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SEC Adopts Rule Amendments to Permit General Solicitation in Certain Private Offerings

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Overview

On July 10, 2013, the Securities and Exchange Commission ("SEC") adopted final rules to eliminate the prohibition against general solicitation and general advertising in certain securities offerings under Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933, as amended ("Securities Act"), as mandated by the Jumpstart Our Business Startups Act ("JOBS Act"). The final rules will take effect on the 60th day after publication in the Federal Register (the "Effective Date"). Accordingly, the Effective Date will likely be in September 2013.

In addition, the SEC: (1) proposed customer protection rules that are intended to enhance the SEC's ability to assess market developments in the private placement market; and (2) adopted rule amendments that disqualify securities offerings involving certain felons and other bad actors from reliance on Rule 506.

I. Offerings Involving Use of General Solicitation -- New Rule 506(c)

In its final form, new Rule 506(c) has been expanded to list non-exclusive methods for verifying that investors who are natural persons are accredited. Otherwise, the final Rule 506(c) is the same as proposed on August 29, 2012.[1]

Under Rule 506(c), an issuer may use general solicitation and general advertising in a securities offering that satisfies the requirements of Rule 501 and Rules 502(a) and 502(d) of Regulation D if the purchasers are "accredited investors" as defined in Rule 501 of Regulation D, and if the issuer takes reasonable steps to verify that the purchasers are accredited investors.

An issuer generally is required to consider all relevant facts and circumstances to assess whether the verification steps taken are reasonable for purposes of relying on Rule 506(c). Rule 506(c) mandates an objective, principles-based verification process in lieu of rigid rules. Under this standard, issuers will be required to consider the particular conditions surrounding the offering to determine whether the process used to verify each purchaser's accredited investor status is sufficient, including:

- 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;
- the manner in which the purchaser was solicited to participate in the offering; and

[1] *See* SEC Release No. 33-9354. To view our prior alert that contains a discussion of the proposed amendments, please click here.

- the terms of the offering, particularly a minimum investment amount.

The adopted guidance sets forth flexible and sliding scale approaches toward assessing these factors. For a description of the similar related guidance provided by the SEC in the proposing release, see our prior alert.

The final rule provides additional guidance to issuers that wish to comply with Rule 506(c) by including a non-exclusive list of methods that may be used to verify that purchasers who are natural persons are accredited investors. An issuer shall be deemed to have taken reasonable steps to verify accredited investor status if the issuer uses, at its option, one of the following methods of verifying (provided that the issuer does not know that the person is not accredited):

- reviewing copies of Internal Revenue Service forms reporting a purchaser's income for the two most recent years, and obtaining the purchaser's written representation that the purchaser has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;
- reviewing one or more of the following types of documentation, dated within the prior three months, and obtaining the purchaser's written representation that all liabilities necessary to make a determination of net worth have been disclosed:
    - for 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
    - for liabilities: a credit report from at least one of the nationwide consumer reporting agencies;
- obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor; or
- for any natural person who purchased an issuer's securities as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the issuer at the time of the Rule 506(c) offering conducted by the same issuer, obtaining the purchaser's written certification that the purchaser is an accredited investor.

The Rule 506(c) verification requirement does not supplant the "reasonable belief" standard that is part of the Rule 501 definition of accredited investor in Regulation D. The final rule confirms the SEC's view, articulated in the proposed rule release, that, if the purchaser actually meets the Rule 501 enumerated requirements for an accredited investor but the issuer has not taken reasonable steps to verify accredited status, the Rule 506(c) safe harbor would not be available (unless the issuer has actual knowledge that the purchaser meets one or more of the Rule 501 enumerated categories). Thus, the verification requirement is separate and distinct from the requirement that all purchasers be accredited investors.

Offerings Not Involving Use of General Solicitation – Renumbered Rule 506(b)

The final rule preserves the existing ability of issuers to conduct Rule 506 offerings without the use of general solicitation and without verifying purchasers' accredited status, under renumbered Rule 506(b). Thus, if there is no general solicitation, an issuer must only have a reasonable belief that a purchaser is an accredited investor.

