the key provision?

- Capital raisers (issuers) must take reasonable steps to **verify** that all investors are accredited

To implement the JOBS Act, the SEC amended Rule 506 of Regulation D^[3] to add new paragraph (c), under which the prohibition against general solicitation contained in Rule 502(c) would not apply, provided that all purchasers of the securities are accredited investors and the issuer take reasonable steps to verify that such purchasers are accredited investors. In addition, the SEC amended Form D, which is a notice required to be filed with the SEC by each issuer claiming a Regulation D exemption, to add a check box to indicate whether an issuer is claiming an exemption under Rule 506(c).^[4]

Rule 506(b) continues to exempt offerings of up to 35 non-accredited investors (subject to investor sophistication and increased disclosure requirements) and an unlimited number of accredited investors, but general advertising is not allowed. Rule 506(b) is still in place and has not been supplanted by the new Rule 506(c). **By contrast, the new Rule 506(c) allows general advertising but requires all investors to be accredited.**

What are the "reasonable steps" to verify accredited investor status? The SEC mandates that an objective determination must be made by the person or issuer raising the capital (or those acting on his, her or its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. Under this principles-based approach, issuers would consider a number of factors when determining the reasonableness of the steps to verify that a purchaser is an accredited investor, such as:

- 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 has specified a non-exclusive list of objective methods for issuers to verify that all investors are accredited.

Income Test

In verifying whether a natural person is an accredited investor *on the basis of income*, the SEC states an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of any Internal Revenue Service form that reports income, including, but not limited to, a Form W-2, Form 1099, Schedule K-1 of Form 1065, and a copy of a filed Form 1040 for the two most recent years, along with 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.

Net Worth Test

In verifying whether a natural person is an accredited investor *on the basis of net worth*, the SEC states an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing one or more of the following types of documentation, dated within the prior three months, and by obtaining a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed. For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties are deemed to be satisfactory; and for liabilities: a consumer report (also known as a credit report) from at least one of the nationwide consumer reporting agencies is deemed to be satisfactory.

An issuer is also deemed to satisfy the verification requirement in Rule 506(c) by 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 that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor.

The SEC also voted to propose new rules for amendments to Form D for individuals and companies to make filings with the SEC that describe in detail the capital raise and use of proceeds. In particular, the SEC proposed that issuers will have to file a Form D with the SEC at least 15 days before they begin general solicitation, and amend that Form D to state that they are done soliciting within 30 days of finishing.[5]

Rule 506 offerings are generally not available to persons with criminal backgrounds involving securities, or who have otherwise been the subject of administrative or court action by the SEC, in each case prospectively (i.e., occurring after the New Rules become effective per new Rule 506(d)). However, such



events occurring before the New Rules become effective must be disclosed, per new Rule 506(e).[6]

The New Rules become effective 60 days after publication in the Federal Register, which is expected to occur soon. Until that time, companies, funds and individuals seeking capital in Rule 506 offerings should not engage in any general advertising or general solicitation.

The SEC has still not issued rules on raising capital through "crowdfunding", which are internet-based funding portals that are open to everyone.

To discuss this alert or any securities law matter, please contact your Lathrop Gage attorney or any of the attorneys listed on this alert.

[1] Release No. 33-9415; Release No. 34-69959; Release No. IA-3624; File No. S7-07-12 (Jul. 10, 2013).

[2] Pub. L. No. 112-106, §201(a), 126 Stat. 306, 313 (Apr. 5, 2012).

[3] 17 CFR 230.506.

[4] 17 CFR 239.500.

[5] Release No. 33-9416 (July 10, 2013).

[6] Release No. 33-9414 (July 10, 2013).