PUBLICATION

The Private Placements They Are A-Changin - General Solicitation, Bad Actor Prohibitions and Proposed Additional Changes to Rule 506 Private Offerings [Ober|Kaler]

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A periodic bulletin keeping small businesses informed about current developments in securities law and related matters.

By way of background, pursuant to Section 5 of the Securities Act of 1933 (Securities Act) and state securities laws, any offer and sale of a security must be registered with the Securities and Exchange Commission (SEC) and any applicable state securities regulators, or exempt from such registration. The most commonly used exemption, which also exempts the offering from registration under state securities laws, is for private offerings conducted in compliance with Rule 506 of Regulation D promulgated pursuant to Section 4(a)(2) the Securities Act, which exempts from registration "transactions by an issuer not involving any public offering." Pursuant to Rule 506, a company can sell an unlimited amount of securities to accredited investors (as defined in Rule 501(a)) and up to 35 non-accredited investors who meet the sophistication requirements set forth therein if the offering otherwise complies with the requirements of Regulation D. One of the hallmarks of private offerings under Section 4(a)(2) and Regulation D has always been, but for limited exceptions for small private offerings conducted under Rule 504, that such offerings could not involve any form of general solicitation or general advertising. Rule 502 of Regulation D provides that general solicitation and general advertising includes, but is not limited to, (i) radio, newspaper, television or similar media advertisements, articles, notices and other communications, and (ii) "any seminar or meeting whose attendees have been invited by any general solicitation or general advertising." General solicitation and advertising can also include mass mailings and emails, statements on a public Web site, and contacting large numbers of people with whom none of the issuer, its executive officers or directors or anyone acting on their behalf in the offering has a prior, substantive relationship. Much time and energy has been spent in debating whether certain actions in connection with a private offering constitute "general solicitation or general advertising."

Last month, in accordance with its mandate under the Jumpstart Our Business Startups (JOBS) Act, the SEC adopted amendments to Regulation D that lifts the ban on general solicitation and general advertising for certain Rule 506 offerings. The SEC also adopted rules pursuant to The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) that prohibit certain felons and other "bad actors" from conducting or participating in private offerings conducted under Rule 506. These new provisions will be effective on September 23, 2013. Finally, the SEC has proposed additional revisions to Regulation D that will impact Rule 506 offerings if adopted. We discuss each of these developments below.

General Solicitation Permitted in Certain Private Placements Under New Rule 506(c)

The new amendments to Regulation D will now permit general advertising and general solicitation in offerings conducted under Rule 506 in which (i) sales are made only to accredited investors (which includes investors the issuer reasonably believes meet the accredited investor standards) and (ii) the issuer takes "reasonable

steps to verify" that all investors in the offering are, in fact, accredited, assuming the other conditions of the exemption are complied with. This new exemption is set forth in new paragraph (c) of Rule 506.

Perhaps the most uncertain part of the new exemption is what actions will constitute "reasonable steps" to verify accredited investor status. In response to pleas from commenters, the new rule sets forth four non-exclusive methods to verify accredited investor status for natural persons that will be deemed to satisfy the verification requirement, including (i) review of IRS forms (i.e. W-2 statements, tax returns) that report the investor's income for the past two years in conjunction with investor certification that he or she expects to reach the requisite income level in the current year, (ii) review of documentation (dated within the last three months) setting forth the investor's assets, such as bank statements, brokerage statements, CDs and similar documentation, and liabilities – in particular the investor's credit report, and obtaining a representation from the investor that "all liabilities necessary to make a determination of net worth have been disclosed," (iii) written confirmation from a registered broker-dealer or investment adviser, or licensed attorney or registered CPA in good standing, that such person has taken reasonable steps to verify that the investor is accredited within the last three months and determined that the investor is accredited, and (iv) with respect to accredited investors who purchased securities in a Rule 506 offering by the same issuer before September 23, 2013 and continues to hold such securities, certification from the investor at the time of sale that he or she continues to qualify as an accredited investor. The SEC emphasized in the both the adopting release and in the new Rule that these verification methods are *non-exclusive* and *not mandatory*, meaning that other methods to verify accredited investor status may also satisfy the requirement, although no matter what steps are taken the issuer will not have satisfied the standard if it has knowledge that the investor is not accredited. Of course, other methods will have to be developed by issuers and the industry, if for no other reason than the fact that the SEC did not set forth any methods to verify the accredited investor status of entities. With respect to such other methods of verification, the SEC stated in the adopting release that whether such methods comply with the rule is a "facts and circumstances" determination, and set forth factors that issuers should consider when analyzing whether the actions taken to verify accredited investor status are "reasonable." Such considerations include (i) the nature of the purchaser and the type of accredited investor the purchaser claims to be, (ii) the amount and type of information that the issuer has about the purchaser, and (iii) 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. The adopting release also sets forth other types of information issuers could review that might, depending on the circumstances, constitute reasonable steps to verify accredited investor status.

