# Navigating the Recent Changes to Regulation D Rule 506

The elimination of the ban on general solicitation in Rule 506 offerings presents exciting new opportunities for companies raising capital under the Regulation D safe harbor, particularly small and mid-sized companies. But the new rules are complex and issuers and practitioners should be aware of potential pitfalls, especially under the new Rule 506(c) investor verification requirements and the Rule 506(d) bad actor disqualification provisions.

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On July 10, 2013, the Securities and Exchange Commission (SEC) adopted important amendments to the Regulation D safe harbor from the registration requirements of the Securities Act of 1933 (Securities Act) (Amendments). The Amendments, effective from September 23, 2013:

- Eliminated the prohibition on general solicitation and general advertising for certain offerings under Regulation D Rule 506 (and for offerings under Rule 144A), changes mandated by Section 201(a) of the Jumpstart Our Business Startups Act of 2012 (JOBS Act).
- Disqualify offerings from relying on the Rule 506 safe harbor if any felons or other specified "bad actors" are involved in the offering, a change mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

This article explains these new rule changes, describes the evolving Rule 506(c) market and offers practical tips for issuers, placement agents and their counsel.

## THE RULE 506 SAFE HARBOR

Regulation D is a set of rules under which an issuer may conduct limited offers and sales of securities without having to register the offering with the SEC under the Securities Act.

Rule 506 is the most frequently used safe harbor under Regulation D and one of the most important means of raising capital in the US. A recent SEC market study showed that Rule 506 offerings:

- Raised $898 billion in new capital in 2012, compared to $1.2 trillion raised through SEC-registered offerings.
- Accounted for almost 99% of the total capital raised under Regulation D between 2009 and 2012 (with the remaining amount raised in offerings under Rule 504 and Rule 505).

(*Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012, July 2013*.)

A Rule 506 offering may be conducted by the issuer alone or together with a placement agent that helps identify eligible investors and structure the transaction. Before the Amendments, Rule 506 permitted issuers to raise unlimited capital from an unlimited number of accredited investors (as defined in Rule 501 of Regulation D) and up to 35 non-accredited investors without having to register the offering with the SEC, as long as the offering did not involve general solicitation or general advertising (see *Box, What is General Solicitation and General Advertising?*).

## GENERAL SOLICITATION NOW PERMITTED UNDER NEW RULE 506(c)

The Amendments lifted the ban on general solicitation under Rule 506 by adding a new subsection (c). Under new Rule 506(c), an issuer can use general solicitation in connection with a Rule 506(c) offering if:

- All of the purchasers of the securities are accredited investors, as defined in Rule 501 of Regulation D.
- The issuer takes reasonable steps to verify that all of the purchasers are accredited investors (see below *Verifying Accredited Investor Status for Rule 506(c) Offerings*).
- All of the terms and conditions in Rule 501 (definitions), Rule 502(a) (integration) and Rule 502(d) (limitations on resale) are satisfied.

### VERIFYING ACCREDITED INVESTOR STATUS FOR RULE 506(c) OFFERINGS

Under Rule 506(c), an issuer must take reasonable steps to verify the accredited investor status of the purchasers in a Rule 506(c) offering. Whether the specific verification steps an issuer takes are reasonable is an objective, principles-based determination. This determination should be based on the particular facts and circumstances of each purchaser and transaction.

The adopting release for the Amendments states that an issuer should consider factors including:

- The nature of the purchaser and type of accredited investor the purchaser claims to be (in other words, which prong of the accredited investor definition it is relying on).
- The amount and type of information the issuer has about the purchaser.
- The nature and terms of the offering.

Under this principles-based, facts-and-circumstances approach, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status. For example, if the terms of the offering require a high minimum investment amount and the purchaser is able to meet those terms without third-party financing, then the likelihood of that purchaser satisfying the definition of accredited investor may be so high that, absent red flags to the contrary, it may be reasonable for the issuer to take fewer steps, or no additional steps, to verify accredited investor status.

#### Nature of the Purchaser

Under the principles-based approach, the issuer should first consider the nature of the purchaser. The Rule 501(a) definition of accredited investor includes natural persons and entities that come within any of eight specified categories, or that the issuer reasonably believes come within one of those categories. Some purchasers may be accredited investors based on their status or on a combination of their status and total assets, including:

- Registered broker-dealers.
- Registered investment companies.
- An employee plan established by a state or state agency with total assets in excess of $5 million.
- A 501(c)(3) organization with total asset in excess of $5 million.
- A natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence.
- A natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and who has a reasonable expectation of reaching the same income level in the current year.

