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SEC Lifts Ban on General Solicitation in Private Placements, While Adopting and Proposing Other Limitations and Requirements

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Earlier this month, the SEC adopted amendments mandated by the JOBS Act that will permit general solicitation and advertising[1] in certain private securities offerings under Rule 506 of Regulation D, as well as in private offerings under Rule 144A. These amendments potentially will benefit both operating companies and private investment funds. The SEC balanced this liberalization of its private offering rules by: (1) adopting new "bad actor" provisions mandated by the Dodd-Frank Act that would disqualify an issuer from conducting offerings under Rule 506 if certain of its affiliates, officers, directors or other persons and entities associated with the issuer or the offering have been the subject of specified regulatory or judicial actions; and (2) proposing for public comment additional investor "safeguards" that would principally impose additional requirements related to Form D filings for private offerings under Rule 506.

The SEC's amended rules related to general solicitation and "bad actors" will become effective on September 23, 2013, and will:

- Remove the prohibition against general solicitation for sales to accredited investors under newly designated Rule 506(c) of Regulation D, and for sales to QIBs under Rule 144A;
- Require issuers to take "reasonable steps to verify" the accredited investor status of purchasers in offerings under Rule 506(c) (i.e., offerings using general solicitation);
- Preserve an issuer's ability to rely on pre-amendment Rule 506, which prohibits general solicitation, in order to avoid the new investor verification and other new requirements. Upon the effective date of the amended rules, pre-amendment Rule 506 will be designated Rule 506(b);

Add new boxes on Form D for an issuer to indicate whether the issuer is relying on Rule 506(c) or Rule 506(b);

- Confirm that general solicitation continues to be prohibited in other private offerings under Section 4(a)(2) of the Securities Act, including private offerings pursuant to other rules under Regulation D;
- Confirm the ability of private investment funds to engage in general solicitation under new Rule 506(c) without undermining their exemptions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940;
- Confirm that the use of general solicitation in Rule 506(c) or Rule 144A offerings will not prevent issuers from undertaking simultaneous offerings outside the United States under Regulation S; and
- Disqualify an issuer from relying on Rule 506 if the issuer; any of its predecessor or affiliated issuers; any of the issuer's directors, executive officers, other officers participating in the offering, investment managers, general partners or managing members; any beneficial owner of 20% or more of the issuer's voting equity securities; or any other specified associated person (including any placement agent for the offering and its controlling persons) has been convicted of certain crimes or subject to other specified regulatory or judicial rulings and orders. The disqualification rule applies prospectively, so that only disqualifying events that occur following the effective date of the new rules result in a prohibition on using Rule 506. However, disclosure of otherwise disqualifying events that occurred prior to the effective date must be made to investors "a reasonable time prior to sale" under Rule 506 after the effective date.

General Solicitation under Rule 506(c)

The SEC has amended Rule 506 to eliminate the Rule's prohibition on general solicitation in offerings where securities are sold only to accredited investors. While general solicitation in offerings under new Rule 506(c) will be permitted, an issuer must take "reasonable steps to verify" that the purchasers are accredited. Unlike Rule 506(b), which permits sales to a limited number of non-accredited investors, sales to non-accredited investors will not be permitted in offerings under Rule 506(c). An issuer will need to indicate on its Form D filing for a Rule 506 offering whether the offering will be conducted under Rule 506(b) or Rule 506(c).

The SEC provides issuers with flexibility in devising the steps it employs to verify accredited investor status depending on the particular facts and circumstances. In determining what steps are appropriate, the SEC confirmed in the adopting release that the issuer should consider the nature and type of purchaser, the amount and nature of pre-offering information that the issuer has about the purchaser, the nature of the offering (such as the manner in which the purchaser was solicited), and the terms of the offering (such as any minimum investment amount).