We expect there to be robust discussion regarding acceptable verification methods and will monitor developments in this regard. Further, the proposed amendments to Form D, discussed below, will, if adopted, require issuers taking advantage of the new Rule 506(c) exemption to disclose the methods they used, or intend to use, to verify that purchasers in the offering are accredited investors. Therefore, the methods that issuers using the new exemption are using to verify accredited investor status will be publicly available if the amendments to Form D are adopted, further developing accepted practice in this area and, we anticipate, giving the SEC or the Staff of the Division of Corporation Finance the opportunity to use their review of this disclosure to offer guidance on whether the verification methods being reported are acceptable. The SEC did state, however, that having a purchaser check a box in a questionnaire or sign a form confirming accredited investor status would not, alone, constitute reasonable steps to verify the purchaser's status as an accredited investor. However, given the SEC's statements in the release that issuers can continue to conduct offerings under current Rule 506, we have no reason to believe that such "self certification," common in private offerings conducted under Rule 506 today, would not satisfy the "reasonably believes" requirement for private offerings conducted under Rule 506 without the use of general solicitation or general advertising.

After effectiveness of new Rule 506(c), issuers may continue to use the current rule 506 exemption, set forth in paragraph (b) of the Rule. The SEC was clear in the adopting release that the existing Rule 506 offering

exemption (Rule 506(b)) may continue to be used by companies that may want to raise capital without utilizing general solicitation or general advertising, may want the option of selling to non-accredited but "sophisticated" investors, or who may not want to take the additional steps to verify accredited investor status. In other words, after effectiveness of the amendments companies may continue to use Rule 506 to conduct private offerings in the same manner that they are conducted today (i.e. without general solicitation or general advertising), and without compliance with the new verification requirements for Rule 506(c) offerings.

Rule 503 of Regulation D requires that issuers file a Form D with respect to any offering conducted thereunder within 15 days of first sale. The SEC has amended Form D to provide that issuers conducting a Rule 506(c) offering "indicate that they are relying on the Rule 506(c) exemption by marking the new check box in Item 6 of Form D." The adopting release provides that "an issuer will not be permitted to check both boxes at the same time for the same offering," meaning that an issuer must decide prior to commencing its offering whether it intends to rely on Rule 506(b) or (c). Presumably, however, an issuer could change the type of offering and amend its Form D accordingly, assuming the requirements of the exemption could still be complied with (i.e. no general solicitation or general advertising has been conducted if switching from 506(c) to 506(b), or no sales to purchasers whom the issuer has not taken reasonable steps to verify are accredited investors if switching from 506(b) to 506(c)). The SEC has also proposed additional amendments to Form D, as discussed below.

The SEC also adopted similar amendments to Rule 144A, which provides an exemption from Securities Act registration for stockholders that resell their securities to "qualified institutional buyers." Pursuant to the amendment, securities in Rule 144A offerings may be offered to persons other than QIBs as long as the seller and any person acting on their behalf reasonably believe the purchasers are QIBs.

Keep in mind that while general solicitation and advertising is permitted under the new Rule 506(c) exemption, any such statements and materials will be subject to the anti-fraud provisions of federal and state securities laws.

The adopting release with respect to these amendments is available here.

Disqualification of Felons, Other "Bad Actors"

As noted above, the SEC has adopted a new paragraph (d) to Rule 506 that disqualifies issuers and other market participants from relying on Rule 506 if "felons and other 'bad actors'" participate in the offering. The disqualification applies to all Rule 506 offerings, regardless of whether general solicitation is used or sales are restricted solely to accredited investors. In general, under new Rule 506(d) an issuer will not be able to rely on a Rule 506 registration exemption safe harbor for sales of its securities in a private offering if: (i) the issuer; (ii) any predecessor of the issuer or affiliated issuer; (iii) any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer; (iv) any beneficial owner of 20% or more of the issuer's outstanding voting equity securities calculated on the basis of voting power; (v) any promoter (as defined in Rule 405 under the Securities Act) connected with the issuer at the time of sale; (vi) any investment manager (which includes both investment advisers and any other investment manager) of an issuer that is a pooled investment fund; (vii) any person paid in connection with solicitation of investors in the offering; (viii) any general partner or managing member of any such investment manager or solicitor; and (ix) any director, executive officer or other officer participating in the offering of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor, is the subject of any of the "triggering events" set forth in the rule. Such triggering events include certain convictions and orders, judgments and decrees of courts or federal or state regulatory agencies, including the SEC and the Commodities Futures Trading Commission (CFTC), principally relating to (i) securities sales or actions within the securities business (i.e. as an underwriter or broker), (ii) false SEC filings and bars from engaging in certain

