

**CLIENT ADVISORY - CORPORATE / SECURITIES / M&A****SEC Rule 506 Private Securities Offerings Can Now Be Publicly Advertised****SEPTEMBER 23, 2013**

Summary. In a fundamental shift in federal securities laws, new U.S. Securities and Exchange Commission (“SEC”) rules will permit companies seeking to raise capital in Rule 506 private placements to engage in “general advertising and solicitation” (e.g., internet solicitations, mass mailings, website banner ads, etc.) to attract investors. Thus, 80 years of securities laws requiring that “non-public offerings” or “private placements” remain “private” (including conditions intended to limit the offering to potential investors with whom the company or its senior management have pre-existing relationships) have been overturned.

The new rules affect securities offerings under Rule 506 of SEC Regulation D and are effective as of September 23, 2013. In effect, companies seeking to raise capital under the Rule 506 exemption from securities registration requirements can now make public solicitations in order to cast a wide net for investors, though companies seeking to utilize these more permissive “manner of offering” rules may only sell securities to “accredited investors” and must satisfy heightened compliance requirements (including new “bad boy” disqualification rules).

Private Placements Generally. By way of background, companies (issuers) seeking to raise capital through the sale of securities must either register the securities offering with the SEC (and state securities administrators) or rely on exemptions from registration (under federal and state securities laws). Most of the exemptions from registration prohibit companies from engaging in general advertising or

solicitation in connection with securities offerings. One such exemption — Rule 506 of Regulation D — is the most widely used exemption from securities law registration requirements. In a Rule 506 offering, an issuer may generally raise an unlimited amount of capital from an unlimited number of “accredited investors” and up to 35 non-accredited investors (though anti-fraud, full and fair disclosure, filing, resale limitations and other requirements still apply). Failure to comply with the requirements of an exemption effectively grants investors a “put” right against the issuer and its management/control persons for rescission/return of funds (plus interest, attorney fees, etc.), thus exposing management to personal liability.

Congressional Mandate. The new rules were mandated by the Jumpstart Our Business Startups Act (JOBS Act). However, while Congress directed the SEC to remove the ban on general advertising and solicitation, the staff of the SEC (and state securities administrators for that matter) have not been so willing to upset 80 years of securities laws deeming “general advertising and solicitation” to be inconsistent with “transactions not involving a public offering” (private placements). The result, following lengthy rule-making delays, is that additional compliance actions are required before a company may engage in general advertising and solicitation to raise capital in reliance on the new rules. The major consequences of this SEC rule change are outlined below.

General Solicitation Now Permitted. While a Rule 506 offering may now be conducted

using general advertising and solicitation, the issuer may then only accept subscriptions from “accredited investors.” “Accredited investors” are individuals who meet certain minimum income or net worth levels, or institutions such as trusts, corporations or charitable organizations that meet certain minimum asset levels.

“Accredited Investor” Verification Requirements. The company must take “reasonable steps” to verify that investors are “accredited investors.” This verification requirement requires a company to “objectively assess” the “facts and circumstances” of each purchaser in order to determine accredited investor status. Such an assessment is easily called “objective,” but as a practical matter a subjective element is present in certain of the “accredited investor” tests. For instance, a company raising capital in a Rule 506 offering might review an individual investor’s filed tax returns (including Forms W-2, etc.) to assess the level of income for the preceding two (2) years (objective), but the company must also determine that the investor is reasonably expected to earn the required income level in the next year. Further, because different income, asset and other tests apply to different classes of investors (e.g., individual, corporation, charitable organization, trust, etc.) and in some cases the tests “look through” an entity investor to its beneficial owners, the SEC declined to define the “reasonable steps” and instead offered only a limited, non-exclusive and non-mandatory list of methods that issuers might use to satisfy the verification requirement for individual investors.

