

SEC ALLOWS GENERAL SOLICITATION IN OFFERINGS OF UNREGISTERED SECURITIES UNDER REGULATION D

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The SEC on July 10, 2013 amended Regulation D to allow the use of general solicitation in certain Rule 506 offerings of securities not registered under the Securities Act of 1933. This long awaited amendment to Regulation D required by the Jumpstart Our Business Startups Act (JOBS Act) becomes effective on September 23, 2013. Regulation D sets forth specific procedures which, if complied with, exempt the offer and sale of securities from the registration requirements of Section 5 of the Securities Act of 1933. Compliance with Regulations D requires compliance with the rules governing integration of offerings, information to be disclosed, manner of sale, number and type of purchasers and in some cases a limitation on the dollar amount of securities sold as well as the timely filing of a Form D. Regulation D offerings, although exempt from registration requirements, remain subject to the anti-fraud and civil liability provisions of the Securities Act of 1933.

Rule 506(c) Offerings

This amendment to Regulation D, by inserting Rule 506(c), created a special class of Regulation D offerings where the use of general solicitation and general advertising in the offer and sale of securities is allowed. The additional requirements that distinguish these offerings from the traditional Rule 506 offerings are that:

- (1) all the purchasers must be accredited investors, as defined in Regulations D, and
- (2) the issuer has to have taken reasonable steps to verify that all the purchasers are accredited investors.

The SEC left intact existing Rule 506(b) providing for the private offering and sale of securities without general solicitation which offering could include up to 35 non-accredited investors. Other than the lifting of the prohibition on general solicitation, the provisions of Regulation D applicable to Rule 506 offerings in general remain in effect for Rule 506(c) offerings.

Advertising

This monumental change in the allowable marketing practices for unregistered securities will permit start-ups, small businesses, private equity funds, hedge funds and other issuers of unregistered securities to use the internet, email, social media, radio, television, mass mailings or

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even billboards to advertise the sale of securities if the issuers are willing to limit their offering to accredited investors. The only requirements on these offering will be the usual restrictions of Rule 506 offerings and the additional requirements for Rule 506(c) offerings set forth above. However, given that general solicitation of unregistered securities was never allowed before, the ability to use advertising, while available commencing September 23, 2013, will require a learning process as issuers of securities find ways to use this new found freedom in a manner that meaningfully enhances the capital raising process.

Verification

Rule 506(c) offerings require the issuer take reasonable steps to verify that all the purchasers are accredited investors. The final rule amendment, in reaction to criticism of the initial proposed rule amendment, includes a non-exclusive list of methods that an issuer can use that will be deemed reasonable steps to verify that the purchasers who are natural persons are indeed accredited investors.

- When accredited investor status is based on income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the necessary income level for the current year;
- When accredited investor status is based on net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:
 - (1) With respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and
 - (2) With respect to liabilities: a credit report from at least one of the nationwide consumer reporting agencies; or
- Obtaining a written confirmation from one of the following entities that such 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:

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- (1) A registered broker-dealer;
 - (2) An investment adviser registered with the SEC;
 - (3) A licensed attorney who is in good standing; or
 - (4) A certified public accountant who is duly registered and in good standing.
- In regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to September 23, 2013 and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

Disqualification of Bad Actors

Section 926 of the Dodd-Frank Act required the SEC to promulgate rules to exclude issuers associated with certain bad actors from using Regulation D to sell securities. In a separate release also issued on July 10, 2013, the SEC adopted new Rule 506(d) which disqualifies issuers from using Rule 506 to sell securities when a covered person has been the subject of a disqualifying event. Such covered persons include the issuer; any director, executive officer, other officer participating in the offering; any general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer's outstanding voting equity securities; any promoter connected with the issuer in any capacity at the time of such sale; any investment manager of an issuer that is a pooled investment fund; any person that has been or will be paid for solicitation of purchasers; and certain others. Disqualifying events include, among others, being convicted of any felony or misdemeanor in connection with the sale of any security; being subject to any order of any court or state securities commission that restrains such person from engaging any conduct in connection with the sale of any security; or being subject to certain orders of the SEC.

