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Corporate / Financial Institutions ALERT

SEC Adopts Rules Eliminating the Prohibition Against General Solicitation in Certain Private Offerings and Disqualifying Bad Actors From Certain Offerings and Proposes New Reg D Requirements

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Summary

The Jumpstart Our Business Startups Act (JOBS Act) directed the U.S. Securities and Exchange Commission (SEC) to:

- amend Rule 506 of Regulation D to permit general solicitation or general advertising in offerings made under Rule 506; and
- adopt rules which will permit offers of securities pursuant to Rule 144A, including by means of general solicitation or general advertising.

In August 2012, the SEC proposed rules to allow advertising in private placements under Rule 506 and Rule 144A.

On July 10, 2013, the SEC:

- amended Rule 506 by adding Rule 506(c) to permit general solicitation or general advertising in offerings made under Rule 506, provided that all purchasers of the securities are accredited investors; and
- adopted rules which permit offers of securities pursuant to Rule 144A, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers (QIBs).

The SEC also approved final rules disqualifying securities offerings from relying on Rule 506 if certain felons or other “bad actors” participate in the offering.

These rules will be effective 60 days after their respective publication in the Federal Register. Until that date, the SEC’s existing regime regulating Rule 506 and 144A offerings remains unchanged.

The SEC also proposed new Regulation D requirements which, if adopted would, among other things:

- disqualify an issuer from using Rule 506 if it fails to timely file a Form D;
- require the filing of a Form D 15 calendar days in advance of the first use of general solicitation materials in a Rule 506(c) offering; and
- for a two-year period following the adoption of Rule 506(c), require issuers to submit written general solicitation materials to the SEC no later than the date first used.

Background of Rule 506

Under existing Rule 506, an issuer may offer and sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors," as defined in Regulation D, and to no more than 35 nonaccredited investors who meet certain sophistication requirements. Offerings under Rule 506 are subject to all the terms and conditions of Rules 501 and 502, including Rule 502(c) which prohibits any form of general solicitation or general advertising

Amendment to Rule 506

Rule 506(c) permits the use of general solicitation and general advertising in the offer and sale of securities provided:

- all purchasers of securities are accredited investors, either because they qualify as accredited investors under Regulation D or the issuer reasonably believes that they do at the time of the sale of the securities; and
- the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors.

Rule 506(c) eliminates the prohibition on general solicitation and advertising. As a consequence, a number of forms of solicitation (e.g., advertisements, email, internet media, television and radio) can be used. Issuers would also be able to conduct seminars where prospective purchasers are invited by general advertising. It should be noted, however, that SEC rules still prohibit the making of false or misleading statements.

Other provisions of Regulation D (*e.g.,* definition of accredited investor, integration and the resale restrictions) have not been changed. An issuer relying on Rule 506(c), therefore, must comply with all of Regulation D's other applicable requirements.

Issuers planning to take advantage of Rule 506(c) will have "to take reasonable steps to verify that purchasers of the securities are accredited investors." In the SEC's view, whether the steps taken are "reasonable" is an objective determination, based on the particular facts and circumstances of each transaction. Under these standards, issuers may not be able to rely on the certificate of a purchaser of the purchaser's accredited investor status. Additional steps may have to be taken.

The new rules include specific, nonexclusive and nonmandatory methods of verifying accredited investor status, including:

- when determining whether an individual meets the accredited investor income test, reviewing any IRS forms that report the investor's income for the two most recent years and obtaining a written representation from the individual;

- when determining whether an individual meets the accredited investor net worth test, reviewing certain bank, brokerage and similar documents issued within the previous three months and obtaining a written representation from the individual; and

- obtaining written confirmation from a registered broker-dealer or an SEC registered investment adviser, a licensed attorney or a CPA that has taken reasonable steps to verify that the purchaser is an accredited investor.

If an issuer has conducted a Rule 506 offering prior to the enactment of Rule 506(c), an individual who qualified as an accredited investor in the earlier offering and still holds the issuer's securities may qualify as an accredited investor in the same issuer's Rule 506(c) offering if the investor certifies that he or she is still an accredited investor.

Several other factors should be considered when determining the reasonableness of the steps to verify that a purchaser is an accredited investor. Examples of these factors include:

- 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.

Nature of the Purchaser. The definition of "accredited investor" in Rule 501(a) includes natural persons and entities that come within any of the categories in the rule, or that the issuer reasonably believes come within one of those categories, at the time of the sale of securities to that natural person or entity.

