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NEW SEC RULES GOVERNING GENERAL SOLICITATION AND ADVERTISING FOR PRIVATE SECURITIES OFFERINGS TAKE EFFECT

This Client Alert briefly summarizes the final rules relating to general solicitation and advertising under Rule 506 of Regulation D of the Securities Act of 1933 that became effective on September 23, 2013 and includes commentary on the recent rule changes from a securities practioner's perspective.

On July 10, 2013, the U.S. Securities and Exchange Commission adopted amendments eliminating the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A offerings. See Securities Act Release 33-9415 / Exchange Act Release 34-69959. The amendments, implementing Section 201(a) of the Jumpstart Our Business Startups Act, permit the use of general solicitation in what were formerly "private securities offerings" so long as the ultimate purchasers are all accredited investors. However, a heightened verification standard has been adopted such that the former check-the-box style representations will no longer satisfy an issuer's reliance and "reasonable steps" must be undertaken to verify that the purchasers of the securities are in fact accredited. Non-exclusive standards have been adopted for verification and these standards permit the use of a registered broker-dealer, a SEC registered investment advisor, a licensed attorney, or a certified public accountant. The Commission did note that the availability of general solicitation would only pertain to Rule 506(c) offerings and would not otherwise affect reliance on the statutory exemption under Securities Act 4(2) (now known as 4(a)(2)).

SUMMARY OF KEY CHANGES

Section 201(a) of the JOBS Act directed the SEC to eliminate the prohibition on general solicitation in Rule 144A and Rule 506 offerings. The SEC proposed implementing rules in August 2012 and final rules in July 2013. The final rules became effective on Monday, September 23, 2013.

Pursuant to the adopting release and final rules:

- ***There is a non-exclusive list of four verification methods.*** The amended rule includes four specific, yet non-exclusive, methods of verifying accredited investor status:
  - when verifying whether an individual meets the accredited investor income test, reviewing for the two most recent years any IRS forms that reports the individual's income and obtaining a written representation from the individual with respect to the expectation of income for the current year;
  - when verifying whether an individual meets the accredited

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investor net worth test, reviewing certain bank, brokerage and similar documents and obtaining a written representation from the individual with respect to the disclosure of all liabilities;
  - obtaining written confirmation from a SEC registered broker-dealer or investment adviser, a licensed attorney or a CPA that has itself taken reasonable steps to verify, and has determined within the prior three months, that the purchaser is an accredited investor; or
  - obtaining a certification of accredited investor status at the time of sale from an individual who invested in an issuer's Rule 506(b) offering as an accredited investor, prior to the effective date of Rule 506(c), for any Rule 506(c) offering conducted by the same issuer.

- ***The "reasonable steps to verify" determination is left flexible.*** Whether verification steps are reasonable depends on facts and circumstances. The SEC suggested that some relevant factors include:
  - the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
  - the amount and type of information the issuer has about the purchaser; 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, such as a minimum investment amount.

- ***Rule 506(c) will permit general solicitation in Regulation D private placements under certain conditions.*** New Rule 506(c) permits the use of general solicitation if:
  - the issuer takes "reasonable steps to verify" that purchasers are accredited investors;
  - all purchasers are accredited investors, or the issuer reasonably believes that they are, at the time of sale; and
  - all requirements of Rules 501 (definitions), 502(a) (integration) and 502(d) (resale restrictions) are met.

- ***General solicitation will be permitted in all Rule 144A transactions.*** Revised Rule 144A(d)(1) requires simply that securities must be sold – not offered and sold, as under current Rule 144A – only to Qualified Institutional Buyers ("QIBs") or to purchasers that the seller and any person acting on behalf of the seller reasonably believe are QIBs. As a result, the Rule 144A exemption now will be available even where general solicitation is actively used in the marketing process or has occurred inadvertently.