Although the "reasonable steps to verify" requirement generally is principles-based, the SEC has sought to provide some limited objective guidance in applying it in certain contexts. For individuals, the final rules include a non-exclusive list of methods that are deemed to satisfy the verification requirement. First, for an individual who seeks to qualify as an accredited investor based on income, the list includes, among other methods, obtaining tax filings or Forms W-2 for the past two years, together with a written representation that the individual has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year. Second, in order to verify an individual's accredited investor status based on net worth, an issuer could review a specified document detailing that individual's assets (e.g., a bank statement) and a consumer credit report, each dated within the prior three months, and obtain a certification that the individual has disclosed all liabilities. A third approved verification method for an individual is to obtain a written confirmation from a registered broker-dealer, SEC-registered investment adviser, a licensed attorney or a CPA that such person or entity has taken reasonable steps to verify the individual's status as an accredited investor within the prior three months. Finally, an issuer may rely on an individual investor's own written certification if the investor is an existing investor who participated in an offering by that issuer under Rule 506 prior to the effective date of the amended rules, and continues to hold those securities. This last method will not apply where an individual is investing in a private investment fund that is a successor to the fund in which that individual previously invested since the successor fund is a separate issuer.

Offerings Following the Pre-Amendment Rules: Rule 506(b)

An issuer may continue to rely on the current version of Rule 506, which will now be designated Rule 506(b). Under Rule 506(b), general solicitation will continue to be prohibited, but sales may be made to up to 35 non-accredited investors, and the new "reasonable steps to verify" requirement will not apply. Note, however, that the new "bad actor" provisions described below will apply to offerings under Rule 506(b). We expect that many issuers will continue to rely on the "old" approach under Rule 506(b) if they see no need to reach beyond traditional means for identifying potential investors (the use of general solicitation is more likely to be useful in retail offerings than in institutional offerings). In addition, general solicitation may subject the issuer to potential liability based on hindsight evaluation of its compliance with the new "reasonable steps to verify" requirement or the application of the anti-fraud rules to any public statements. The SEC has stated that it intends to increase its cooperation with state regulators in connection with general solicitation activities.

Transitional Offerings

An issuer that, prior to the effective date of the amended rules, has commenced an offering under Rule 506 as currently in effect may continue that offering after the effective date in reliance on Rule 506(b) or 506(c). General solicitation that occurs after the effective date will not affect the exemption for offers and sales that occurred prior to the effective date in reliance on Rule 506 as currently in effect.

Relying on New Rule 506(c) in Cases of Unintended Public Statements

Unintended public statements in the course of a private placement have occurred from time to time, and they call into question the availability of the traditional private offering exemption because they might be deemed to constitute general solicitation. Upon adoption of the JOBS Act, commentators suggested that elimination of the general solicitation prohibition could mean that an unintended public statement in a traditional private placement would no longer be a concern so long as no sales were made to non-accredited investors. Language in the SEC's adopting release calls into question whether that is the case.

The SEC's adopting release states that an issuer will not be permitted to check both Rule 506(b) and Rule 506(c) as applicable exemptions on its Form D filing. An issuer that does not intend to engage in general solicitation but nevertheless conducts an offering that complies with the Rule 506(c) requirements related to accredited investors and "reasonable steps to verify" will have gained insurance against accidental public statements. However, it is unclear whether an issuer that has not complied with Rule 506(c) from the commencement of the offering can switch from a traditional offering under Rule 506(b) to an offering under Rule 506(c) midstream, especially if sales have already occurred. Such a "switch" presumably would involve an amendment to the issuer's original Form D filing indicating that it is now relying on Rule 506(c) rather than 506(b). The issuer also would need to have already complied with the other requirements under Rule 506(c), or seek to comply with them retroactively. The adopting release did not state that the steps to verify accredited investor status could be taken after the fact. Further, as noted below under *The Proposed Regulatory "Safeguards" for 506 Offerings*, the SEC has proposed a requirement that a Form D be filed at least 15 days in advance of any general solicitation in an offering under Rule 506(c), and another requirement that any "written" general solicitation materials be submitted to the SEC no later than the date of first use. These requirements, if adopted, would make it difficult to switch from Rule 506(b) to 506(c) in the case of an unintended public statement.

General Solicitation under Rule 144A

The amendments to Rule 144A provide that securities sold under the rule now may be offered publicly, including necessarily to persons who are not QIBs, provided that securities are only sold to those that the seller and those acting on its behalf reasonably believe are QIBs.