New “Bad Boy” Disqualification Provisions for 506 Offerings. SEC “bad boy” prohibitions — disqualifying provisions that previously applied only to other SEC exemptions from registration — will now

apply to SEC Regulation D Rule 506 offerings. Issuers seeking to raise capital now have an increased compliance burden to ensure that their officers, directors, other senior management or persons holding more than twenty percent (20%) of the issuer’s equity securities do not have prior securities law violations or other disqualifying bad acts as those “bad boys” will prohibit the issuer from relying on SEC Regulation D Rule 506.

Exclusive Election Effect. Issuers seeking to engage in general advertising and solicitation under a Rule 506 offering will now have increased motivation to strictly comply with all conditions of the Rule 506 registration exemption, since the fact of general advertising and solicitation will destroy reliance on nearly all other federal and state exemptions from registration. Stated differently, raising capital through general advertising and solicitation is largely an election to rely exclusively on Rule 506 and precludes reliance on “alternative” or “secondary” exemptions should there be a problem with another aspect of the Rule 506 offering.

Increased Scrutiny Likely. The legislative and regulatory history, as well as public comments from state securities administrators and certain SEC commissioners, suggests that the SEC and state securities administrators are less than thrilled with the new rules (the prevailing view being that the new regime will lead to increased fraud on investors) and therefore may scrutinize Rule 506 offerings which utilize general advertising and solicitation much more closely. Indeed, the SEC has also published proposed rules intended to enhance the SEC’s ability to better evaluate Rule 506 offerings. As proposed, these rules will, among other things, require the filing of a Form D before the issuer engages in general solicitation; require written general solicitation materials used in Rule

506 offerings to include certain legends and other disclosures; and require the submission, on a temporary basis, of written general solicitation materials used in Rule 506 offerings to the SEC.

RQ&N Practical Insights. Our experience in representing issuers and investors in seed, early-stage, angel and venture capital financings suggests that issuers with seasoned management and technical/operational sophistication will be less likely to pursue intentional advertising and solicitation to raise capital (the better path being a traditional private placement with investors with whom a bona fide, pre-existing relationship is already in place). Nonetheless, a number of issuers will find the general advertising and solicitation opportunity to be advantageous.

One thing is nearly certain: we will all receive an increased level of investment solicitations since general advertising and solicitation is now permitted, thus making it more difficult to discern legitimate offerings from other investment solicitations (as feared by securities regulators).

About Ray Quinney & Nebeker's Corporate, Securities and Tax Sections. RQ&N's Corporate, Securities and Tax group is the largest transactional practice in the State of Utah (comprised of 21 attorneys) and includes a range and depth of experience which enables us to represent corporations and other business entities throughout their life cycle and for all stages of growth and development, including formation, financing, taxation, licensing, development and distribution agreements, as well as merger, acquisitions, joint ventures or other business combination or "exit" transactions. We regularly represent issuers and investors in seed, early-stage, angel and venture capital financings.

Mark A. Cotter, Esq. Mr. Cotter is a shareholder of Ray Quinney & Nebeker and the Chair of its Corporate and Securities Section. Mr. Cotter practices business, corporate, securities, intellectual property and health care transactional law. Mr. Cotter has advised both entrepreneurs and business entities in all aspects of business formation, growth and development, including corporate structuring, private placements, venture capital financing and SEC compliance, stock options and key employee equity incentive arrangements, mergers, acquisitions and divestitures, intellectual property licenses, cooperative development arrangements and related matters. Mr. Cotter maintains an AV Preeminent (5.0) rating with Martindale-Hubbell, which is the highest rating awarded to attorneys for professional competence and ethics. He has been included on the list of The Best Lawyers in America in Corporate Law and has also been voted by his peers throughout the state as one of Utah's "Legal Elite" in the category of Corporate Law & Transactions (as published in Utah Business Magazine).

Disclaimer This Client Advisory has been prepared and published only for informational purposes for clients (and friends) and is not offered, and should not be construed, as legal advice. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.