Rule 506(c), while only applying to disqualifying events occurring on or after September 23, 2013, requires disclosure of events that would have disqualified the issuer from using Regulation D if they have occurred on or after September 23, 2013.

Practical Considerations

Exclusion of Non-Accredited Investors. With this change the offering of securities under Rule 506 becomes even less likely to include non-accredited investors. Currently, most issuers do not offer securities under Rule 506 to unaccredited investors to avoid the need to provide the more elaborate disclosure document required when the purchasers include non-accredited investors.

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With this new amendment, the case for not selling securities under Rule 506 to non-accredited investors becomes even stronger.

Updated Subscription Documents and Procedures. Subscription documents will need to be updated to include the certifications and other documentation required for the safe harbor methods of verifying accredited investor status. Few issuers will be willing to use methods other than the safe harbors except with investors with which the issuer has a long history. The SEC has stated that it does not believe that an issuer will have taken reasonable steps to verify accredited investor status if it required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.

While the SEC did not indicate that there was any change in how accredited investors status in traditional Rule 506(b) offerings should be determined, it remains to be seen whether the increased verification requirements of Rule 506(c) offerings using general solicitation will cause traditional Rule 506(b) offerings without public solicitation to continue to rely on less due diligence to ascertain an investor's accredited investor status. Moreover, many Rule 506(b) offerings will require the additional information required by Rule 506(c) to allow them at a later date to use general solicitation if the market conditions seem appropriate.

Need to Verify No Bad Actors. The bad actor disqualification provisions of Rule 506(d) will require that issuers conduct due diligence on their officers, directors and any solicitors to determine that they do not disqualify the offering from using Regulation D. Accordingly, agreements with solicitors will need to be updated to cover the bad actor disqualifications of Rule 506(d).

The Need for Careful Recordkeeping. The documentation of an investor's accredited investor status will need to be retained to later prove that the offering was entitled to the Rule 506(c) exemption from registration. The issuer must show it took reasonable steps to verify accredited investor status and not just that the investor was in fact an accredited investor. Additionally, the due diligence to ascertain that no bad actors were involved in the offering will also need to be retained.

Advertisements Must be Carefully Reviewed. Advertising, even if allowed, will still be subject to various rules. In terms of securities law compliance, the advertising will need to be carefully scrutinized so that it is not deemed to be misleading or to fail to disclose material information. Additionally, telemarketing and email solicitations have other laws that govern their use for advertising generally such as the FTC's Telemarketing Sales Rule and the CAN-SPAM Act.

General Solicitation Limits the Use of Other Exemptions. None of the other exemptions from registration for the offer and sale of securities besides Rule 506(c) allow for general solicitation.

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Consequently, a failure to strictly comply with the terms of the terms of Rule 506(c) will leave an offering where general solicitation was used with no other paths to asserting an exemption from the registration requirements of the Securities Act of 1933. Consequently, the use of Rule 506(c) requires heightened due diligence and compliance vigilance on the part of the issuer because there is no back-up position.

Proposed Additional Amendments to Regulation D

The third release SEC issued on July 10, 2013 was a set of additional proposed amendments to Regulation D. The stated purposes of these amendments are investor protection and to allow evaluation of the development of the market for unregistered securities offered through general advertisements or other types of general solicitations. First, the amendment would require a filing of a Form D report of the intent to use general solicitation 15 days prior to its use. Currently, a Form D is only required to be filed within 15 days of the first sale of securities in the offering. Second, the amendment would require substantial additional information about the offering be included in the Form D. Additionally, general solicitations taking advantage of Rule 506(c) would be required to place a prescribed legend on all such general solicitations. Additionally, as a temporary measure, advertising materials would need to be filed with the SEC. Many commentators have already reacted negatively to these proposed amendments because the additional requirements are seen by many as inhibiting capital formation by making Regulation D less user-friendly for small issuers.

Summary

While advertising may be used in Regulation D offerings come September 23, 2013, it must be used carefully. Recordkeeping and due diligence on the personnel connected with the issuer and the purchasers have become more important when using Regulation D.

For More Information

If you have questions about the subject matter of this Alert, please contact your attorney at Sugar Felsenthal Grais & Hammer LLP or Etahn Cohen at 312-704-2196 or ecohen@sugarfgh.com.



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