Private Investment Funds and Section 3(c)(1) and 3(c)(7) Exemptions

Private investment funds that rely on Rule 506 to raise capital will have the same choice as other issuers to use Rule 506(b) without general solicitation, or to use new Rule 506(c) and satisfy the "reasonable steps to verify" and other requirements.

For funds that decide to engage in general solicitation under Rule 506(c), the SEC has confirmed that such activities will not undermine their otherwise available exemptions under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. Section 3(c)(1) excludes from the definition of "investment company" a fund beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) excludes from the definition of "investment company" a fund the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" and which is not making and does not at that time propose to make a public offering of such securities. Since the JOBS Act's mandate to permit general solicitation did not mention private investment funds, there had been speculation that general solicitation in offerings under Rule 506 might run afoul of the prohibition on "public offerings" for purposes of these two primary exemptions on which private investment funds rely.

It should be noted that a private investment fund seeking to comply with the "de minimis exemption" in CFTC Rule 4.13(a)(3) (so that the fund's manager can avoid registration with the CFTC) must not be "marketed to the public in the United States." Accordingly, absent further guidance from the CFTC, it is unclear whether CFTC Rule 4.13(a)(3) will be available to a manager with respect to a fund that is marketed using general solicitation. This may cause many private investment funds that trade commodity interests regulated by the CFTC to rely on Rule 506(b) rather than Rule 506(c).

"Directed Selling Efforts" under Regulation S

The SEC responded to concern from commentators that general solicitation under the amended rules would constitute "directed selling efforts" in violation of Regulation S, which governs offshore offerings and prohibits directed selling efforts in the United States. Many issuers engage in private offerings under Regulation D or Rule 144A simultaneously with offshore offerings under Regulation S. The SEC confirmed that general solicitation will not amount to "directed selling efforts" if conducted in conformity with amended Rules 506(c) and/or 144A. However, given the global nature of many types of communications, an issuer should consider whether its Rule 506(c) general solicitation activities will jeopardize the availability of private placement exemptions in non-U.S. jurisdictions that do not permit general solicitation in connection with offerings to investors in those jurisdictions.

The New "Bad Actor" Disqualification Standards for Rule 506 Offerings

Satisfying a requirement under Section 926 of the Dodd-Frank Act, the SEC also has amended Rule 506 to preclude felons and other "bad actors" from participating in any offering under Rule 506, whether or not general solicitation is used. Rule 506 previously did not include any such disqualification standards.

The scope of persons whose "bad acts" may have a disqualifying effect is relatively broad. The Rule covers the issuer, as well as any predecessor or affiliated issuer. Subject to any further clarification from the SEC, the Rule accordingly appears to cover, with respect to a private investment fund, other affiliated funds and portfolio companies that are considered "affiliates" of the fund. However, "bad acts" that occurred before the affiliate relationship existed may not count, depending on the nature of the affiliate relationship. Covered persons with respect to an issuer also include: (1) executive officers, directors, other officers participating in the offering, general partners and managing members; (2) any beneficial owner of 20% or more of the issuer's voting equity securities, calculated on the basis of voting power; (3) in the case of a private investment fund, any investment manager for the fund (typically its management company), and any direct or indirect director, executive officer, officer participating in the offering, general partner or managing member of the investment manager; (4) any promoter connected with the issuer; and (5) any person who will be paid for soliciting purchasers (such as a finder or placement agent) and any direct or indirect director, executive officer, other officer participating in the offering, general partner or managing member of such paid solicitor.

Amended Rule 506 includes a lengthy list of disqualifying events, some of which are limited by look-back periods. Most of the events involve criminal, civil or regulatory rulings and orders related to securities laws or participation in the securities industry, but some also involve rulings of state securities, banking and insurance regulators.

Significantly, disqualification will not apply in the case of otherwise disqualifying events that occurred prior to the effective date, although in such cases the issuer will be required to disclose the prior bad acts to prospective investors within a "reasonable time prior to sale" under Rule 506 after the effective date. A failure to provide the required disclosure of pre-effective date "bad acts" on a timely basis will undermine the issuer's claim to an exemption under Rule 506, and therefore could result in a violation of Section 5 of the Securities Act. An issuer will not lose the benefit of the Rule 506 exemption for acts of which it was not aware, provided that it can demonstrate that it had conducted a "factual inquiry" that was reasonable under the circumstances.