#### Verification Methods for Natural Persons

To provide additional clarity, Rule 506(c) specifies that an issuer will be deemed to take reasonable steps to verify that a natural person is an accredited investor if it uses any of the following verification methods:

- **Performs an income test.** If the determination is based on income, the issuer:
  - reviews copies of any Internal Revenue Service form that reports the purchaser's income for the past two years; and
  - obtains a written representation that the purchaser reasonably expects to reach the income level required to qualify as an accredited investor in the current year.
- **Performs a net worth test.** If the determination is based on net worth, the issuer:
  - reviews copies of bank, brokerage or similar statements, certificates of deposit, tax assessments or appraisal reports as evidence of the purchaser's assets;
  - reviews a report from one of the national consumer reporting agencies as evidence of the purchaser's indebtedness; and
  - obtains a written representation that the purchaser has disclosed all liabilities necessary to make a net worth determination.
- **Obtains third-party confirmation.** The issuer obtains written confirmation from a registered broker-dealer, SEC-registered

## What is General Solicitation and General Advertising?

Historically, the prohibition on general solicitation in Rule 506 offerings prohibited an issuer from marketing its offering through, among other things:

- Advertisements, articles, notices or other publication in any newspaper, magazine or similar media, including the internet.
- Broadcasts through television, radio or the internet.
- Seminars or meetings where the attendees were invited by any general solicitation or advertisement.

This non-exclusive description of general solicitation, from Rule 502(c) of Regulation D, has been supplemented over the years by SEC guidance relating to investor road shows, product advertising and other issuer communications.

Search General Solicitation and Start-up Capital Raising: Existing Guidance and New Questions for more on the law, guidance and open questions on what constitutes general solicitation in Rule 506 offerings.

investment adviser, licensed attorney or certified public accountant that it has taken reasonable steps to verify the purchaser's accredited status within the last three months.

- **Sells to an existing Rule 506(b) investor that certifies its accredited investor status.** The issuer permits an existing securityholder who acquired securities of the issuer in a Rule 506 offering as an accredited investor before the effective date of Rule 506(c) to purchase securities in the Rule 506(c) offering, as long as that securityholder certifies its accredited investor status at the time of the Rule 506(c) sale.

These steps, set out in Rule 506(c)(2)(ii), are not exclusive or mandatory. The SEC release adopting the final rule changes also discusses other factors that issuers may consider when verifying a purchaser's status.

### NO CHANGE TO UNDERLYING SECTION 4(a)(2) EXEMPTION

While Rule 506 is ostensibly a safe harbor under the Section 4(a)(2) private placement exemption, practitioners should be aware that a Rule 506(c) offering with general solicitation that fails to satisfy all of the requirements for the Rule 506 safe harbor will not be eligible to fall back on the Section 4(a)(2) exemption.

In its adopting release, the SEC stated that the rule changes affect only the Rule 506 safe harbor itself and that "even after the effective date of Rule 506(c) . . . public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)."

### TRADITIONAL RULE 506 OFFERINGS UNDER RULE 506(b)

Issuers that wish to engage in Rule 506 offerings without general solicitation may continue to do so under pre-existing Rule 506(b). A traditional Rule 506(b) offering may be attractive for issuers that want to avoid the expense and effort involved in verifying accredited investor status under Rule 506(c). In particular, an issuer with pre-existing substantive relationships with a pool of investors, or an issuer that engages a placement agent with such relationships, may decide that the additional costs of a Rule 506(c) offering outweigh the potential benefits of general solicitation.

Issuers may also forgo general solicitation and rely on Rule 506(b) instead to avoid the risk of having a failed Rule 506(c) offering that does not qualify for the Section 4(a)(2) private placement exemption.

### FORM D AMENDED TO ADD NEW CHECKBOX

Rule 503(a) of Regulation D requires an issuer to file a notice on Form D with the SEC no later than 15 days after the first sale of securities in a Regulation D offering. In addition to providing basic information about the issuer, offering expenses and other matters on its Form D, the issuer must check a box to indicate which exemption from registration it is claiming. As part of the Amendments, Form D was revised to:

- Rename the former "Rule 506" checkbox as "Rule 506(b)."
- Add a new "Rule 506(c)" checkbox.

If an issuer files a Form D with a checkmark in the Rule 506(c) box and engages in general solicitation, it may not then change course and claim reliance on Rule 506(b) for the same offering. This is because general solicitation remains prohibited under Rule 506(b). Accordingly, practitioners must carefully evaluate up front whether to proceed under Rule 506(b), Rule 506(c) or another exemption from registration.