Steps that would be reasonable for an issuer to take to verify whether a purchaser is an accredited investor under proposed Rule 506(c) will vary depending on the type of accredited investor that the purchaser claims to be. For example, the steps that may be reasonable to verify that an entity is an accredited investor by virtue of being a registered broker-dealer (such as by going to FINRA's BrokerCheck website) would necessarily differ from the steps that would be reasonable to verify whether a natural person is an accredited investor.

Information about the Purchaser. The amount and type of information that an issuer has about a purchaser would be a significant factor in determining what additional steps would be reasonable to verify the purchaser's accredited investor status. Where an issuer has actual knowledge that the purchaser is an accredited investor, the issuer would not have to take any steps at all. Such information could be obtained from a variety of sources, including:

- publicly available information in filings with a federal, state or local regulatory body;

- third-party information that provides reasonably reliable evidence that a person falls within one of the enumerated categories in the accredited investor definition; and

- verification of a person's status as an accredited investor by a third party, provided that the issuer has a reasonable basis to rely on such third-party verification.

In the SEC's view, third-party verification services may develop that will verify a person's accredited investor status for purposes of Rule 506(c). For example, this may be used by issuers relying on web-based Rule 506 offering portals that include offerings for multiple issuers. The third-party service could obtain the needed documents or take steps to verify accredited investor status.

Nature and Terms of the Offering. The nature and terms of the offering may be relevant in determining the reasonableness of the steps taken to verify accredited investor status.

When an issuer solicits new investors through a website accessible to the general public or through a widely disseminated email or social media solicitation, the issuer would have to take additional steps to verify a purchaser's status. Conversely, an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party, such as a registered broker-dealer, would not have to take such measures. An issuer may rely on such verification provided that the issuer has a reasonable basis to rely on such third-party verification.

Absent other information, an issuer would not have taken reasonable steps if it required only that a person check a box in a questionnaire or sign a form.

The terms of the offering may also impact the verification methods. An investor's ability to satisfy a sufficiently high minimum investment requirement with a direct cash investment (that is not financed) could be considered when verifying accredited investor status.

Record Keeping. Issuers must retain adequate records that document the steps taken to verify that a purchaser was an accredited investor. An issuer claiming an exemption has the burden of showing that it is entitled to that exemption.

Misrepresentations by a Purchaser. It is possible that a purchaser could circumvent measures put in place by an issuer to verify the purchaser's status. If a purchaser is not an accredited investor, the issuer would be able to rely on the Rule 506(c) exemption, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that the purchaser was an accredited investor.

Current Rule 506 Offerings

Existing Rule 506 (now Rule 506(b)) allows issuers to conduct Rule 506 offerings without the use of general solicitation or general advertising; this provision will not be changed. Issuers that do not wish to engage in general solicitation or general advertising in their Rule 506 offerings would not be obligated to take reasonable steps to verify the accredited investor status of purchasers. However, as required by Rule 506(b), an issuer would still have to reasonably believe at the time of sale that an investor is an

accredited investor. Issuers relying on Rule 506(b) will be able to sell to up to 35 nonaccredited investors who meet Rule 506(b)'s sophistication requirements.

Amendment to Form D

Form D is the notice of an offering of securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D. Under Rule 503 of Regulation D, an issuer offering or selling securities in reliance on Rule 504, 505 or 506 must file a notice of sales on Form D with the SEC for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering.

Form D had been revised to add a separate box for issuers to indicate whether they are claiming an exemption under Rule 506(c).

Bad Actor Disqualification Adopted

The SEC adopted rules to implement the ban on the participation by "bad actors" in Rule 506 offerings (as required by the Dodd-Frank Act), including offerings using general solicitation under new Rule 506(c). The rules take effect 60 days from the date of publication in the Federal Register.

Under the new rules, an issuer will not be able to rely on Rule 506 if covered persons — certain individuals (including directors and officers who participate in the offering, promoters and shareholders who own more than 20 percent of the issuer) or entities — have been subject to a disqualifying event. Disqualifying events include a conviction for securities fraud, certain criminal convictions and certain SEC disciplinary orders.

Events that occurred prior to the effectiveness of the new rules will not count, although they will have to be disclosed in the offering materials. If an issuer can demonstrate that 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, it may rely on Rule 506.