Under amended Rule 506, the SEC, or in some cases the regulator that issued the order or ruling that otherwise would have triggered disqualification, may determine that disqualification from using Rule 506 will not apply as a result of the event. We expect that the SEC will receive numerous waiver requests following the effective date of the new rules.

The Proposed Regulatory "Safeguards" for 506 Offerings

In addition to the rules described above that amend the substance and operation of the private placement exemption under Rule 506, the SEC has proposed new rules that, if adopted, would impact the content of Form D and the timing of its filing. Among other things, the proposed rules would:

- Amend Rule 503 to require the filing of Form D at least 15 days in advance of any general solicitation in reliance on Rule 506(c), which filing would include certain required information, with a subsequent amendment to include the remaining information required by Form D to the extent that it was omitted from the first filing. This requirement would effectively preclude an issuer that is undertaking a traditional offering without general solicitation under Rule 506(b) from complying with the new Form D filing requirement in the case of an inadvertent public statement, although the SEC requested comment on this point;
- Amend Rule 503 to require the filing of a closing amendment to Form D within 30 days after the end of the offering, which would disclose, among other things, the total amount of securities ultimately sold in the offering. In certain circumstances, issuers can effectively avoid making such disclosure under the current rules;

For the first two years following the effective date of the new rules, require the submission to the SEC of any written general solicitation materials no later than the day on which such materials are first used. The materials will not be made publicly available. This would be another requirement that an issuer engaging in an inadvertent general solicitation (involving the use of written materials, including presumably emails and other graphic or recorded communications) would not be able to comply with on a timely basis;

- Require that written general solicitation materials include certain legends and other specified disclosures in the new rules;
- Amend Form D to require additional information for Rule 506 offerings (including, for offerings using general solicitation, the types of general solicitation to be used and the steps the issuer proposes to take to verify accredited investor status);
- Amend Rule 156, which describes in a general way circumstances in which sales literature could be considered misleading (and therefore violate anti-fraud rules) in connection with offerings by investment companies, to extend the Rule to sales literature of private investment funds. This proposal, if adopted, is not likely to result in significant changes to existing marketing practices for private investment funds, given that anti-fraud rules already apply to their sales literature; and

Preclude an issuer from relying on Rule 506 for future private placements for a one-year period if it, or any of its predecessor or affiliated issuers, failed to file a Form D in compliance with Rule 503 at any time in the previous five years (although the five-year look back would not go beyond the effective date of the new rule, if adopted). For a private investment fund, the one-year penalty potentially could be triggered by Form D violations in connection with offerings by portfolio companies that are "affiliates" of the private fund, and vice versa. The SEC specifically requested comment on the inclusion of portfolio companies as affiliated issuers of private funds. The rule would include a 30-day grace period (which could be used only once per offering) so that a Form D filing that is only modestly untimely would not trigger the one-year penalty. The one-year penalty would run from the time that all required Form D filings were made. While a violation of the filing requirements of Rule 503 would result in the one-year penalty for future offerings, it would not result in loss of the Rule 506 exemption for the offering in which the violation occurred. The SEC would have the authority to grant waivers from the one-year penalty.

The SEC also requested comment on the definition of "accredited investor," the standards for which are likely to become more stringent in the future, particularly for individuals.

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A copy of the SEC's final rule amendments on general solicitation and Rule 506 is available at the following link: http://www.sec.gov/rules/final/2013/33-9415.pdf, and a copy of the final amendments adding new "bad actor" requirements is available at the following link: http://www.sec.gov/rules/final/2013/33-9414.pdf. The SEC is seeking comment on the proposed amendments described under *Proposed Regulatory "Safeguards" for Rule 506 Offerings*, above, which are due no later than September 23, 2013, and the SEC's proposing release is available at the following link: http://www.sec.gov/rules/proposed/2013/33-9416.pdf. We will continue to monitor this proposal and provide updates as appropriate. Please feel free to contact us with questions or comments.

[1] General solicitation and advertising are referred to in this alert together as general solicitation.

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