### USE OF RULE 506(c) BY PRIVATE FUNDS

Private equity funds, venture capital funds and hedge funds generally rely on statutory exclusions from the definition of "investment company" that are set out in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (ICA) to avoid being regulated as an investment company under the ICA. However, these statutory exclusions are not available to a fund if it makes a public offering of securities.

In its adopting release, the SEC confirmed that, under Section 201(b) of the JOBS Act (which mandated the Rule 506 amendments), a private fund engaging in general solicitation in a Rule 506(c) offering does not lose the benefit of these statutory exclusions under the ICA.

Search JOBS Act: Regulation D and Rule 144A General Solicitation Summary and Section 4(a)(2) and Regulation D Private Placements for more on the general solicitation rule changes.

## NEW BAD ACTOR DISQUALIFICATION RULES UNDER RULE 506(d)

The SEC adopted new Rule 506(d), effective September 23, 2013, as required under Section 926 of the Dodd-Frank Act.

Rule 506(d) disqualifies securities offerings from relying on the Rule 506 safe harbor if any felons or other specified "bad actors" are involved in the offering. An offering is disqualified under Rule 506(d)(1) if a person covered by the rule was subject to one or more specified disqualifying events.

### COVERED PERSONS AND DISQUALIFYING EVENTS

Covered persons under Rule 506(d)(1) include:

- The issuer, any predecessor of the issuer and any affiliated issuer. For these purposes, an affiliated issuer is any affiliate (as defined in Regulation D Rule 501(b)) of the issuer that is issuing securities in the same offering, including offerings subject to integration with the offering under Rule 502(a).
- Directors, executive officers, other officers participating in the offering, general partners and managing members of the issuer.
- Beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power.
- Promoters connected with the issuer at the time of the sale of securities.
- Investment managers of an issuer that is a pooled investment fund (each, an Investment Manager).
- Persons that have been or will be paid, directly or indirectly, for soliciting purchasers in connection with the sale of securities (each, a Compensated Solicitor).
- General partners and managing members of any Investment Manager or Compensated Solicitor.
- Directors, executive officers and other officers participating in the offering of any:
  - Investment Manager or Compensated Solicitor; or
  - general partners or managing members of any Investment Manager or Compensated Solicitor.

Disqualifying events under Rule 506(d)(1) include certain:

- Criminal convictions within the last ten years (five years for the issuer, any predecessors and any affiliated issuers).
- Orders, judgments or decrees of US courts within the last five years.
- Final orders issued by state securities, insurance, banking, savings association or credit union regulators, federal banking agencies, the Commodity Futures Trading Commission or the National Credit Union Administration.
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers and investment advisers and their associated persons.
- SEC cease-and-desist orders within the last five years relating to scienter-based anti-fraud provisions of the federal securities laws or Section 5 of the Securities Act.
- Suspension or expulsion from membership in a self-regulatory organization.
- SEC stop orders and orders suspending a Regulation A exemption within the last five years.
- US Postal Service false representation orders within the last five years.

## Additional Proposed Rule Changes

On the same date the SEC adopted the Amendments, it also proposed a set of complementary rule changes designed to offer additional investor protection safeguards and to assist in evaluating the evolution of the Rule 506 market.

Among other things, the proposed changes would:

- Require an issuer relying on Rule 506(c) to file a Form D at least 15 days before engaging in general solicitation.
- Disqualify issuers that fail to file a required Form D from relying on the Regulation D safe harbor during a period ending one year after all required filings are made.
- Make the anti-fraud guidance for investment companies set out in Securities Act Rule 156 applicable to offers and sales by all private funds, including in offerings under Rule 506(c).

The proposed rule changes were the target of heavy criticism during the public comment period, with many commentators calling the pre-offering filing requirement impractical and the disqualification penalty draconian. At this time, the changes remain at the proposal stage and it is unclear whether or when the SEC will act on them.

Search SEC Proposes Rule Amendments to Evaluate Rule 506 Market for more on these proposed rule changes.

### REASONABLE CARE EXCEPTION

An exception to the disqualification provisions is available under Rule 506(d)(2)(iv) if the issuer can show that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. For example, this may occur when, despite the exercise of reasonable care, the issuer:

- Was unable to determine the existence of a disqualifying event.
- Was unable to determine that a particular person was a covered person.
- Initially reasonably determined that a person was not a covered person but then subsequently learned that its initial determination was incorrect.

The reasonable care standard imposes a due diligence obligation on the issuer to inquire into relevant facts, with appropriate steps depending on the particular facts and circumstances.

