

# Paradigm

INTERNATIONAL SOCIETY OF PRIMERUS LAW FIRMS

WINTER 2014

*The Power of Primerus*

---

*How Does Primerus Help You?*

---

*Current Legal Topics:*

*North America • Europe, Middle East & Africa  
Latin America & Caribbean • Asia Pacific*





Wythe Michael

# Advertising and General Solicitation Now Permitted for Companies Conducting Private Securities Offerings

Historically, U.S. Securities and Exchange Commission (SEC) rules have prohibited companies seeking to raise capital in a private securities offering from conducting any sort of advertising or “general solicitation” to obtain investors. In April 2012, however, Congress attempted to make it easier for companies to find investors and raise capital by passing the JOBS Act.<sup>1</sup> The JOBS Act directed the SEC to remove the prohibition on general solicitation and general advertising for securities offerings relying on Rule 506 of Regulation D (a commonly used exemption). After a 15-month period, the SEC issued a final rule in July 2013 containing the changes to Regulation D. The rule changes became effective on September 23, 2013.

**What changed?** Under new Rule 506(c), companies seeking capital

can place advertisements, post announcements and publish information concerning the offering in various outlets (including newspapers, journals, magazines and web sites).<sup>3</sup> Companies may also “cold call” potential investors, email potential investors, utilize social media to attract investors and engage in other activity that previously would have constituted “general solicitation.”

**What are the new requirements for using Rule 506(c)?** To utilize the relaxed general solicitation rules, new Rule 506(c) requires (among other things) that all investors must be “accredited investors”<sup>4</sup> and that companies must take “reasonable steps” to verify that the investors are accredited investors.

**What types of “reasonable steps” must be undertaken?** The SEC release states that the company must look at the

facts and circumstances of each purchaser and each offering to determine the types of reasonable steps necessary to verify that investors are accredited. According to the release, companies should consider: (1) the type of accredited investor that the purchaser claims to be; (2) the amount and type of information that the issuer has about the purchaser; and (3) the nature of the offering, such as the manner in which the purchaser was solicited, and the terms of the offering.

For example, if a purchaser is an individual, was solicited via an advertisement or a cold call, and the minimum investment amount is \$25,000, the company would likely be required to take greater steps to verify the investor’s status. On the other hand, if the minimum investment amount is \$1,000,000, the company could take fewer steps to verify the investor’s status. Note that the company has the burden of proving that it took reasonable steps. Accordingly, the company should retain all documentation and verification that it received.

---

**Wythe Michael** focuses his practice on the legal issues facing growing businesses. Often acting as an outside general counsel, he provides practical solutions to legal issues by working with company management to understand and implement their business strategy. He regularly assists companies in connection with the structuring and documentation of private securities offerings.

**Goodman Allen & Filetti**  
4501 Highwoods Parkway, Suite 210  
Glen Allen, Virginia 23060  
804.322.1902 Phone  
804.346.5954 Fax  
wmichael@goodmanallen.com  
www.goodmanallen.com

## Are there any safe harbor methods to verify accredited investors status?

Although the SEC guidance above is extremely vague, Rule 506(c) contains four specific methods of verifying accredited investor status. These methods, if used, are deemed to satisfy the verification requirement contained in Rule 506(c). However, companies are not required to use the safe harbor methods and can use the general reasonableness standard. Below is a brief summary of the four safe harbor methods:

- **Income Verification.** To verify the income of an investor, a company can obtain copies of IRS forms from the past two years that report income, including Form W-2, Form 1099, Schedule K-1, and a filed copy of Form 1040. A representation from the investor regarding current income should also be obtained.
- **Net Worth Verification.** To verify the net worth of an investor, a company can obtain items such as bank statements, brokerage statements, tax assessments and appraisal reports dated within the last three months and obtain a representation from the investor concerning liabilities. Documentation of liabilities must also include a credit report from at least one of the major credit agencies.
- **Confirmation from Third Party.** Instead of the first two options above, a company may obtain a written confirmation of an investor's accredited investor status from a registered broker-dealer, an SEC registered investment advisor, a licensed attorney, a certified public accountant and, possibly, a third party certification service. The representation should indicate that the third party has, within the previous three months, taken reasonable steps to verify that the investor is accredited.

- **Prior Investor.** A company is deemed to have complied with the verification requirement if an investor who previously invested in a company's prior offering under Rule 506 invests in a subsequent offering and certifies that the investor continues to qualify as an accredited investor.

Although these safe harbors are helpful, it is unfortunate that the SEC required the use of a credit report with respect to verifying net worth. We believe that few investors will agree to provide a credit report. It is also burdensome to require re-certifications of net worth every three months. Finally, some investors will be reluctant to provide specific information regarding their income. Therefore, we believe that third party confirmation will likely become the most utilized of the safe harbor verification methods.

## Are there any restrictions on the content of advertising or solicitation methods?

Although the SEC has issued a proposed rule requiring legends in advertising materials, it is unclear whether this rule will be finalized and there is currently no specific guidance regarding advertising content or solicitation methods. Nevertheless, companies should use common sense in developing advertisements and in determining the methods of general solicitation.

Legends similar to the legends described in the SEC's proposed rule should be included in any written advertising or communications. Additionally, companies should not make statements that cannot be substantiated and should avoid statements regarding future performance. Misleading information contained in advertisements could subject a company to claims from investors and securities regulators for violation of anti-fraud rules. Finally, other laws may impose restrictions

on certain types of solicitations. For example, there are restrictions on phone and email solicitations under various state and federal laws. Also, if the company will be utilizing broker-dealers, the Financial Industry Regulatory Authority (FINRA) imposes specific rules regarding advertising content.

**Are there any other limitations?** The SEC issued rules in July that prohibit certain felons and other "bad actors" (and companies where these individuals have a significant ownership interest or control rights) from participating in securities offerings under Rule 506.<sup>5</sup> This will require a significant amount of pre-offering due diligence on the part of companies and their counsel to ensure that principals of the company are not subject to such restrictions.

Finally, the SEC issued proposed rules with several other requirements.<sup>6</sup> Although these proposed rules contain additional burdensome requirements (including pre-submission of general solicitation materials to the SEC), the proposed rules have not been finalized and it is unclear whether the rules will be finalized in their current form. **P**

1 The "Jumpstart Our Business Startups Act" can be found at: [www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf](http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf)

2 The SEC's final rule can be found at: [www.sec.gov/rules/final/2013/33-9415.pdf](http://www.sec.gov/rules/final/2013/33-9415.pdf)

3 Note that "old" Rule 506 (now Rule 506(b)) is still available to companies who do not need to utilize general solicitation or advertising. We believe that many companies will continue to use Rule 506(b) because it is less burdensome than Rule 506(c).

4 The definition of "accredited investor" can be found at 17 CFR §230.501.

5 Note that this restriction applies to both Rule 506(b) and Rule 506(c) offerings. The SEC's final rule regarding bad actors can be found at: [www.sec.gov/rules/final/2013/33-9414.pdf](http://www.sec.gov/rules/final/2013/33-9414.pdf)

6 The SEC's proposed rule containing additional requirements can be found at: [www.sec.gov/rules/proposed/2013/33-9416.pdf](http://www.sec.gov/rules/proposed/2013/33-9416.pdf)