

# EB-5 Capital Markets

Legal perspectives on EB-5 project finance

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## What the SEC's Elimination of the Prohibition on General Solicitation for Rule 506 Offerings means to the EB-5 Community

By John Tishler on July 12, 2013

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As we previously reported, on July 10, 2013, the SEC adopted the amendments required under the JOBS Act to Rule 506 that would permit issuers to use broad-based marketing methods such as the Internet, social media, email campaigns, television advertising and seminars open to the general public. These types of methods are referred to in U.S. securities laws as “general solicitation,” and they have until now been prohibited in most offerings of securities that are not registered with the SEC. This is an important development to the EB-5 community because EB-5 offerings very often rely on Rule 506 as an exemption from offering registration requirements.

In addition, the SEC amended Rule 506 to disqualify felons and other “bad actors” from being able to rely on Rule 506. This is also an important development for the EB-5 community, which has developed a heightened sensitivity to the potential for fraud in the wake of the Chicago Convention Center project.

**Please note that these new rules are not yet effective.** See “*When do the new rules become effective?*” below.

### **Overview**

Companies intending to raise capital through the sale of securities in or from the United States must either register the securities offering with the SEC or rely on an exemption from registration. Failure to assure an available exemption for unregistered securities can result in civil and criminal penalties for the participants in the offering and rescission rights in favor of the investors.

For EB-5 programs, a widely used exemption from registration is Rule 506 of Regulation D, under which an issuer may raise an unlimited amount of capital from an unlimited number of “accredited investors” and up to 35 non-accredited investors. Historically, this exemption has prohibited general solicitation or advertising in connection with the offering, including publicly available web sites, social media, email campaigns, television advertising and seminars open to the general public.

The other commonly used exemption, Regulation S, has been less restrictive on general solicitation, but is

not available for investors already present in the United States and does not preempt state securities law registration/exemption obligations, which often prohibit general solicitation. Rule 506 does preempt such state laws (except as to notice filings and filing fees). For many EB-5 programs and investors, there is no available exemption other than Rule 506 that does not also prohibit general solicitation.

In connection with the passage by Congress of the Jumpstart Our Business Startups (JOBS) Act in April 2012, Congress directed the SEC to remove the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506, provided that sales are limited to accredited investors only and that the issuer takes reasonable steps to verify that all purchasers of the securities meet the requirements for accredited investors. The SEC initially proposed a rule to implement these changes in August 2012, but did not pass final rules on the changes to Rule 506 until now.

### ***What changes were made to Rule 506?***

The final rule adds a new Rule 506(c), which permits issuers (that is, the partnerships or other organizations actually issuing partnership interests and the like in exchange for EB-5 capital) to use general solicitation and general advertising for the offer their securities, provided that:

- All purchasers of the securities are accredited investors as defined under Rule 501; and
- The issuer takes “reasonable steps” to verify that the purchasers are all accredited investors.

### ***Who is an accredited investor?***

Under Rule 501 of Regulation D, a natural person qualifies as an “accredited investor” if he or she is either:

- An individual net worth (or joint net worth with a spouse) that exceeds \$1 million at the time of the purchase, excluding the value of a primary residence; or
- An individual annual income of at least \$200,000 for each of the two most recent years (or a joint annual income with a spouse of at least \$300,000 for those years), and a reasonable expectation of the same level of income in the current year.

### ***What are reasonable steps to verify that an investor is accredited?***

What steps are reasonable will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. The SEC indicates that among the factors that issuers should consider under this facts and circumstances analysis are:

- 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 a minimum investment amount.

The final rule provides a *non-exclusive* list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons, including:

- For the income test, reviewing copies of any IRS form that reports the income of the purchaser for the two most recent years and obtaining a written representation that the purchaser will likely continue to earn the necessary income in the current year.
- For the net worth test, reviewing one or more of the following types of documentation dated

within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:

- With respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and
- With respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies;
- As an alternative to either of the above, an issuer may receive a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that it has taken reasonable steps within the prior three months to verify the purchaser's accredited status.

