

## THE SEC PROPOSED RULE 506(c) TO PERMIT GENERAL SOLICITATION

On August 29, 2012, the Securities and Exchange Commission (the “SEC”) released its first proposed rule for the implementation of the Jumpstart Our Business Startups Act (the “JOBS Act”): “Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings.” The proposed rule seeks to implement Section 201(a) of the JOBS Act, which will allow companies to use general solicitation and advertising (collectively, “General Solicitation”) in securities offerings by using virtually any means available, including the internet, as long as sales of securities are made only to accredited investors. Often called “Accredited Crowdfunding,” the new proposed Rule 506(c) of the Securities Act of 1933 (“Rule 506(c)”) has been heralded as an opportunity for issuers to expand their network of investors by increasing the visibility of start-up companies seeking capital.

Under the SEC’s proposal, Rule 506(c) will allow General Solicitation if reasonable steps are taken to identify every purchaser’s accreditation status. As a result, the most significant hurdle that issuers will face in Rule 506(c) offerings is determining the meaning of “reasonable steps” in vetting potential purchasers. The SEC has stated that this is an “objective determination, based on the particular facts and circumstances of each transaction”; consequently, the SEC is reluctant to provide a list of safe-harbor methods for verifying accreditation. Instead, the SEC is seeking a more flexible rule that will focus on several factors when determining whether the issuer has taken “reasonable steps,” including:

- (i) The nature of the purchaser and the type of accreditation the investor claims to have;
- (ii) The amount and type of information available to the issuer about the purchaser; and,
- (iii) The nature of the offering, including the manner of solicitation and the minimum investment amount.

Ultimately, the SEC has signaled that using the traditional “check-the-box” subscription agreement will not be sufficient to prove accreditation in proposed Rule 506(c) offerings.

Critics are concerned that the “reasonable steps” standard may raise privacy concerns for accredited investors when issuers seek personal financial information to vet their subscription agreement. The SEC has tried to combat this criticism in the release by stating that the greater the personal relationship the investor and issuer have, the lesser the investigation that is necessary to meet the reasonable level. In addition, the SEC has pointed out that public and third party sources are available for certain information that could be used to substantiate a claim of accreditation. Finally, the SEC has suggested that receiving a comfort letter from attorneys, broker-dealers, and accountants of the investor may be enough for the issuer to rely on the investor’s claim of accreditation. Regardless of the method of vetting the issuer, the SEC strongly urges issuers to keep documentation of their investigation process.

Conducting an offering under the proposed Rule 506(c) is likely to require the issuer to seek substantial third party aid to conduct the necessary background checks and ensure the proper documentation of the due diligence searches. Some hedge funds and companies may start requiring high minimum investment thresholds, such as \$1 million, to ensure investors are accredited. The SEC has indicated that a high investment threshold would amount to a reasonable assumption of accredited investor status. Raising investment thresholds to over \$1 million, however, could potentially have a chilling effect on alternative investments.

In its proposed Rule 506(c), the SEC has made strides to broaden the possibilities of Rule 506 and provide flexibility to the most common exemption for private offerings. The “reasonable steps” that must be taken to verify the accreditation of investors, however, may complicate the provisions of Section 201(a) of the JOBS Act. Although the “reasonable steps” standard provides flexibility, it lacks clarity, which will make it more difficult to structure offerings. Creating a grey standard also gives the SEC flexibility to bring enforcement action in situations where the Commission believes proper steps have not been taken. As a result, issuers and their legal counsel will likely need to implement conservative due diligence policies to establish the accreditation of investors to prevent running afoul of the “reasonable steps” standard.



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