businesses or in stock offerings, (iii) suspension or expulsion from membership in self regulatory or other organizations or associations or suspension or revocation of registration as a broker, dealer, municipal securities dealer or investment adviser, (iv) fraudulent, manipulative or deceptive conduct, and (v) violation of certain securities or other laws, as well as being subject to SEC stop orders or U.S. Postal Service false representation orders. For criminal convictions and certain orders, the look-back period for such events is either five or ten years, but other orders will result in a disqualification if the applicable person or entity remains subject to the order at the time of sale. In either case, however, the disqualification will not apply if the triggering event took place on or before September 23, 2013, the effective date of the new rule. Issuers will have to disclose to investors a "reasonable time prior to sale" any such event that would have triggered the disqualification but for the fact that the event took place before September 23, 2013. In addition, the disqualification will not apply if the authority issuing the relevant judgment, order or other triggering directive advises the SEC, either in such order, judgment, etc. or by direct communication to the SEC, that disqualification of reliance on Rule 506 should not be a consequence of the order, judgment or other action. The disqualification also will not apply if waived by the SEC (by delegation to the Director of the Division of Corporation Finance) "upon a showing of good cause" or "[i]f the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed." Therefore, an issuer conducting a private offering under Rule 506 will need to make factual inquiries to confirm that neither it nor any of its directors, executive officers or other persons for whom the disqualification could be applicable are the subject of such triggering events, disclose such events if they exist but took place before September 23, 2013, take action to sever the relationship between a disqualified person and the issuer prior to commencement of the offering or ensure that any such person does not participate in the offering, as appropriate, or not engage in the offering, unless another exemption is available or the issuer registers sales of the securities in the offering under the Securities Act.

In addition, the SEC amended Form D to include a certification whereby issuers relying on Rule 506 will have to confirm that the offering is not disqualified under Rule 506(d).

The new disqualification provisions will apply to sales of securities made in reliance on Rule 506 on or after September 23, 2013, even if part of an offering that began before such date.

The adopting release with respect to the new "bad actor" disqualification is available here [PDF].

Proposed Amendments to Rule 506 Offerings

Finally, in conjunction with the changes discussed above, the SEC has proposed a number of other changes to the Rule 506 offering process. Many of these changes are geared towards helping the SEC understand, monitor and analyze the use of the new Rule 506(c) private offering exemption or to gather intelligence regarding the private offering market in general. The SEC has developed a "work plan" with respect to Rule 506(c) offerings, and the information it gathers pursuant to the proposals discussed below may lead to additional proposed changes to Rule 506(c) in the future. The proposing release is available here. We discuss the material elements of these proposed changes below.

Form D Filings; Disqualification

The proposed amendments would require companies conducting a private offering using the new Rule 506(c) exemption to file a Form D at least 15 days prior to the use of any general solicitation materials in the offering; in order to have the flexibility to conduct an offering using general solicitation, issuers could file such an "Advance Form D" even if no specific offering is contemplated at the time of filing. An Advance Form D could exclude responses to certain limited informational items of Form D with respect to the offering, including the proposed new items discussed below. Companies that omit such information would be required to file an

amendment to the Advance Form D within 15 days of first sale to provide the information so omitted. In addition, companies conducting any Rule 506 private offering, including one that does not use general solicitation or general advertising, would have to file a closing amendment to the Form D within 30 days after termination of the offering that, like all Form D amendments, provides current information with respect to the issuer and the offering. These new amendment filings would be in addition to the existing Form D amendment requirements to correct material mistakes, reflect a change in the information provided (with certain exceptions), and for offerings continuing for more than a year since the last Form D or amendment filing, and would have to be complied with until the closing amendment was filed. In other words, until the closing amendment is filed the offering is considered open, meaning the obligation to file amendments to Form D in accordance with the current requirements continues.

The SEC is also proposing to amend Form D to require disclosure of additional information, primarily with respect to Rule 506 offerings, including, among other more modest changes, how the issuer intends to use the proceeds of the offering and on what basis accredited investors in the offering qualify as accredited and, for Rule 506(c) offerings, the methods used or intended to be used to verify accredited investor status, the types of general solicitation or general advertising used and to be used, and information with respect to control persons of the issuer.