### WAIVERS UNDER RULE 506(d)(2)(ii) AND (iii)

Under Rule 506(d)(2)(ii), an issuer may seek a waiver of Rule 506(d) disqualification from the SEC. Separately,

Rule 506(d)(2)(iii) provides that a court or regulatory authority that enters an order or judgment may advise in writing that its order or judgment should not result in disqualification under Rule 506(d)(1).

### DISCLOSURE REQUIREMENT UNDER RULE 506(e)

Disqualifying events that occurred before the September 23, 2013 effective date for new Rule 506(d) do not trigger actual disqualification. However, under new Rule 506(e), the issuer must disclose those earlier events in writing to all prospective purchasers a reasonable time before completing the sale of the securities. This disclosure obligation is not subject to waiver.

Search Section 4(a)(2) and Regulation D Private Placements for more on applying the bad actor provisions, including related SEC guidance.

## EVOLVING MARKET PRACTICE AND PRACTICAL TIPS

### RULE 506(c) OFFERINGS USING GENERAL SOLICITATION

Based on information gathered from Form D filings, Rule 506(c) offerings have accounted for only a small percentage of all Rule 506 offerings since the Amendments.

To date, it seems that most small to medium-sized companies with previous experience raising capital under Rule 506 are concluding that it is more efficient to raise new funds from existing investors under Rule 506(b) than to use general solicitation to attract new investors and be forced to comply with the accredited investor verification requirements of Rule 506(c). The same is also true for private equity funds and hedge funds, the vast majority of which continue to maintain long-established practices of preserving privacy and confidentiality in their fundraising activities.

In contrast, early-stage companies without previous experience raising capital under Rule 506 are more likely to use Rule 506(c) offerings. The expanded reach available through general solicitation may be particularly attractive to small-scale issuers engaging in an offering without the help of a placement agent to assist in locating potential investors. For these issuers, a Rule 506(c) offering may have the added benefit of increasing market awareness of the company's name and business. In particular, early-stage consumer goods and services companies can use Rule 506(c) offerings to combine their (often simultaneous) capital raising activities with their marketing activities.

Market participants engaging in general solicitation under Rule 506(c) have been fairly conservative to date. Most communications have been limited to advertisements and website disclosures consisting of no more than the factual information permitted under the Securities Act Rule 135c safe harbor for limited notices of unregistered offerings, despite no requirement to comply with Rule 135c in this situation.

Among other things, this cautious approach reflects concerns that:

- Rule 506(c) general solicitation activities remain subject to the anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Securities Exchange Act of 1934.
- Registered broker-dealers participating in a Rule 506(c) offering must comply with Financial Industry Regulatory Authority (FINRA) Rule 2210, which governs the content of broker-dealer communications with investors. This concern is amplified by the fact that offering materials for some Rule 506(c) offerings must be filed with FINRA under FINRA Rule 5123.

A key factor in predicting the future popularity of the Rule 506(c) exemption is the fate of the SEC's additional proposed rule changes. The proposed changes would, among other things, require an advance Form D filing and apply a one-year bar on Regulation D offerings by any issuer that fails to make a required Form D filing (see *Box, Additional Proposed Rule Changes*).

The following are practical tips for general solicitation activities when contemplating or participating in a Rule 506(c) offering:

- Issuers should consider implementing a written corporate communications policy, to be reviewed and signed by all employees and management, that:
  - specifies the company representatives authorized to speak on the issuer's behalf; and
  - includes procedures to control and monitor communications to ensure approved, consistent messaging.
- Issuers and their counsel and, if present, placement agents and their counsel should agree up front on:
  - the scope of the general solicitation communications to be employed, including the types of information and specific media channels; and
  - procedures for vetting and approving all communications before dissemination.
- Where one or more placement agents are involved, they and the issuer should consider memorializing their agreement on the scope of communications and the vetting procedures in the engagement letter or placement agency agreement.

Search General Solicitation (Rule 506(c)) Representations and Covenants for Placement Agency Agreement for standard provisions to include in a placement agency agreement or other similar agreement in a Rule 506(c) offering.

