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client alert

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SEC ALLOWS PUBLIC ADVERTISING OF PRIVATE SECURITIES OFFERINGS

In a previous client alert we discussed rules proposed in August 2012 by the Securities and Exchange Commission ("Commission") to allow for general solicitation, or public advertising, in private securities offerings conducted pursuant to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933. On July 10, 2013, the Commission adopted final rules to eliminate the ban on general solicitation in offerings pursuant to Rules 506 and 144A. In addition, the Commission adopted final rules to prohibit certain "bad actors" from participating in Rule 506 offerings and proposed rules that would impose additional requirements on issuers conducting Rule 506 offerings.

ELIMINATION OF THE GENERAL SOLICITATION BAN FOR OFFERINGS UNDER RULES 506 AND 144A

Rule 506 Offerings

New Rule 506(c) was adopted to allow issuers to use general solicitation to offer securities in Rule 506 offerings. There are a few conditions to the rule:

- All terms and conditions of Rule 501 (definitions of terms in Regulation D, including "accredited investor"), Rule 502(a) (when two or more offerings will be considered "integrated" into one offering) and Rule 502(d) (securities obtained in a Rule 506 offering will be "restricted securities") must be satisfied;
- All purchasers of securities must be accredited investors; and
- The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors.

It is noteworthy that the requirement that issuers take "reasonable steps to verify" that purchasers are accredited investors is separate from, and independent of, the requirement that sales be limited to accredited investors and must be satisfied even if all purchasers turn out to be accredited investors. Consistent with the proposed version of the rule, the final rule states that issuers should consider the following factors when determining what reasonable steps to take to verify that the purchasers are accredited investors:

- The nature of the purchaser and the type of accredited investor the purchaser claims to be;
- The amount and type of information that the issuer has about the purchaser (issuers may rely on tax returns, proxy statements, pay stubs, information from third parties, etc.); and
- The nature of the offering (e.g., manner of solicitation, terms of the offering and minimum investment amount).

Based on an analysis of these factors under the issuer's specific facts and circumstances, the issuer must assess the reasonable likelihood that a potential purchaser is an accredited investor. The issuer may decide that more, fewer or no additional steps are needed to verify whether a purchaser is an accredited investor. Issuers will need to retain sufficient records supporting their accredited investor analysis because issuers bear the burden of proof that the offering is entitled to the registration exemption, including the requirement that the issuer took reasonable steps to verify that all purchasers are accredited investors.

The Commission stated that it is open to allowing issuers to rely upon third-party services to verify a purchaser's status as an accredited investor where only the third party maintains the requisite documentation. In particular, issuers may use reliable third-party services that function in connection with web-based Rule 506 offering portals and include offerings for multiple issuers.

The Commission also provided guidance that will be helpful in determining whether the nature and terms of an offering make it easier for an issuer to determine that the purchasers are accredited investors. For example, if an issuer solicits new investors through a website accessible to the general public or some widely disseminated advertisement, then greater measures will likely be needed to verify accredited investor status than if the issuer has solicited investors from a database of pre-screened investors already determined to be accredited investors by a third party. Simply asking investors to check boxes on a questionnaire will not be sufficient to verify an investor's status without other information indicating that the investor is an accredited investor.

In response to comments on the proposed version of the rule, the Commission offered helpful guidance in the final rule that it was reluctant to include in the proposing release. The Commission provided the following non-exclusive list of methods that issuers may use to verify the accredited investor status of natural persons:

1. In verifying income, reviewing copies of any IRS form that reports income for the most recent two years and obtaining a written representation of income from the investor regarding the current year;
2. In verifying net worth, reviewing one or more of the following, dated within the prior three months and with a representation by the person that all liabilities necessary to determine net worth have been disclosed:
    a. Bank statements;
    b. Brokerage statements and other statements of securities holdings;
    c. Certificates of deposit;
    d. Tax assessments and appraisal reports issued by independent third parties; and
    e. Credit reports.
3. Obtaining a written confirmation from a registered broker-dealer, SEC-registered investment adviser, attorney, or CPA that such person has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that the person is an accredited investor; and
4. Obtaining a certification confirming accredited investor status at the time of the sale from a natural person who invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of new Rule 506(c) and remains an investor of the issuer.

Regardless of an issuer's compliance with any, or all, of the methods above, if an issuer or its agent has knowledge that a purchaser is not an accredited investor, the verification requirement will not be deemed to have been satisfied.