Specific Issues for Private Funds

Privately offered funds — such as hedge funds, venture capital funds and private equity funds — typically rely on the Rule 506 safe harbor when raising funds. Such funds generally rely on Section 3(c)(1) or 3(c)(7) under the Investment Company Act (ICA) when making Rule 506 offering.

Section 3(c)(1) excludes from the definition of "investment company" any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 beneficial owners. Section 3(c)(7) excludes from the definition of "investment company" any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers." In addition, under either exemption, the issuer must not be making and must not at the time of the sale propose to be making a public offering of its securities.

Under Rule 506(c), privately offered funds may use general solicitation or advertising when selling securities under Rule 506(c) without losing either of the exemptions available under the ICA.

Background of Rule 144A

Rule 144A is a nonexclusive safe harbor exemption from the Securities Act's registration requirements for resales of certain "restricted securities" to QIBs. For a transaction to come within existing Rule 144A, a seller must have a reasonable basis for believing that the offeree or purchaser is a QIB and must take reasonable steps to ensure that the purchaser is aware that the seller may rely on Rule 144A. Further, only securities that were not, when issued, of the same class as securities listed on a U.S. securities exchange or quoted on a U.S. automated interdealer quotation system are eligible for resale under Rule 144A. Also, the seller and a prospective purchaser designated by the seller must have the right to obtain from the issuer, upon request, certain information on the issuer, unless the issuer falls within specified categories as to which this condition does not apply.

Rule 144A does not include an express prohibition against general solicitation or general advertising. Because offers of securities under Rule 144A must be limited to QIBs, Rule 144A offerings do not use general solicitations or advertising.

Amendment to Rule 144A

The SEC revised Rule 144A(d)(1) to provide that securities sold pursuant to Rule 144A may be offered by means of general solicitation or advertising provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a QIB.

Unlike the requirements of Rule 506(c), an issuer relying under Rule 144A would not have to implement verification measures. However, the issuer must reasonably believe that the buyers are QIBs.

Integration With Offshore Offerings

Regulation S provides a safe harbor for offers and sales of securities outside the United States and includes an issuer and a resale safe harbor. Two general conditions apply to both safe harbors: (1) the securities must be sold in an offshore transaction, and (2) there can be no directed selling efforts in the United States. Regulation S offerings are often conducted in conjunction with offerings made in the United States. The U.S. portion of the offering is usually conducted in accordance with Rule 144A or Rule 506 and the offshore portion is conducted in reliance on Regulation S.

Concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings that are conducted in compliance with the amendments to Rule 506 or Rule 144A. As a consequence, issuers will be able to use general solicitation or advertising in the Rule 506 and Rule 144A offerings that are conducted with Regulation S offerings.

Proposed Rules

The SEC proposed rules to expand the requirements of Regulation D. In particular, under the proposal:

- Rule 503, as revised, would require the filing of Form D information no later than 15 calendar days in advance of the first use of general solicitation in a Rule 506(c) offering. Under Rule 503 of Regulation D, an issuer offering or selling securities in reliance on Rule 504, 505 or 506 must file a

notice of sales on Form D with the SEC for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering.

- Rule 503, as amended, would require the issuer to file an amendment to Form D within 30 calendar days after terminating any Rule 506 offering.

- Rule 507, as revised, would disqualify an issuer from using Rule 506 for one year for new offerings if the issuer or its affiliates did not comply, within the prior five years, with all the Form D filing requirements in a Rule 506 offering. The five-year period would not, however, extend to noncompliance that occurred prior to the effective date of the new rule. There will be a cure period for late filings.

- Issuers relying on Rule 506 would have to provide additional information on their Form D such as identifying the issuer's website, methods used to verify accredited investor status and information about the types of solicitation used.

- Proposed Rule 509 would require prescribed legends in any general solicitation in written form in a Rule 506(c) offering.

- Rule 510T, as proposed, would require issuers to submit any written general solicitation materials used in Rule 506(c) offerings to the SEC no later than the date of first use of these materials. These submissions would not be available to the public. Rule 510T would expire two years after its effective date.

- Private funds would also be required to include an additional legend and certain disclosures if, for example, it includes past performance information in its written general solicitation materials.

- All private funds would have to comply with Rule 156, as amended, when advertising a Rule 506(c) offering.

For more information on this issue, please contact Tim Sullivan, Michael D. Morehead or your regular Hinshaw attorney.