Simply relying on a representation from the purchaser, or merely checking a box on an accredited investor questionnaire, will not meet the requirement for objective verification. EB-5 Regional Centers should consider this carefully if they intend to make "accredited investor" determinations.

### ***What actions must an issuer take to rely on the new exemption?***

Issuers selling securities under Regulation D using general solicitation must file a Form D. The final rule amends the Form D to add a separate box for issuers to check if they are claiming the new Rule 506 exemption and engaging in general solicitation or general advertising. An issuer is currently required to file Form D within 15 days of the first sale of securities in an offering, but the SEC promulgated proposed rules to require an earlier filing. See "***Are there any other changes contemplated for Rule 506?***" below.

### ***Will the new rule affect other Rule 506 offerings that do not use general solicitation?***

Not directly. The existing provisions of Rule 506 remain available as an exemption. This means that an issuer conducting a Rule 506 offering without using general solicitation or advertising is not required to perform the additional verification steps.

### ***Who is excluded from using the Rule 506 exemption?***

Under the new rule regarding "bad actors" required by the Dodd-Frank Act, an issuer cannot rely on a Rule 506 exemption (including the existing Rule 506 exemption) if the issuer or any other person covered by the rule has had a "disqualifying event." The persons covered by the rule are the issuer, including its predecessors and affiliated issuers, as well as:

- Directors and certain officers, general partners, and managing members of the issuer;
- 20% beneficial owners of the issuer;
- Promoters;
- Investment managers and principals of pooled investment funds; and
- People compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor.

### ***What is a "disqualifying event?"***

A "disqualifying event" includes:

- Felony and misdemeanor criminal convictions in connection with the purchase or sale of a

security, making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within 10 years of the proposed sale of securities (or five years in the case of the issuer and its predecessors and affiliated issuers).

- Court injunctions or restraining orders in connection with the purchase or sale of a security, making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The injunction or restraining order must have occurred within five years of the proposed sale of securities.
- Final orders from certain regulatory authorities that:
  - bar the issuer from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or
  - are based on fraudulent, manipulative, or deceptive conduct and were issued within 10 years of the proposed sale of securities.
- Certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons.
- SEC cease-and-desist orders related to violations of certain anti-fraud provisions and registration requirements of the federal securities laws.
- Suspension or expulsion from membership in or association with a self-regulatory organization (such as FINRA, the membership organization for broker-dealers).
- U.S. Postal Service false representation orders issued within five years before the proposed sale of securities.

### ***What disqualifying events apply?***

Only disqualifying events that occur after the effective date of the new rule will disqualify an issuer from relying on Rule 506. However, matters that existed before the effective date of the rule and would otherwise be disqualifying must be disclosed to investors.

### ***Are there exceptions to the disqualification?***

Yes. An exception from disqualification exists when the issuer can show it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. The SEC can also grant a waiver of the disqualification upon a showing of good cause.

### ***When do the new rules become effective?***

Both rule amendments will become effective 60 days after publication in the Federal Register. Publication normally occurs within two weeks after final rules are adopted.

### ***Are there any other changes contemplated for Rule 506?***

In connection with the foregoing final rules, the SEC separately published for comment a proposed rule change intended to enhance the SEC's ability to assess developments in the private placement market based on the new rules regarding general solicitation. This proposal would require issuers to provide additional information to the SEC, including:

- identification of the issuer's website;

- expanded information about the issuer;
- information about the offered securities;
- the types of investors in the offering;
- the use of proceeds from the offering;
- information on the types of general solicitation used; and
- the methods used to verify the accredited investor status of investors.

**Though this proposed rule is not specifically directed to EB-5 offerings, the SEC could use such information to enhance the monitoring it is already doing of EB-5 programs.**

The proposed rule would also require issuers that intend to engage in general solicitation as part of a Rule 506 offering to file the Form D at least 15 calendar days **before** engaging in general solicitation for the offering. Then, within 30 days of completing the offering, the issuer would be required to update the information contained in the Form D and indicate that the offering had ended.

The proposed rule has a 60-day comment period.

The Sheppard Mullin has an experienced interdisciplinary team to assist with all aspects of the EB-5 program.

### ***Disclaimer***

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