Issuers that desire to make offers or sales to 35 or fewer non-accredited investors who meet Rule 506(b)'s sophistication requirements may still conduct Rule 506 offerings in the traditional manner but will be subject to the pre-existing prohibition on general solicitation. An issuer will need to check the appropriate box on Form D to indicate whether it is conducting the offering under the traditional method without general solicitation (Rule 506(b)) or under the new method using general solicitation (Rule 506(c)).

Rule 144A Offerings

Prior to the amendments adopted by the Commission, a condition to comply with Rule 144A was that securities only be offered or sold to qualified institutional buyers (QIBs). As a result of the amendments, Rule 144A now only requires that sales (not offers) of securities be made to QIBs. Consequently, offers of Rule

144A securities may be made by general solicitation as long as the securities are sold only to persons whom the seller reasonably believes to be a QIB. However, these new rules do not change the reasonable belief standard for determining an investor's status as a QIB in Rule 144A offerings. Thus, the "reasonable steps to verify" a purchaser's accredited investor status set forth in Rule 506(c) are not required for determining QIB status in Rule 144A offerings.

TRANSITION RULES

The final rules take effect 60 days after the rules are published in the federal register. For offerings under Rule 506 that are ongoing at the time the rules take effect, issuers may choose to continue the offerings under either the current rules or Rule 506(c), allowing issuers to begin general solicitation immediately when the rules take effect. This will not affect offers and sales of securities made pursuant to Rule 506(b) prior to the effective date of Rule 506(c). Similarly, the Commission stated that ongoing offerings under Rule 144A will be able to begin using general solicitation immediately upon effectiveness of the rules without jeopardizing the exemption for offers and sales made prior to the effective date.

PROPOSED AMENDMENTS TO REGULATION D

In a separate release, the Commission proposed amendments to Regulation D designed to address some of the concerns that were raised about newly permitted general solicitation in Rule 506 offerings. The proposed amendments were supported by only three of the Commissioners; Commissioners Paredes and Gallagher withheld their support for the proposal, which may portend difficulty in getting final rules adopted. Nevertheless, we have provided a brief summary of the proposed rules here.

Proposed Form D Amendments

Currently, issuers must file a Form D no later than 15 calendar days after the date of the first sale of securities in an offering made under Regulation D. Form D provides information on the offering and the issuer. The Commission commented in its Rule 506(c) adopting release that non-compliance with the Form D filing requirement is widespread. According to the Commission, a significant number of issuers do not file Form D because it is not a condition to Rule 506 or possibly because they do not want the information made public. Now that the ban on general solicitation has been lifted for Rule 506 offerings, the Commission proposes to amend Regulation D to require the filing of certain Form D items no later than 15 calendar days in advance of the first use of general solicitation in a Rule 506(c) offering and the filing of additional and updated information in a closing Form D amendment within 30 calendar days after the termination of a Rule 506 offering. Furthermore, the Commission proposed amending Form D to require disclosure of additional information regarding Rule 506 offerings, including the issuer's website address, persons controlling the issuer, and information specific to Rule 506(c) offerings, such as the types of general solicitation used and the methods used to verify the accredited investor status of purchasers.

An issuer would also be disqualified from relying on Rule 506 for one year for new offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply within the last five years with all of the Form D filing requirements in a Rule 506 offering. The disqualification period ends one year after all required Form D filings for prior Rule 506 offerings are filed. The new rule would provide a 30-day cure period and a process for obtaining waivers from disqualification.

Proposed Rules and Amendments Relating to General Solicitation

The Commission also proposed amendments to its rules that would require legends to be included in any written communication that constitutes general solicitation in any offering conducted in reliance on Rule 506(c). In addition, the Commission is seeking to require issuers conducting general solicitation under Rule 506(c) to submit their general solicitation materials to the Commission no later than the date of the first use of the materials. These submissions would not be available to the public. Furthermore, the Commission proposes to prohibit an issuer from relying on Rule 506(c) for future offerings if such issuer has been subject to any order, judgment or court decree enjoining such person for failure to comply with the proposed rule.

IMPACT ON PRIVATE FUNDS

The Commission affirmed the position it expressed in the proposing release that private funds will be

permitted to engage in general solicitation in compliance with new Rule 506(c) without losing important exclusions under the Investment Company Act of 1940. Because the Jumpstart Our Business Startups Act (JOBS Act) specifically states that Rule 506, as revised, is not deemed to be a public offering under the Federal securities laws, private funds can still rely upon the exclusions from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

While many commenters implored the Commission to impose higher standards on private funds, the Commission noted that private funds will continue to be subject to the anti-fraud provisions of the federal securities laws prohibiting false statements and other deceptive conduct in connection with a securities offering. Indeed, the Commission noted that it has recently brought enforcement actions against private fund advisers and others for material misrepresentations to investors and prospective investors regarding fund performance, strategy and investments. Furthermore, in the adopting release, the Commission warned private funds to implement appropriate policies and procedures regarding the nature and content of sales literature, including general solicitation materials, to prevent the use of fraudulent or materially misleading advertising.

