EQUITY FINANCING STRATEGIES: KEY DIFFERENCES OF RULE 506(B) VS. RULE 506(C)

For some companies, securing capital through debt financing is not a viable option, which may lead the owners to pursue an equity raise. Equity financing requires compliance with either Rule 506(b) or Rule 506(c), two key exemptions under Regulation D of the Securities Act of 1933 (the “Act”), which essentially allow companies to raise funds privately without full public registration. Both Rule 506(b) and (c) have opened the door for companies to attract investors and raise capital without going through a full public offering. However, choosing between these exemptions is a crucial decision as there are notable differences in terms of solicitation, types of investors allowed, and compliance obligations. Below, we outline the key features and requirements of Rule 506(b) and Rule 506(c).

Key Features of Rule 506(b):

Rule 506(b) is the more commonly used exemption under Regulation D and is known for its flexibility in limiting public solicitation.

1. **General Solicitation Prohibited:**

   (a) Under Rule 506(b), companies are not allowed to advertise or engage in general solicitation to the public. This means the offering can only be marketed to a select group of individuals or entities with whom the company or its agents have an existing relationship or have prequalified as potential i investors.

   (b) An unlimited number of accredited investors can participate in a Rule 506(b) offering. Accredited investors are individuals or entities that meet specific financial thresholds, such as a net worth of over $1 million (excluding their primary residence) or an annual income of more than $200,000 ($300,000 if combined with a spouse).

   (c) Rule 506(b) allows up to 35 non-accredited but sophisticated investors (those who possess sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment). However, if non-accredited investors participate, the company must provide detailed disclosures like those in a registered offering (such as a private placement memorandum).

2. **Disclosure Requirements:**

   (a) If only accredited investors are involved, specific disclosures are not required, although investors typically receive a private placement memorandum ("PPM") to outline the terms, risks, and details of the investment.

   (b) If non-accredited investors participate, more comprehensive disclosures are required to protect these investors, including financial statements and other critical company information.

3. **Filing Requirements:** Companies conducting a Rule 506(b) offering must file Form D with the SEC within 15 days of the first sale of securities.

4. **Resale Restrictions:** Securities sold under Rule 506(b) are considered "restricted" and cannot be resold unless they are registered or an exemption from registration applies.

Summary of Rule 506(b) provisions:

- General solicitation not permitted.
- Ability to raise an unlimited amount of capital.
- Unlimited number of accredited investors permitted.
- Up to 35 non-accredited investors subject to additional disclosures.
- Securities are restricted and subject to resale limitations.

Key Features of Rule 506(c)

Rule 506(c) was introduced as part of the JOBS Act of 2012 and allows companies to advertise their offerings publicly. However, this type of offering has stricter requirements regarding investor qualifications and verification.

1. **Rule 506(c) permits companies** to engage in general solicitation and advertising, which allows the founders to publicly market the offering via various channels, such as online platforms, social media, print media, or events. Importantly, only accredited investors are permitted to purchase 506(c) offerings.

2. **Verification of Accredited Investor Status:**

   (a) One of the key differences in Rule 506(c) is that the issuer must take reasonable steps to verify that each investor is accredited. This verification must be more thorough than a simple self-certification or representation from the investor, as is typically acceptable under Rule 506(b).

   (b) Common verification methods include reviewing financial documents (e.g., tax returns, bank statements), obtaining confirmation from a third-party financial advisor or attorney, or using online verification services.

3. **Disclosure Requirements:** While Rule 506(c) does not require specific disclosures if only accredited investors are involved, issuers typically provide a PPM to outline the investment terms and risks. More importantly, the issuer must ensure that all accredited investors are verified.

4. **Filing Requirements:** Companies conducting a Rule 506(c) offering must also file Form D with the SEC within 15 days of the first sale of securities.
5. **Resale Restrictions:** Similar to Rule 506(b), securities sold under Rule 506(c) are "restricted" and cannot be freely traded unless registered or an exemption applies.

Summary of Rule 506(c):

- General solicitation permitted.
- Ability to raise an unlimited amount of capital.
- Limited to accredited investors.
- Verification of accredited investor status is required.
- Securities are restricted and subject to resale limitations.

Conclusion:

Generally, companies relying on the Rule 506 exemptions can raise an unlimited amount of money. The choice between Rule 506(b) and Rule 506(c) depends on your fundraising strategy. If you want the flexibility to reach a broader audience through general solicitation, Rule 506(c) is the better option, but you'll need to strictly verify that all investors are accredited. If you prefer to avoid the burden of verification and want to include some non-accredited investors, Rule 506(b) is more suitable, though you must avoid public advertising and solicitation. Businesses should weigh the pros and cons to determine the best method to raise capital for their company.

If you have questions or would like further information on equity fundraising strategies, please contact Attorneys Gary R. Pannone or Paige E. Macnie at 401-824-5100; gpannone@pldolaw.com or pmacnie@pldolaw.com.

Gary R. Pannone
Principal

Paige E. Macnie
Associate

PANNONE LOPES DEVEREAUX & O'GARA LLC
counselors at law