- ***Private investment funds will be able to engage in general solicitation.*** The SEC confirmed that privately offered pooled investment vehicles relying on the qualified purchaser (Section 3(c)(7)) or the100-holder (Section 3(c)(1)) exemptions under the Investment Company Act of 1940 may also engage in general solicitation under Rule 506.

COMMENTARY

In much the same manner that former legislation and promulgated rules have come into force, the adoption of the heightened verification standards is a product of good intentions, but the creation of material obstacles to the development of well-functioning capital markets. First, the primary issue in meeting the heightened verification standards is that of the sharing of confidential financial information. It will now be the investor's duty to prove their accreditation to either

an entity that has no procedural protections for sharing that information to the government or to a third-party verification service with which the investor has had no prior dealings. Both registered broker-dealers and SEC registered investment advisors have a duty to disclose comprehensive records to their regulators (the SEC and FINRA, respectively), and there is generally no availability for that registered entity to put confidentiality protections for an investor.

Recent examination techniques have expanded document production requirements on these institutions and have effectively provided regulatory authorities with duplicates of all communications and records from these institutions. In essence, both the broker-dealer and the investment advisor became enforcement tools of U.S. authorities and roadmaps for concentrations of wealth; and now with the ever more coordinated information sharing between governmental agencies. While some may argue that there is no need for concern for most investors, many investors do have legitimate privacy interests and which may become jeopardized by a government's own inability to protect their sensitive information.

Second, the thrust of the regulation is an attack on the separation of powers and the judicial preference to uphold the private right of contract. Despite the SEC's and FINRA's prior attempts to expand their enforcement powers and, for FINRA, their revenue generating mechanisms, courts have generally been reluctant to provide investors recovery for losses sustained when appropriate representations have been obtained by the issuer; namely demonstrating the investor's accreditation for purposes of Regulation D and/or the broader knowledge and sophistication requirements constructed for reliance on the statutory exemption formerly known as 4(2). Where investors have misrepresented their own wealth or sophistication, courts have simply been reluctant to provide any form of recovery.

Third, non-exclusive standards now impose a professional due diligence requirement on an issuer. For example, footnote 124 of the adopting release provides that both attorneys and accountants must be in good standing to meet the new standards which, effectively, will become industry standards and safe harbors. However, questions will inevitably arise such as whether an issuer's reliance on the Rule 506(c) exemption is jeopardized as a result of an accreditation service's failure to use a designated verifying party or whether a licensed lawyer's or accountant's failure to maintain good standing (such as that for failing to meet a continuing education requirement) will invalidate the otherwise proper verification. This becomes only more complicated in consideration of the fact that many of the third-party accreditation services are not law or accounting firms themselves and simply outsource the work to undesignated attorneys or accountants who themselves may not have any experience in rendering the verifications or necessary procedures appropriately documenting it to sustain a regulatory attack on the investors' accreditation.

While there is no perfect solution, the use of a law firm provides the best option for those investors seeking to make an investment into Rule 506(c) offering. Unlike registered financial institutions, law firms generally do not have continuing disclosure requirements to state bars. While non-privileged information can be sought from a law firm, and not otherwise protected by the attorney-client privilege, this would generally require a court-issued subpoena for the production of those records and the attorney would be in the best position to alert the investor as to the existence of the demand; thereby at least offering the ability to challenge disclosure of that information with such mechanism as a motion to quash. In contrast, most lawyers err on the side of non-disclosure as confidentiality is one of the most important ethical obligations in the attorney-client relationship and disclosure should only be made when, and only to the extent, that such is authorized by

the client or mandated by law. Law firms also have restrictions on assignment of work to third-parties. In essence, issuers can then inquire as to which lawyer(s) will provide the certification and then simply contact the state bar to periodically verify that particular lawyer's good standing.

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This client alert is presented by the Securities Practice Group of Convergent Litigation Associates, LLC. The firm focuses on securities transactions and complex securities litigation, including enforcement matters. In compliance with the Rule 506(c) requirements, the verification and accreditation service is provided exclusively by licensed attorneys in good standing within the United States.