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Considerations to Take into Account Before Relying on Rule 506(c)

Each issuer relying on Rule 506 will be required to disclose in Form D whether it is relying on Rule 506(b) or Rule 506(c) with respect to each securities offering that it conducts. A sponsor of multiple private funds should not conduct offerings concurrently under Rule 506(b) and Rule 506(c) without first considering whether any general solicitation conducted under the Rule 506(c) offerings would compromise the safe harbor for the Rule 506(b) offerings. An issuer will not be permitted to check both the Rule 506(b) box and the Rule 506(c) box in Form D at the same time for the same offering.

Investment pools that trade commodity interests may be unable to engage in general solicitations despite the adoption of Rule 506(c) if their general partners, managers or advisers rely on the *de minimis* exemption from commodity pool operator ("CPO") registration. The *de minimis* exemption in Commodity Futures Trading Commission ("CFTC") Regulation 4.13(a)(3) requires interests in the commodity pool to be offered and sold without marketing to the public in the United States. Similarly, investment pools whose general partners, managers or advisers are registered as CPOs and rely on the exemptive relief set forth in CFTC Regulation 4.7(b) (for offerings limited to sophisticated investors) may be unable to engage in general solicitations due to a similar prohibition against marketing to the public. We understand that CFTC staff intends to consider whether to modify these exemptions in response to the adoption of Rule 506(c).

Rule 506(c) may not be retroactively available to issuers who inadvertently used general solicitation in an offering, since the Rule requires issuers to verify the accredited investor status of an investor before a sale is made.

An issuer that is conducting a Rule 506 offering at the time Rule 506(c) becomes effective may elect to continue that offering in accordance with Rule 506(b) or Rule 506(c).

Amendments to Rule 144A

As mandated by Section 201(b) of the JOBS Act, the final rule also amends Rule 144A(d)(1) under the Securities Act to provide that securities can be offered pursuant to Rule 144A to persons other than Qualified Institutional Buyers ("QIBs"), including by means of general solicitation, so long as the securities are purchased only by persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs (as defined in Rule 144A). This rule amendment effectively permits general solicitations in Rule 144A offerings.

II. Proposed Customer Protection Rules

Due in part to concerns about the greater potential for fraud in connection with general solicitations, the SEC proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act. These proposed amendments would:

- require issuers to file an initial Form D no later than 15 calendar days *in advance* of the first use of general solicitation in a Rule 506(c) offering[2] (and to amend such initial Form D within 15 calendar days after the date of first sale of securities to complete any remaining information);[3]

[2] It is unclear how inadvertent general solicitations would be handled, although the SEC requested comments on this topic.

[3] An initial Form D would not be required if a Form D has been filed containing all information required with respect to a Rule 506(c) offering (*i.e.*, in connection with an ongoing offering). In addition, an amendment to the initial Form D would not be required to the extent that all information required by Form D was provided in the initial filing. Notably, the SEC has proposed permitting issuers to file an initial Form D without contemplating a specific offering, although the details of this process remain unclear.

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- require all issuers relying upon Rule 506 (whether or not engaged in a general solicitation) to file a closing Form D amendment within 30 calendar days after the termination of an offering;
- amend Form D to require disclosure of additional information, including but not limited to, the issuer's website (if any), types of general solicitation used and the methods used to verify accredited investor status;
- disqualify an issuer from relying upon Rule 506 for future offerings for one year if the issuer, or any predecessor or affiliate of the issuer, did not comply with all Form D filing requirements in a Rule 506 offering within the last five years;[4]
- require issuers to include prescribed legends in any written general solicitation materials in connection with any Rule 506(c) offering;
- require that private fund issuers (*i.e.*, issuers that rely upon the exceptions in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, as amended) include additional legends in written general solicitation materials, as well as disclosures concerning performance data (if used in such materials);[5]
- disqualify an issuer from relying upon Rule 506 for future offerings if the issuer, or any predecessor or affiliate of the issuer, has been subject to any order, judgment or court decree enjoining such person for failure to include such legends and disclosures (as described in the preceding two bullet points) or for failure to submit written general solicitation materials (as described in the following bullet point);
- for two years following the effective date of the proposed rules, require issuers to submit any written general solicitation materials to the SEC no later than the date of first use of such materials;[6] and
- amend Rule 156 to apply to private funds (whether or not engaged in general solicitations), thereby providing guidance on the types of information in sales literature that could be misleading under the antifraud provisions of the federal securities laws.

