Regulation D Rule 506(c) and Rule 506(d) Overview and Basics

As of September 2013, the Jumpstart Our Business Startups Act of 2012 ("***JOBS Act***") has discontinued a near century old bar on general solicitation and advertising for private offerings. As a result, startups, and mature private companies may now broadcast to the world at large that such companies are conducting a private offering under Rule 506(c) of Regulation D.

Regulation D Offerings before the JOBS Act

Regulation D is comprised of Rules 504, 505 & 506. These rules each provide an exemption from securities having to be mandatorily registered with the Securities and Exchange Commission ("***SEC***"). The most frequently employed of these Regulation D exemptions is Rule 506(b). And the reason for that is clear, since it allows issuers to raise unlimited monies from accredited investors and up to thirty-five non-accredited investors. In addition, *all* 506 investors also must be "sophisticated", meaning they have sufficient "knowledge experience in financial and business matters." Traditionally, Rule 506 also barred issuers from resorting to general solicitation or advertising. Hence, a company that employs the 506(b) exemption cannot advertise the fact it is selling its securities (e.g., by using the company website to announce the offering or by emailing directly potential investors it has not developed a substantial and preexisting relationship. Typically, to fill this void, issuing companies relying on 506(b) engage broker-dealers to assist in selling these securities.

Recently Added Rule 506(c)

The Rule 506 amendment creates a separate class of exemption under new Rule 506(c). This rule can be employed by an issuer looking to generally solicit investors or generally advertise the issuer's securities. Under the new Rule 506(c) exemption, issuers are permitted to generally solicit and advertise to potential investors, provided the following factors are satisfied:

- The issuer takes *reasonable steps* to verify the investors are accredited investors, pursuant to the definition set forth under Rule 501 of Regulation D; and
- All securities purchasers are accredited investors or the issuer reasonably believes that such parties are accredited investors, at the time of the sale.

To satisfy the "reasonable steps" standard, an issuer must examine the unique facts and circumstances of each purchaser in context of the transaction. The SEC has created a non-exhaustive set of factors that issuers should evaluate in reaching a conclusion:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- The amount and type of information that 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 whether it requires a minimum investment amount.

As far as verification via the Internet, the SEC has made clear that simply having investors shunted through a website or an email to an electronic check the box or signature form (in the absence of the issuer obtaining additional information about the purchaser), in order to confirm accredited investor status, does not amount to reasonable steps. However, in the event the minimum investment threshold is so high that a reasonable party could conclude only accredited investors are capable of buying in at that

amount, then it may be reasonable for the issuer avoid taking further steps to verify that the investor is accredited, outside of confirmation that the purchaser's cash investment is not being financed by the issuer or a third party. The SEC also has set forth a non-exhaustive series of steps issuers can take to verify accredited investor status that would qualify as "reasonable steps":

- Review copies of Internal Revenue Service documentation of reported income for the two most recent years demonstrating that a person meets the income test in the definition of accredited investor and obtain a written representation from such person that he or she has a reasonable expectation of reaching the necessary income threshold during the current year;
- Review specified documentation dated within the prior three months to confirm assets and liabilities showing that a person meets the net worth test in the definition of accredited investor and obtain a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed;
- Obtain written confirmation from a third party (such as a registered broker-dealer, SEC-registered investment adviser, licensed attorney or certified public accountant) that it has verified the person's accredited investor status within the prior three months; and
- Obtain a certification from an existing investor who previously invested in the issuer's Rule 506(b) offering prior to the effective date of Rule 506(c) and who remains an investor of the issuer.

The language and substance of Rule 506(b) has been left unaffected. As a result, the Rule 506(b) exemption remains available to issuers who have made the tactical decision that general solicitation or advertisement is not a necessary feature of their offering. The following high level breakdown chart compares the provisions of the Rule 506(b) and Rule 506(c):

	(Legacy) Regulation D, Rule 506(b)	**(New) Regulation D, Rule 506(c)**
General solicitation and general advertising allowed:	No	Yes
Maximum number of Accredited Investors who may invest:	Unlimited	Unlimited
Number of non-Accredited Investors who may invest:	35 non-Accredited Investors	None (must be an Accredited Investor)
Issuers must take reasonable steps to verify investors are Accredited Investors:	No	Yes
Mandatory Disclosure of Information to non-Accredited Investors:	Yes	No (Non-Accredited investors not allowed to invest)

Rule 506(d) and "Disqualified Persons"

The new 506(c) rule arrived with a companion 506(d) rule, which prohibits "felons and other 'bad actors'" from conducting Regulation D private placement offerings that rely on any Rule 506 (i.e., 506(b) and 506(c)) exemptions, where a disqualifying event occurs following the effective date of 506(d). Rule 506(d) sets froth the following disqualifying events:

- SEC disciplinary orders;
- SEC cease-and-desist orders;
- SEC stop orders and Regulation A exemption suspensions;
- Final orders by federal and state regulators;
- Criminal convictions in connection with securities offerings or SEC filings;
- Court injunctions and/or restraining orders in connection with securities offerings or SEC filings;
- Suspension by self-regulatory securities organizations; and
- U.S. Postal Service false representation orders.

If a disqualifying event occurred within the proscribed time period prior to 506(d)'s effective date, such event must be disclosed to purchasers prior to consummating a sale (however, if the issuer demonstrates that despite exercising "reasonable care" it did not know and reasonably could not have known of the existence of the disqualifying event, such disclosure may be avoided). Accordingly, issuers leveraging any Rule 506 exemption must undertake due diligence into all relevant persons involved in the offering and their backgrounds.