Private funds should also be advised that the newly proposed rules would require a legend on all general solicitation materials stating that the securities being offered are not subject to the protections of the Investment Company Act. Additional disclosures, similar to those required of registered investment companies, would be required on materials that use performance data. The Commission is seeking recommendations regarding additional manner and content restrictions on written general solicitation materials used by private funds. The proposed rules further seek to apply the anti-fraud provisions of the federal securities laws to sales literature used by private funds.

BAD ACTOR RULE

The Commission also voted, unanimously, to adopt a rule that prohibits felons and other "bad actors" from participating in offerings that rely on Rule 506. The rule covers the issuer, its predecessors and affiliates, directors, certain officers, general partners, managing members, 20 percent beneficial owners, promoters, investment managers and principals of pooled funds, and persons compensated for soliciting investors. The rule lists the "disqualifying events" that would prevent a covered person from being able to participate in an offering under Rule 506. The list of disqualifying events includes certain criminal convictions and Commission orders.

If a disqualifying event occurred before the rule was adopted, the person may still participate in the offering but must disclose the disqualifying event to investors. An issuer can avoid disqualification if it can demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a covered person subject to a disqualifying event participated in the offering. In addition, the Commission may grant an issuer a waiver of disqualification if the issuer satisfies the Commission that it need not deny the registration exemption.

CONCLUSION

There has been a great deal of anticipation, discussion and creative thinking relating to the expected elimination of the restrictions on general solicitation and general advertising in connection with Rule 506 and Rule 144A offerings. Eventually, the impact on current practices will likely be far reaching as participants get accustomed to the new rules and develop creative ways to offer securities within the framework of the new rules.

Once the new rules become effective and issuers consider availing themselves of expanded opportunities under the new rules, they should be certain to clearly establish the reasonable steps they will take to verify that purchasers of the securities will all be accredited investors. In establishing these steps, issuers will need to consider all the facts and circumstances of the offering. Important items to consider will be, among others:

- Size of the offering;
- Minimum investment amount;
- Types of investors solicited (e.g., natural persons, institutional investors, banks or broker-dealers, etc.);

- Manner in which investors will be solicited;
- Types of securities being offered;
- Existing relationships with potential investors; and
- Availability of reliable third parties to verify accredited investor status.

In addition, the general solicitation and general advertising of these offerings may create issues for consideration relating to applicable advertising regulations. The question as to whether an advertisement is considered deceptive is generally considered from the standpoint of the intended audience. The Commission and other regulatory authorities, as well as courts, may impose stricter requirements with regard to issues like clarity and conspicuousness of claims and disclosures once offerings can be advertised to a broader and potentially less sophisticated audience. In addition, public advertising of offerings may subject them to greater scrutiny by other regulators such as the Federal Trade Commission and courts, although they would likely exercise considerable deference to the views of the Commission.

The use of general solicitation in connection with offerings may also give rise to broker-dealer issues for any parties that assist with capital raising. For a more detailed discussion of the application of broker-dealer regulations in private offerings, please refer to our prior client alert.

An additional item worth noting relates to the proposed rules requiring the filing of Form D and the penalties for failing to make such filings. These rules, if adopted as proposed, will likely have a very practical impact on Rule 506 offerings. Currently, issuers in many Rule 506 offerings do not file a Form D and the failure to file often has little impact on the offering because the filing is not a condition to claiming the safe harbor provided under Rule 506. The proposed revisions would likely have a substantial impact on that practice because of the restrictions imposed on future use of Rule 506 for issuers that fail to file the required Form Ds. In addition, many of the restrictions under consideration in connection with the proposed rules could have a substantial dampening impact on the use of newly permitted general solicitation and general advertising. We will continue to follow the Commission's activities regarding these proposed rules and provide updates as they become available.

Please consider the application of these new rules to your involvement in private offerings made under Rules 506 and 144A. These new rules represent a significant change and provide some new opportunities. However, careful analysis is needed to avoid forfeiting the safe harbor protection that Rule 506 provides for unregistered offerings. If you have any questions regarding the application of these new rules or securities laws in general, please contact the Venable lawyer with whom you work, one of the authors of this alert or one of the lawyers listed below. For additional information regarding our Corporate Finance and Securities practice please click here.

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