



New SEC Rules to Permit General Solicitation in Private Placements

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Have you ever wondered why you never see a television pitchman like Billy Mays (famous for his OxiClean infomercials) touting a new private placement of stock by a high-tech start-up company or interests in a real estate investment fund? The reason is in part because the rules of the Securities and Exchange Commission (SEC) have previously prohibited “general solicitation” in connection with the offer and sale of securities in private placements. But the SEC recently adopted new rules which will permit general solicitation in connection with private placements. The rule change becomes effective on September 23, 2013.

Private Placement Exemptions under the Securities Act

The Securities Act of 1933, as amended, requires that all offerings of securities in the United States either be registered with the SEC or exempt from registration under one or more SEC rules. Because registering securities is an expensive and time-consuming process, many securities offerings would be practically impossible if the issuer was unable to identify and comply with a valid exemption from registration. The most popular exemption from registration has traditionally been the SEC’s Rule 506. Securities offered in reliance on Rule 506 are considered to be private placements, rather than public offerings, and are therefore exempt from registration. According to a recent SEC Release, 99% of capital raised in private placements under the SEC’s Regulation D over the last three years has been conducted in reliance on Rule 506. The SEC estimates that in 2012, \$898 billion in capital was raised in reliance on Rule 506, compared to \$1.2 trillion raised in registered offerings.

Traditional Rule 506 Restrictions on General Solicitation

Historically, an issuer of securities desiring to rely upon Rule 506 was strictly forbidden from engaging in any sort of general advertising or other general solicitation activity in connection with the securities offering. The SEC has interpreted this ban on general solicitation broadly to include all sorts of advertising and marketing efforts, including advertising on television, radio, publicly advertised seminars and unrestricted Internet websites. Issuers who refrained from general solicitation, however, could sell an unlimited dollar amount of securities to an unlimited number of accredited investors and up to 35 unaccredited but sophisticated investors under Rule 506. Accredited investors are investors that have a special relationship with

the issuer (such as executive officers) or who meet net worth or income requirements established by the SEC.

The JOBS Act Lifts Restrictions on General Solicitation

Many securities law professionals and others in the business community felt that the restrictions on general solicitation in Rule 506 were unduly slowing capital formation by restricting the ability of issuers to reach potential investors. In response, Congress passed the Jumpstart Our Business Start-ups Act of 2012 (the JOBS Act). Among other provisions, the JOBS Act instructed the SEC to remove the restrictions on general solicitation from Rule 506 in offerings in which the issuer “verifies” that all of the purchasers are accredited investors. The SEC has now complied with the JOBS Act by modifying Rule 506.

New Verification Requirement

The SEC’s new Rule 506 permits general solicitation in connection with offerings relying on Rule 506 so long as the issuer takes reasonable steps to verify that all of the purchasers in the offering are accredited investors. This verification requirement is a more stringent requirement than that which exists under the traditional Rule 506, which only requires that the issuer have a “reasonable belief” that an investor is accredited. The SEC declined to specify what specific steps are necessary to verify someone’s status as an accredited investor, but the SEC did give some examples of some acceptable methods of verification. For example, an issuer could verify that an individual is accredited by reviewing the investor’s tax returns and obtaining a written representation from the purchaser that the purchaser reasonably anticipates a similar income for the current year. The SEC also suggested that the issuer could rely on confirmation of accredited investor status from a third-party, such as an investment advisor.

It should be noted that these changes to Rule 506 will not impact issuers’ ability to rely upon the traditional Rule 506. Issuers may continue to sell securities to purchasers that have not been “verified” as accredited investors under the traditional Rule 506 exemption, but only if the issuer does not engage in any general solicitation in connection with the offering and otherwise complies with the requirements of Rule 506.

Conclusion

The SEC, companies raising capital and other capital market participants are hopeful that the new changes to Rule 506 will accelerate capital formation. It has been suggested by some that the verification requirements in the new Rule 506 will slow, rather than speed, capital formation because potential investors may be reluctant to open up their personal financial information, such as tax returns, to permit investments in private placements. It will be interesting to see if issuers will choose to engage in general solicitation in connection with Rule 506 offerings since doing so will subject issuers to the new verification requirements. Issuers may decide to continue to rely upon the traditional Rule 506, including its restriction on general solicitation, to escape the burdens of investor verification. I suspect that as issuers and investors get more comfortable with the new Rule 506 and its verification requirement we will begin to see more and more advertising for private placements.

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