

## CLIENT ALERT

### SEC Lifts Prohibition on Advertising in Private Placements

Jul.12.2013

Undoing a decades-old regulatory scheme, on July 10, 2013, the U.S. Securities and Exchange Commission (SEC), as directed by Congress in the 2012 JOBS Act, approved rules allowing companies and other issuers of securities to use general solicitation in private placements. As noted by Chairman Mary Jo White during the SEC's open meeting, there has been much change since 1982 when SEC Regulation D, containing the prior prohibition on advertising, was adopted, and this has helped drive the need for the regulatory revisions. The new rule, which will take effect later this year, creates a new Rule 506(c) as part of Regulation D that allows an issuer of securities to use general solicitations so long as the issuer (a) believes that the purchasers are accredited investors and (b) takes reasonable steps to verify the purchasers' "accredited investor" status. If an issuer does not want to use general solicitations, however, then the issuer does not need to satisfy these additional requirements.

Under new Rule 506(c), the key to selling securities in a private placement using a general solicitation is the method an issuer uses to verify a purchaser's accredited investor status. The method must be objectively reasonable in the context of the particular facts and circumstances of each purchaser and each transaction. The SEC indicated certain interrelated factors an issuer should consider in determining how to verify accredited investor status. These factors include:

- **The nature of the purchaser and type of accredited investor status claimed by the purchaser.** It is relatively simple to verify the accredited investor status of purchasers such as broker dealers and investment companies registered under the Investment Company Act of 1940. In contrast, it is more difficult to verify the accredited investor status of an individual, which requires either \$200,000 of individual income or \$300,000 of joint spousal income over the last two years and the reasonable expectation of the same in the current year (the "Income Test") or individual or joint spousal net worth in excess of \$1 million, excluding the value of the purchaser's primary residence (the "Net Worth Test").
- **The quantity and quality of information the issuer has about the purchaser.** Simply put, the more information an issuer has about a purchaser, the more reasonable it will be for an issuer to determine a purchaser's accredited investor status. In addition, it should be reasonable for issuers to rely upon paystubs, and federal, state or local filings, such as a proxy statement detailing the earnings of a corporate executive officer or publicly available tax forms.
- **The nature of the offering, including the type of solicitation, the offering terms, and the minimum investment amount.** The steps required to verify accredited investor status will likely be more onerous when a solicitation is made broadly, whether in a general audience magazine or newspaper or via e-mail or social media, as opposed to a solicitation to a pre-screened database of accredited investors. Furthermore, an issuer may structure an offering with a high minimum investment amount, making it unlikely (if not practically impossible) for purchasers that are not accredited investors to participate.

By establishing a "facts and circumstances" principle-based analysis guided by consideration of factors such as those set forth above, the SEC has created an obligation upon issuers engaging in advertising to determine accredited investor status of potential purchasers that goes beyond the steps that issuers have tended to use over the last several decades. Issuers often have relied upon a purchaser completing an accredited investor questionnaire that involves checking the box to indicate how an

investor is accredited. In its adopting release accompanying Rule 506(c), the SEC has stated that in almost all circumstances, reliance upon such a questionnaire would no longer be adequate.

The SEC offered guidance to issuers on how to determine the accredited investor status of natural persons with a set of four non-exclusive methods:

- To verify that a purchaser satisfies the Income Test, issuers may review copies of IRS forms or reports regarding income, including Form W-2s, Form 1099s, Schedule K-1s, or copies of filed tax returns on Form 1040, for the two most recent years.
- To verify that a purchaser satisfies the Net Worth Test, issuers may review bank statements, brokerage statements, statements of securities holdings, certificates of deposit, tax assessments and appraisal reports, as netted against a consumer credit report from a nationwide consumer reporting agency.
- Issuers may satisfy the verification requirement by obtaining verified written confirmation from a registered broker dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant that a purchaser is an accredited investor.
- In the case of a purchaser who purchased securities of an issuer in a prior exempt transaction as an accredited investor, the issuer may satisfy the verification requirement by obtaining a certification from the purchaser that, at the time of the new purchase, the purchaser remains an accredited investor.

Regardless of the amount and type of information an issuer reviews, no amount of documentation will be deemed to satisfy the verification requirement if an issuer has actual knowledge that a purchaser is not accredited. Should a purchaser provide false information and not be an accredited investor, an issuer will not lose its ability to rely upon Rule 506(c) for an offering so long as the issuer met the reasonable verification requirement and had a reasonable belief that the purchaser was accredited at the time of the sale.

As a companion piece to Rule 506(c), the SEC also adopted new Rule 506(d) to bar certain bad actors from participating in private placements pursuant to Rule 506. Rule 506(d) disqualifies any issuer from using Rule 506 as an exemption for the offer or sale of securities if the issuer or an affiliate of the issuer, such as an executive officer or director (a "Covered Person"), is convicted of certain felonies or is otherwise found to be a "bad actor" after the effective date of Rule 506(d). In addition, if an issuer or a Covered Person was deemed to be a bad actor prior to the effective date of Rule 506(d), then the issuer is required to disclose to potential purchasers, at a reasonable time prior to the sale of the securities, the nature of the bad act. An issuer cannot rely upon Rule 506 exemptions if it fails to comply with the requirements of Rule 506(d) unless it can demonstrate that it was unaware of any bad actor status despite the exercise of reasonable care. Bad acts include criminal violations involving the sale of securities and acts that are inconsistent with just and equitable principles of trade and which have resulted in suspension or expulsion from a registered national securities exchange or association.

In addition to adopting Rule 506(c) and (d), the SEC also proposed additional new rules under Regulation D that would increase investor protections beyond the verification requirements imposed with the lifting of the ban on use of advertisements in private placements. While the use of general solicitations is intended to enhance the likelihood that issuers can raise capital by allowing them to reach out to a broader audience of potential investors, the proposed new rules would create additional regulatory burdens for issuers trying to take advantage of Rule 506(c) if the SEC eventually adopts them as proposed.

While Rule 506(c) and (d) will take effect later this year, the SEC is accepting comments on the newly proposed rules, and it is unclear whether the proposed rules will ultimately be adopted or if any regulatory burdens will be imposed as a result of the lifting of the advertising ban beyond those requiring verification of accredited investor status. For now, however, the SEC's actions allowing for general solicitations have the potential to broaden the base of potential investors available for companies and other issuers. Whether this potential is fulfilled will depend in large part upon the development of a marketplace for advertisements that can successfully connect issuers and potential investors.

The Final Rule lifting the ban on general solicitations may be found [here](#). The Final Rule disqualifying felons and other bad actors from Rule 506 offerings may be found [here](#). The Proposed Rule related to the filing of Form D may be found [here](#).

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

**Jeffrey C. Selman**

Partner – San Francisco

Phone: +1 415.365.7442

Email: [jselman@crowell.com](mailto:jselman@crowell.com)