Currently, the filing of a Form D is not a condition of the exemption from registration provided by Regulation D, although under Rule 507 a company may not conduct a private offering in reliance on Regulation D if it, or any of its predecessors or affiliates, have been subject to any court order, judgment or decree temporarily, preliminary or permanently enjoining such person for failure to comply with the filing requirement, unless such disqualification is waived by the SEC. Although it has asked for comments in this regard, the SEC is not proposing to make the filing of a Form D or any required amendment a condition to a Regulation D exemption, believing that the consequences of disqualifying an existing or completed offering from the exemption from registration (i.e. violation of the registration provisions of the Securities Act and applicable state securities laws) because of a missed Form D filing to be too harsh. It is, however, proposing to amend Rule 507 such that if the issuer, or any predecessor or affiliate, did not comply, within the prior five years, with any Form D filing requirement (subject to a one-time 30-day grace period), the issuer would be prohibited from relying on Rule 506 with respect to *future* offerings (i.e. offerings commenced after the failure to file) until one year after all such required filings were made, unless such disqualification is waived by the SEC. In other words, the disqualification for a missed Form D or amendment would apply to future offerings, but would not impact the exempt status of the offering for which the Form D filing was missed. Such disqualification would, however, apply only to failures to file after the effective date of the amendment.

Written General Solicitation Materials; Disqualification

The SEC is proposing new rules under Regulation D that would require that any written communication that constitutes a general solicitation or general advertising in a Rule 506(c) offering (i) include certain specified legends and (ii) be submitted (but not “filed” or “furnished” under the Securities Act or Securities Exchange Act of 1934) to the SEC by the date of first use. The legends would provide that sales are limited to accredited investors, that the sale of the securities is not registered with the SEC, and address restrictions on resale and other cautionary matters. The submission rule would be temporary and expire two years after its effective date, and the materials submitted would not be publicly available. The SEC's ability to review the materials submitted under the proposed rule would help it assess “whether further action is warranted” in this area.

Although compliance with the submission requirement would not be a condition to the use of Rule 506(c), the SEC is proposing to amend Rule 507 so that issuers may not rely on Rule 506 with respect to a private offering if the issuer, or any of its predecessors or affiliates, have been subject to any court order, judgment or decree temporarily, preliminary or permanently enjoining such person for failure to comply with the proposed legend or

submission requirements for written general solicitation materials, again unless disqualification is waived by the SEC.

Private Funds

Despite the requests of many commenters, the SEC has not excluded private funds (i.e. companies that would be investment companies under the Investment Company Act of 1940 but for the exemptions contained in Sections 3(c)(1) and 3(c)(7) thereof, including hedge funds, venture capital funds and private equity funds) from the ability to conduct private offerings under Rule 506(c) using general solicitation and general advertising. In fact, the SEC confirmed that a private fund's use of general solicitation in a Rule 506(c) offering will not impact its ability to rely on the Sections 3(c)(1) and 3(c)(7) exemptions; private fund managers should note, however, that the use of general solicitation may jeopardize current exemptions from regulation by the CFTC absent further guidance in this regard. In the Rule 506(c) adopting release, the SEC suggested that investment advisers to private funds review their existing policies and procedures designed to prevent the use of fraudulent or materially misleading advertising and amend them as necessary, "particularly if the private funds intend to engage in general solicitation activity." The SEC also noted that it might take further action with regarding to private fund advertising in the future, after it has the opportunity to monitor and study such advertising.

In addition, the SEC is proposing new rules regarding private fund advertising. For example, the SEC has proposed extending to private funds Rule 156 under the Securities Act, which currently interprets the antifraud provisions of the federal securities laws with respect to investment company sales literature. In fact, the SEC stated its view in the proposing release that private funds should currently be considering the principles underlying Rule 156 with respect to their sales literature. Further, under the proposed rules private funds would also have to disclose in their written general solicitation materials that the securities being offered are not subject to the protections of the Investment Company Act, and provide additional cautionary disclosure with respect to the use of performance data (if included in such materials); any such performance data would also have to be as of the most recent practicable date, and funds would have to provide a phone number or Web site where potential investors could obtain current performance data. The SEC is also soliciting comment with respect to mandating additional manner and content restrictions on general solicitation materials used by private funds, including with respect to the use of performance data.

Accredited Investor Definition

While not proposing amendments to the definition of accredited investor at this time, the SEC noted that it agreed with commenters on the Rule 506(c) proposal that "the definition of accredited investor as it relates to natural persons should be reviewed and, if necessary, amended." The Dodd-Frank Act already requires the SEC to review the accredited investor definition as it relates to natural persons, and it has begun to do so. Therefore, the SEC is requesting comment on potential amendments to the definition, and we expect to see a proposal in this regard in the not too distant future.