The SEC has described these proposed amendments as providing "better tools to evaluate this changing market," which would assist federal and state enforcement efforts. In fact, the SEC describes how these proposed amendments would support its plan to review and analyze the use of Rule 506(c) through the coordinated efforts of staff from the Division of Corporation Finance, the

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[4] This disqualification would be in addition to the existing disqualification from reliance upon Rules 504, 505 and 506 that arises from a court injunction for failure to comply with Rule 503. The SEC emphasized that it determined not to propose making the filing of Form D a condition of Rule 506 due to the fact that the loss of a Securities Act exemption would result in severe sanctions (*e.g.*, rescission rights and the loss of "blue sky" pre-emption) that would be disproportionate to the harm of failing to file the Form D. Instead, issuers that failed to comply with the Form D filing requirements (or whose predecessors or affiliates failed to comply with the Form D filing requirements) within the last five years would be prevented from relying upon Rule 506 for future offerings for a period of one year. This five-year look-back period would not extend past the proposed rule's effective date. In addition, the proposed amendments would include a cure period of 30 calendar days to allow issuers to correct oversights, but this proposed cure period would be available only for an issuer's first failure to file timely a Form D or Form D amendment. The proposed rules would also permit the SEC (or its anticipated delegatee, the Director of the Division of Corporation Finance) to waive any disqualification upon a showing of good cause.

[5] Because such offering materials are subject to the antifraud provisions of the federal securities laws, many advisers already include disclosures similar to those proposed by the SEC.

[6] The SEC does not propose that such materials would be treated as "filed" or "furnished" for purposes of the Securities Act or the Securities Exchange Act of 1934, as amended, including the liability provisions thereunder. In addition, the SEC indicated that it does not contemplate conducting a staff review of such written general solicitation materials.

Division of Economic and Risk Analysis, the Division of Investment Management, the Division of Trading and Markets, the Office of Compliance Inspections and Examinations, and the Division of Enforcement. Taken as a whole, if adopted, these changes would make Form D more integral to the private offering process and could mark the start of evolving "regulatory creep" that uses Form D to regulate the private offering process, much as Form ADV has evolved from a "census-like" document into a regulatory and disclosure document.

III. Bad Actor Provisions

The SEC also adopted rule amendments, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, that disqualify securities offerings involving certain felons and "bad actors" from relying on Rule 506. The disqualification provisions cover the following persons, among others— (1) the issuer; any general partner or managing member of the issuer; (2) any beneficial owner of 20% or more of the issuer's outstanding voting equity securities; (3) any investment manager to an issuer that is a pooled investment fund; and (4) any compensated solicitor (collectively, "Covered Persons"). The disqualifying events include, among others—(1) certain criminal convictions; (2) certain injunctions and restraining orders; and (3) certain SEC disciplinary orders.

These Rule amendments will take effect on the Effective Date. Significantly, they will apply only to triggering events occurring after the Effective Date, with pre-existing events being subject to mandatory disclosure.

Considerations for Issuers that are Conducting or are Planning to Conduct Rule 506 Offerings

The Rule amendments require that an issuer furnish to each purchaser, a reasonable time prior to sale, a description in writing of any matters that would have triggered disqualification but that occurred before the Effective Date. Accordingly, an issuer must be prepared to provide such a description to investors a reasonable time prior to any sale that takes place on or after the Effective Date. To that end, issuers should identify all Covered Persons and determine whether they are subject to any disqualifying event under the Rule. An issuer may want to consider sending a questionnaire to each beneficial owner of 20% or more of the issuer's outstanding voting equity securities to obtain the information needed to comply with Rule 506.

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