A healthy dose of stranger danger: How to market your next capital raise

By **Parsons Behle & Latimer** // Feb 4, 2025

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As general economic conditions improve but interest rates for conventional debt remain high, we expect to see in the coming year an increase in private companies that access capital by selling their own equity interests. Equity interests that are sold will be regulated at various state and federal levels as "securities," bringing with them a host of compliance risks. First and foremost, the Securities Act of 1933 (Securities Act) provides that securities being sold in the U.S. must either be 1) registered with the U.S. Securities and Exchange Commission (SEC), typically via an initial public offering, i.e., an IPO, or 2) exempted from such registration.

Because registering securities is an expensive and time-consuming process usually undertaken only by very large and mature companies, most companies that issue securities rely on the private placement offering exemption codified as Section 4(a)(2) of the Securities Act. But Section 4(a)(2) leaves an uncomfortable amount of room for interpretation, so most private securities issuers elect to rely on the safe-harbor guidelines contained in Rule 506 of Regulation D, which also entitles them to federal preemption of state securities laws, meaning state securities regulators are preempted from regulating offerings that comply with Rule 506. (Although, such regulators still require notice filings.)

When issuers take advantage of the Rule 506 safe harbors, two specific offering structures are most commonly used: Rule 506(b) and Rule 506(c). While this article is no substitution for a fact-specific consultation with a qualified securities attorney, below is a brief overview of the benefits and tradeoffs of each structure:

Rules	Who Can Invest	Investor Verification	How to Market
Rule 506(b)	All investors must either: (a) be accredited[1] or (b) possess sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of a potential investment after reviewing costly disclosure materials (this second subgroup being limited to no	Issuers may rely on their reasonable belief that a potential investor is accredited or sufficiently knowledgeable and experienced.	Issuers may market their securities only by relying on what the SEC determines to be "pre-existing, substantive relationships."

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	more than 35 investors in one offering).		
Rule 506(c)	All investors must be accredited.	Issuers must take reasonable steps to verify that all investors are accredited, which often entails hiring a third party to assume the liability of verifying investors' accredited status.	Issuers may market their securities by engaging in public solicitation without the requirement that they have a pre-existing relationship with their prospective investors. This is called "general solicitation."

As shown above, one of the principal differences between Rules 506(b) and 506(c) is how issuers may market their securities. While Rule 506(c) issuers can market their securities to the general public, Rule 506(b) issuers must either 1) rely solely on those investors with whom they have pre-existing, substantive relationships or 2) retain a licensed broker dealer and utilize its relationships. A relationship is generally "pre-existing" if it was formed "prior to the commencement of the securities offering", and a "substantive" relationship is one in which the issuer has enough information to reasonably believe an investor is accredited or otherwise capable of competently evaluating the merits and risks of a prospective investment. While Rule 506(b) issuers may be tempted to find the metaphorical line where "pre-existing, substantive relationships" end and "general solicitation" begins, best practice would be to steer clear from investors whose financial experience and sophistication they did not know prior to the commencement of the offering. This recommendation effectively limits Rule 506(b) issuers to investors already in their own personal networks or in the networks of expensive broker dealers, leading issuers to base the decision between Rules 506(b) and 506(c) on whether they will need to attract investors with whom they don't have pre-existing connections.

If an issuer does not need to raise more capital than its current network possesses, it is likely best to simply rely on Rule 506(b) to avoid the costs and associated liability of verifying accredited investor status. On the flipside, an issuer may opt to conduct a Rule 506(c) offering so it can sell securities to investors both inside and

outside of its current network if it decides that verifying accredited investor status (or outsourcing such verification) is worth it to pull together the needed funds.

Much of the tradeoff between Rules 506(b) and 506(c) boils down to whether the hassle and risk of verifying accredited investor status outweighs the limitations and risks of raising capital through only pre-existing, substantive relationships. If you intend to make a private offering, be sure to consult with an attorney prior to marketing securities so you can know with confidence whether you are in compliance with applicable securities laws.

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[1] ***"Accredited Investor" is defined in Rule 501(a) of Regulation D. The definition is too extensive to include here, but it essentially requires an investor, whether an individual or an entity, to meet a particular net worth threshold or to hold certain positions or professional certifications or credentials that the SEC has deemed to qualify an individual for accredited investor status.***

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