The following are practical tips for verifying accredited investor status in a Rule 506(c) offering:

- **Pre-screen potential investors.** Consider pre-screening potential investors at an early stage with simple questionnaires. For natural persons, while self-certification of income or net worth would not satisfy the verification requirements of Rule 506(c), it should alert potential investors (some of whom may have little experience) of the need to qualify as an accredited investor. For legal entities, pre-screening for accredited investor status should help to quickly eliminate investors and investment vehicles that are ineligible to participate. Pre-screening should help the issuer and placement agent to better and more quickly estimate the size of the potential investor pool.
- **Verify accredited investor status of all prospective investors, even where there is a pre-existing relationship.** The issuer must take reasonable steps to verify the accredited

investor status of all prospective investors, even where there is a pre-existing relationship, as with an investor who previously invested in the issuer in a Rule 506(b) offering. Recent SEC guidance affirmed that the verification requirement in Rule 506(c) is separate from and independent of the requirement that sales be limited to accredited investors. The verification requirement must be satisfied even if all purchasers are accredited investors.

- **Obtain an undertaking from each investor that it will supply the issuer with supporting documentation.** This undertaking may be included in:
  - a form of investor questionnaire or investor verification letter, prepared by issuer's counsel, that is designed to satisfy the requirements of Rule 506(c); or
  - the subscription agreement.

### BAD ACTOR DUE DILIGENCE

The main barrier to conducting thorough and effective bad actor due diligence is lingering confusion about the rules.

Most issuers and many broker-dealers acting as placement agents remain unclear about who are covered persons under the rule and what events constitute disqualifying events. Set out below are practice tips to keep in mind when planning and conducting bad actor due diligence in connection with a Rule 506 offering.

To conduct bad actor due diligence on the issuer, issuer's counsel should prepare a bad actor questionnaire, copies of which should be distributed to all issuer-side covered persons. The questionnaire should clearly identify, or be accompanied by a memorandum that clearly identifies, the categories of issuer-side entities and natural persons who must complete the questionnaire.

To conduct bad actor due diligence on placement agents, issuer's counsel should prepare and send bad actor questionnaires to each placement agent. As with the issuer-side questionnaires, the placement agent questionnaires should include or be accompanied by detailed instructions identifying the categories of placement agent-side entities and natural persons who must complete the questionnaire, including the placements agents':

- Directors, executive officers and other officers participating in the offering.
- General partners and managing members.
- General partners' and managing members' directors, executive officers and other officers participating in the offering.

As market practice develops, some placement agents are electing to provide their own bad actor-related certifications instead of responding to questionnaires prepared by issuer's counsel. In that case, issuer's counsel should carefully review the content of the certifications and ensure that they extend to each Rule 506(d) covered person connected to the placement agent. If the issuer is given a single certification purporting to answer for all placement agent-side covered persons, issuer's counsel should consider instead requesting a separate certification from each covered individual and entity.

As additional due diligence measures on placement agent-side covered persons, issuer's counsel should also:

- Consider obtaining a report about the placement agent from FINRA's BrokerCheck website. If the firm report includes red flags, consider obtaining BrokerCheck reports on all placement agent-side covered persons.
- Insist that each placement agent give bad actor-related representations and warranties in its placement agency agreement.

Search Bad Actor (Rule 506(d)) Disqualification Representations and Covenants for standard bad actor-related provisions to include in a placement agency agreement, distribution agreement or other similar agreement in a Rule 506 offering.

When advising a placement agent in responding to a bad actor questionnaire or preparing a bad actor certification, the placement agent's counsel should be clear and precise in describing the events that trigger Rule 506(d) disqualification. For example, sanctions resulting from a FINRA violation do not necessarily constitute a Rule 506(d) disqualifying event. Placement agent's counsel should also consider advising individuals completing a bad actor questionnaire or certification to review the content of their FINRA Form U4 (Uniform Application for Securities Industry Registration or Transfer), Form U5 (Uniform Termination Notice for Securities Industry Registration) and Form U6 (Uniform Disciplinary Action Reporting Form) filings to confirm whether any events disclosed there constitute disqualifying events under Rule 506(d).

All participants in the bad actor due diligence process must remember to test for the entire look-back period specified for each disqualifying event, even though Rule 506(d) has only been in effect since September 2013. Though disqualifying events that occurred before Rule 506(d)'s effective date do not trigger actual disqualification, the issuer must disclose those events to prospective investors in compliance with Rule 506(e) (see above *Disclosure Requirement under Rule 506(e)*)

Finally, issuers engaging in continuous or follow-on private offerings should remember to update their records to ensure continuing compliance with the bad actor rules. Where an offering is continuous, delayed or long-lived, issuers and their counsel should update their factual inquiries periodically using bring-down representations, questionnaires, certifications, negative consent letters and periodic reviews of public databases, among other steps. This may include the issuer or its counsel re-circulating earlier questionnaires and certifications to its own covered persons and to placement agents, with a request that each person confirm that there has been no change since that person last replied to a bad actor inquiry from the issuer.