Cooley

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On July 10, 2013, the Securities and Exchange Commission finally implemented one of the key provisions of the JOBS Act by adopting amendments to Rule 506 of the Securities Act of 1933 and eliminating the decades-old ban on general solicitation and general advertising in certain private offerings (in other words, in a sale of securities of a company that is not publicly traded). In any offer that includes general advertising, however, issuers must take "reasonable steps" to verify that all purchasers in the offering are accredited investors under SEC rules.

The amendments take effect 60 days after publication in the *Federal Register,* which normally occurs several days after SEC approval.

The amendments could have a major impact on how issuers conduct private offerings, as they permit startups to advertise broadly that they are raising money, which could lead to broader access to capital for startups. We highlight below key provisions of the amendments and what they mean for entrepreneurs. Please note that throughout this *Alert* we often refer to an "issuer." For this purpose, the issuer is the company that is issuing the securities.

I. Lifting the ban on general solicitation and general advertising

New Rule 506(c)

The amendment to Regulation D adds a new Rule 506(c) that permits an issuer to engage in general solicitation or general advertising in connection with an offer and sale of securities under Rule 506 if all purchasers qualify as "accredited investors" under SEC rules. The issuer must take "reasonable steps" to verify that the purchasers of its securities are accredited investors. Issuers may continue to rely on the existing Rule 506 offering rule, which is now Rule 506(b).

"Reasonable steps" to verify accredited investor status

The new Rule 506(c) does not specify uniform verification methods to determine whether a prospective purchaser is an accredited investor, but the adopting release does include a non-exclusive list of methods, applicable to persons, not entities, that, if used by issuers, will be deemed to constitute "reasonable steps":

- Reviewing copies of any IRS form that reports income, including income tax returns, Forms W-2 and 1040 and Schedule K-1s, for the two most recent years, to confirm income of the purchaser.
- Obtaining a written representation from the purchaser, along with reviewing bank, brokerage and other account statements and credit agency reports to confirm asset and liability levels.
- Obtaining a written confirmation from a registered broker-dealer, SEC-registered investment adviser, attorney, or CPA that such person has taken reasonable steps to verify the purchaser's accredited status.
- Obtaining a bring-down certification from an investor who invested in the issuer's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the issuer.

Reasonableness is based on facts and circumstances

Issuers are not required to use any of the methods the SEC describes to verify accredited investor status. Rather, the SEC stressed that whether the process used to verify accredited status was a reasonable one will be determined by the issuer, based on the facts and circumstances of each particular transaction, and should take

into account a number of interconnected factors, 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 (which may include publicly available information); 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 (for example, a minimum investment amount).

Examples of the above factors may include:

- **Broad vs. pre-screened solicitations.** An issuer that solicits new investors through a website accessible to the general public, through widely disseminated social media, or through print media, will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party.
- **Minimum cash investment amount.** A purchaser's ability to meet a high minimum investment amount could be a relevant factor to the issuer's evaluation of the types of steps that would be reasonable to take in order to verify that purchaser's status as an accredited investor.

Amendment to Form D

Issuers relying on Rule 506 are still required to file a Form D with the SEC, but the form has been amended to require issuers to indicate whether they are relying on the provision that permits general solicitation.

Disqualification of "bad actors"

The SEC also amended Rule 506 to add a new paragraph 506(d), which disqualifies issuers and other market participants from relying on Rule 506 if "bad actors" are participating in the offering. The disqualification provisions will only apply to triggering events occurring after the effectiveness of the rule amendment, with pre-existing events subject to mandatory disclosure. These amendments also take effect 60 days after publication in the *Federal Register,* which normally occurs several days after SEC approval.

Proposed rules to help SEC monitor development of market practices

The SEC also proposed new rules that are intended to enhance the SEC's ability to monitor the development of market practices in Rule 506 offerings. Currently, issuers conducting a private placement under Rule 506 must file a notice on Form D within 15 days after the offering. Under the proposed new rules, issuers engaging in general advertising or general solicitation in reliance on the new Rule 506(c) will be required to file a notice on Form D, with expanded requirements, 15 days *prior* to the first general solicitation. In addition, under the proposal, issuers would also be required to submit to the SEC (but not make public) a copy of written general solicitation materials no later than the date of first use and file a final Form D within 30 days after completion of the offering. Under the proposed rules, issuers who fail to make, in a timely manner. Any Form D filing in a Rule 506 offering could be disqualified from relying on Rule 506 for a full year from the date of the corrective filing, although a cure period would be available for late filings. We will monitor additional developments regarding this proposed amendment.

II. What do these amendments mean for entrepreneurs?

With the amended rules, the SEC effectively is removing the "private" from some private placements, and is opening the door to broadly marketed, unregistered securities offerings. Entrepreneurs may be impacted as follows:

- **Reach a wider pool of investors.** General solicitation could help emerging companies attract investors outside their local investment community. Communication tools such as blogs, e-mail newsletters and social media allow startups to reach large numbers of potential investors. The amended rules will allow startups to use these tools to communicate with the general public in the hopes of connecting with new potential accredited investors.
- **Obligation to verify accredited investor status.** Issuers are required to take "reasonable steps" to verify that purchasers of securities under Rules 506(c) are accredited investors. Companies should review with their counsel how best to confirm that all investors qualify and should analyze the "interconnected factors" discussed above. The SEC has clearly stated that having an investor check a box on a questionnaire is not sufficient to verify accredited investor status, absent additional information about the purchaser. We expect to see third parties provide verification services to investors to facilitate this process.
- **Competition for investor attention.** With the ban on solicitation lifted, more investors will learn about potential startup investments. Thus, startups will need to find ways to distinguish themselves from the noise. Entrepreneurs will need to consider what types of solicitation and advertising are appropriate for their businesses, both in terms of substance, format and location. Entrepreneurs may want to consider what impact, positive or negative, any such solicitation or advertising may have on the image or credibility of their company, or on the company's operations or ability to attract appropriate investors.
- **Potential deterrence of investors.** Issuers who wish to take advantage of the new general solicitation rules must request personal and private financial information from investors, or must find some other appropriate way to demonstrate that the investors are accredited. Requesting such information, or obtaining other verification may deter potential investors.
- **Role of "matchmakers."** The new rules further highlight the importance of web-based platforms that match issuers, buyers and sellers of securities and facilitate securities transactions among them. We expect to see investment platforms and other matchmakers develop relatively simple ways for investors to verify accredited status in accordance with the new rules, and we expect these intermediaries to compete not only on access to potential deals, but also on the ease of connecting with investors' financial information to demonstrate accredited status, as well as on privacy and data security. We expect that investors will be unlikely to provide financial information sufficient to verify accredited status to more than a few intermediaries, so those intermediaries that can convince investors to provide this information will gain a significant advantage.
- **Existing Rule 506 still in effect.** Issuers do not need to use the new rules. The SEC has made it clear that these amendments are limited to transactions under new Rule 506(c). Issuers may continue to rely on Rule 506(b) and conduct private offerings the "old way," provided that no general solicitation or general advertising is used, and we expect that most startups will continue to conduct their fundraising this way for the time being.

In this summary we have highlighted what we view as the most significant aspects of the SEC's lifting of the ban on general solicitation and general advertising from certain private transactions and how they impact entrepreneurs. If you have questions about these amendments, any of the proposed rules, or any other provisions of the JOBS Act, please contact a member of your Cooley team or any of the individuals named in this *Alert*.

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