

Q&A on Rule 506 Changes

What is Rule 506 of Regulation D anyway? Former Rule 506 (new Rule 506(b)) provides that an issuer may sell an unlimited amount of securities to Accredited Investors and to no more than 35 Experienced and Sophisticated Investors (generally, an investor who has knowledge and experience in financial and business matters that he/she is capable of evaluating the merits and risks). However, the issuer is prohibited from engaging in General Solicitation and General Advertising (“General Solicitation”) to offer or sell the securities. Rather, the issuer must possess a “pre-existing substantive relationship” with the investor. Despite these restrictions, Rule 506 serves as an attractive and useful exemption. First, there is no monetary cap on the total offering amount. Second, States are preempted from imposing registration requirements on Rule 506 deals, making state securities law compliance less onerous. Pursuant to Release 33-9414, the SEC notes its records reflect “90% to 95% of all Regulation D Offerings” are Rule 506 deals. As Rule 506 is an exemption, issuers avoid costly and time-consuming registration provisions.

How does new Rule 506(c) change the landscape? The General Solicitation ban will be lifted for certain offerings and sales. In other words, issuers will now be able to market securities to the general public and still qualify for an exemption from registration pursuant to Rule 506(c). However, the SEC sets forth 3 elements, all of which an issuer must meet. These are:

- The issuer takes “Reasonable Steps to Verify” that purchasers are Accredited Investors; AND
- All purchasers are Accredited Investors, either because they meet the “Accredited Investor” definition at the time of sale or the issuer reasonably believes that they qualify; AND
- All other terms and conditions set forth in Rule 501 (Definitions) and Rule 502(a) (Integration) and Rule 502(d) (Limitations on Resale) are satisfied.

What or who is an Accredited Investor? Did this definition change? The definition did not change. An Accredited Investor includes, but is not limited to:

- A person whose individual net worth, (or joint net worth with his/her spouse) exceeds \$1 million, excluding the value of the investor’s primary residence OR who has an individual income in excess of \$200,000 in each of the 2 most recent years (\$300,000 with his/her spouse) and has reasonable expectation of reaching the same income level in the current year.
- A charitable organization, corporation, or partnership with assets exceeding \$5 million.
- A director, executive officer, or general partner of the company selling the securities.
- A business in which all the equity owners are Accredited Investors.

What are “Reasonable Steps to Verify”? The SEC has declined to provide a complete list of “Reasonable Steps to Verify” at this time, although that would have provided clarity. Instead, it provides a non-exclusive list of reasonable steps to verify the Accredited Investor status of an investor, including:

- By 2 most recent years of IRS-reported income and a written representation from the purchaser of purchaser’s expectation to reach the income level necessary to qualify during the current year.
- By net worth, from recent personal financial documentation and purchaser’s written promise that all liabilities in making the net worth determination were revealed.
- By written confirmation from an attorney or a registered broker-dealer, investment adviser, or CPA who has undertaken reasonable steps to determine that the purchaser is accredited.
- By having been previously qualified and remaining an Accredited Investor.

If an issuer fails to take “Reasonable Steps to Verify”, but ultimately sells the securities solely to Accredited Investors, may it claim reliance on Rule 506(c)? No. In the final rule, the SEC makes clear that an issuer must be able to demonstrate (through documentation) that it took reasonable steps to verify that each investor was accredited.

Is General Solicitation now defined? No. Under Rule 502(c), General Solicitation includes any “advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio” and “any seminar or meeting whose attendees have been invited by any general solicitation or general advertising”. As set forth in Release 33-9415, issuers could “solicit potential investors directly through both physical (such as mailings, newspaper advertisements and billboards) and electronic (such as the Internet, social media, email and television) means”.

May an Issuer rely on former Rule 506? This is permissible. Its continued availability garnished much support in commentary submitted to the SEC. So, if an issuer finds the “Reasonable Steps to Verify” unattractive or burdensome or if it wishes to continue to afford itself of the ability to sell to “Experienced and Sophisticated Investors,” the issuer may rely on former Rule 506 (new Rule 506(b)).

Did the SEC enact any safeguards simultaneously? Yes, Rule 506(d) has been added. Generally, no exemption under Rule 506 will be available for “bad actor” issuers and its affiliates, directors, officers, general partners, and managing members, among others. A “bad actor” includes anyone who/that:

- Has been convicted, within 10 years before a sale (or 5 years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor in connection with the purchase or sale of any security; making of any false filing with the SEC; or arising out of the conduct of certain financial intermediaries.
- Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within 5 years before a sale, that, at the time of such sale, restrains or enjoins such person from engaging in or continuing any conduct in connection with the purchase or sale; making of any false filing with the SEC; or arising out of the conduct of certain financial intermediaries.
- Is subject to certain final orders of a state securities regulator; a state regulator of banks, savings associations, or credit unions; a state insurance regulator; an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration.
- Is subject to certain SEC orders.
- Is suspended or expelled from membership in a registered national securities exchange or a registered national or affiliated securities association for certain acts or omission to act.
- Has filed with the SEC (or served/named an underwriter in) any registration statement or Regulation A offering statement that, within 5 years before such sale, was the subject of a refusal or stop order, or order suspending the Regulation A exemption, or is under investigation to determine whether a stop or suspension order should be issued.
- Is subject to a U.S. Postal Service false representation order entered within 5 years before such sale, or is, at that time, subject to a temporary restraining order or preliminary injunction.

Will Form D be revised? Form D will include a check-the-box space for Rule 506(c). Also, the signature block will include a certification whereby an issuer generally confirms that the issuer is not disqualified. Also, the SEC has proposed further Regulation D and Form D amendments. This proposal includes collecting additional information on the issuer, the securities and the investors, mandating a Form D filing, filing additional offering materials with the SEC, and regulating sales literature of private funds.

Will Pennsylvania’s Blue Sky Laws change? The securities will continue to be treated as covered securities and States will be prohibited from imposing registration requirements on the offer and sale of securities pursuant to Rule 506(c). However, revisions to PA’s securities laws should be forthcoming.

Should Issuers proceed cautiously? Yes. The antifraud provisions still apply. An issuer must weigh the pros and cons if it decides not to rely on one of the enumerated “Reasonable Steps to Verify”. “Bad actor” rules must be examined. Documentation is crucial.

Should Investors proceed cautiously? It could be difficult to distinguish legitimate from illegitimate offerings, in part due to the increased volume of offerings available for viewing. It appears the SEC is citing the “bad actor” disqualification to help weed out what may otherwise be illegitimate offerings.