Practical Considerations for a Rule 506(c) General Solicitation

Brian M. Katz | katzb@pepperlaw.com
Edward T. Dartley | dartleye@pepperlaw.com

So you want to jump into the fray and take advantage of the new opportunities created by the JOBS Act's elimination of the ban on general advertising of private placements? In providing issuers with this new opportunity for raising funds, the U.S. Securities and Exchange Commission (SEC) imposed a significant gatekeeping requirement: a new affirmative obligation that the issuer take "reasonable steps" to verify that participants in private placements are "accredited investors" under the Securities Act of 1933 (an accredited investor must have either (i) a net worth of at least $1 million, not including the value of one's primary residence, or (ii) income of at least $200,000 in each year of the last two years (or $300,000 together with his or her spouse if married) and have the expectation to make the same amount in the current year).

The threshold question you need to address is whether you are going to perform the verifications yourself or if you are going to turn to a third-party verification service. The SEC identified third-party verification by attorneys, accountants, broker-dealers, and SEC-registered investment advisers as "non-exclusive" methods for meeting the verification requirement. Third-party verification has some significant advantages: (i) it takes the administrative burden of verification off the issuer, (ii) it takes the risk of getting it wrong off the issuer, and (iii) it provides a neutral and confidential intermediaray that may be more palatable to potential investors who are interested in investing and who otherwise may balk at the thought of providing their private financial information to investment managers or companies with whom they have never dealt.

While these advantages make this method of verification very attractive, as of this writing third-party verification services have yet to emerge as a cottage industry, although that is expected to occur. Accordingly, while we expect this to be a viable option in the coming months, in the near term, issuers wishing to take advantage of Rule 506(c) will need to "go it alone" and rely on their own verification efforts. The SEC had identified several additional methods for meeting the verification requirement. The simplest of these allows an issuer to continue to rely on "self-certification" by the prospective investor, if the investor is a natural person and is a current investor in a prior private placement offering under Rule 506. While this verification method is fairly simple, it has limited value to issuers that are seeking an audience beyond those investors who are already invested in one or more of the issuer's private placements.

> ***Pepper Point:*** *Note that the Rule 506(c) amendments focus on the "issuer;" if an affiliate of the issuer (such as a different private fund under the control of the same investment adviser or general partner) had made the prior private placement it is unclear (and probably doubtful) that the new "issuer" (i.e., the new fund) could rely on this rule. The safest bet is for the new fund (i.e., the new "issuer") to do the required Rule 506(c) due diligence.*

The other two non-exclusive methods for verification identified by the SEC—verification of income and/or net worth—will require the collection and evaluation of sensitive and confidential financial information from the investor, including tax returns, credit reports, and bank and brokerage statements, as well as assessments of liabilities. As the issuer in a Rule 506(c) offering, you will need to address a host of practical considerations that flow from obtaining – and retaining – this information, such as:

This publication may contain attorney advertising.

The material in this publication was created as of the date set forth above and is based on laws, court decisions, administrative rulings and congressional materials that existed at that time, and should not be construed as legal advice or legal opinions on specific facts. The information in this publication is not intended to create, and the transmission and receipt of it does not constitute, a lawyer-client relationship. Internal Revenue Service rules require that we advise you that the tax advice, if any, contained in this publication was not intended or written to be used by you, and cannot be used by you, for the purposes of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. Please send address corrections to phinfo@pepperlaw.com. © 2013 Pepper Hamilton LLP. All Rights Reserved.

- Who at your firm will have access to this financially sensitive information?
- Who will be responsible for the care and custody of the information?
- Who will be responsible for evaluating the information and deciding whether or not the investor qualifies as an accredited investor?
- Do you need to have multiple reviewers involved so that determinations can be double-checked?
- How much backup is enough backup in making these determinations, from both a commercial perspective and a regulatory perspective?
- How long will you need to retain investors' financial information?
- What are the privacy issues that you will need to consider and plan for in advance of accepting such information?
- What changes will you need to make to your document retention policies as a result of holding this documentation?
- If you are an SEC-registered investment adviser, what other changes do you need to make to your policies and procedures?

Pepper Point: *If you are contemplating using new Rule 506(c) to tap new markets for your private placement, these are some of the considerations that you should be addressing well in advance of any general advertising pursuant to that rule. Issuers must avoid the temptation of just putting information on the Internet without going through these steps, as it is clear that an open Web site unprotected by a password is considered to be a general solicitation, and thus, on and after September 23, 2013, it must comply with Rule 506(c).*

We at Pepper Hamilton have already begun tackling these issues with issuers that are interested in jumping into the new world of advertising private placements.

More Resources on the JOBS Act

Pepper Hamilton is hosting two in-person seminars (in Philadelphia on August 13 and in Princeton on August 20) to complement the ones held in New York and Boston recently.

For additional information, please visit Pepper's JOBS Act Resource Center available online at www.pepperlaw.com/news.aspx?AnnouncementKey=1957.