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Securities Law ADVISORY ■

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SEC Adopts Final Rules Regarding General Solicitation and Advertising in Private Securities Offerings and Proposes New Form D Requirements

On July 10, 2013, the Securities and Exchange Commission held an open meeting at which it adopted amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (the Securities Act), as directed by Section 201(a) of the Jumpstart Our Business Startups Act (the JOBS Act).[1] The revised rules remove the historic restriction on general solicitations in private offerings by allowing issuers who rely on the revised sections of Rule 506 and Rule 144A, including private funds, to publicly advertise the offering of securities and engage in other forms of general solicitation without having to register the transaction with the SEC, provided such issuers comply with the other requirements of such rules. This means that issuers will be permitted to market unregistered securities on the Internet, television, radio and in other mass media, even though unregistered securities can generally only be sold to accredited investors or qualified institutional buyers (QIBs).

The revisions to Rule 506 and Rule 144A (the Revised Rules) permit the use of general solicitation and general advertising in private offerings,[2] so long as:

- in Rule 506 offerings, (1) the actual purchasers of the securities are accredited investors[3] and (2) the issuer takes reasonable steps to verify the purchasers' status; and
- in Rule 144A offerings, the seller or person acting on the seller's behalf reasonably believed the actual purchasers were QIBs.

Additionally, the Revised Rules include four, non-mandatory and non-exclusive methods that will be deemed to satisfy the "reasonable steps to verify" accredited investor status requirement of new Rule 506(c) with respect to natural persons.

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1 This advisory is based on the comments made at the July 10, 2013, open meeting, the related SEC press release (available at: http://www.sec.gov/news/press/2013/2013-124.htm) and the adopting and proposing releases for these rules.

2 The adopting release lifting the general solicitation ban is available at: http://www.sec.gov/rules/final/2013/33-9415.pdf.

3 Rule 501(a) of the Securities Act defines an accredited investor as a person or entity who meets, or the issuer reasonably believes meets, certain specified criteria at the time of the sale of the securities.

At the same open meeting, the SEC adopted the "bad actor" rule, as mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which prohibits certain felons and other "bad actors" from participating in private placements under Rule 506.[4] The changes to Regulation D, Rule 144A and the "bad actor" rules will all become effective 60 days after publication in the Federal Register.

Finally, the SEC proposed a set of new rules that are intended to enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings and address certain concerns about the potential for fraud in private placements under the Revised Rules.[5]

What to Do Now?

- Consider your capital needs and existing investor base and determine whether your company would benefit from utilizing the new provisions that allow for general solicitation in private placements.
- If utilizing the Revised Rules, establish policies and procedures for verifying that purchasers of securities in a Rule 506 offering are accredited investors in order to ensure satisfaction of the requirement that an issuer using general solicitation in its 506 offer takes "reasonable steps to verify" such status.
  - Begin with using the methods identified by the SEC in Rule 506(c)(2)(ii) for purchasers who are natural persons to take advantage of the safe harbor provided in the final rules and consider other methods if appropriate.
  - Make sure these procedures include a retention policy to maintain adequate records of this verification process.
- Companies should notify their investor relations departments of the new rules and prepare them for a potential marketing campaign for private placement offerings.
- Investment banks, broker-dealers and private funds may want to re-evaluate their policies and procedures and revise their forms to take advantage of the new ability to market private placements of securities more broadly.

Background Information

Rules 506 and 144A provide exemptions from the registration requirements of Section 5 of the Securities Act. Rule 506 permits an issuer to offer an unlimited amount of securities in an offering sold only to accredited investors and up to 35 nonaccredited investors who meet certain sophistication requirements. Rule 144A permits the resale of an unlimited amount of securities to QIBs. Historically, the exemption provided by Rule 506 prohibited issuers from engaging in any general solicitation of investors, which includes public advertising, in connection with private offerings of their securities, and the exemption provided by Rule 144A prohibited any offer to a potential investor that is not a QIB (effectively prohibiting any general solicitation). Critics have argued for many years that these prohibitions cause a significant reduction of the pool of potential investors in a private offering, thereby restricting a company's access to capital.

In order to address this issue, and expand issuers' access to capital, Section 201(a) of the JOBS Act directed the SEC to remove the prohibition on general solicitation and advertising contained in Rule 506 and Rule 144A. The SEC issued proposed rules on August 29, 2012, and the rules were adopted substantially as proposed, with the

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4 The adopting release for the disqualification of bad actors is available at: http://www.sec.gov/rules/final/2013/33-9414.pdf.

5 The proposing release for the Regulation D amendments is available at: http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

addition of a non-exclusive list of criteria that issuers can use to verify the accredited investor status of natural persons, at an open meeting on July 10, 2013.[6]

While issuers may take advantage of the new rules once they are effective,[7] issuers should keep an eye on the proposed rules and craft any capital raising materials with the future proposed rules in mind.

How Do the Revised Rules Impact Rule 506 Offerings?

An additional exemption for issuers who engage in general solicitation or advertising in private offerings

The amendments effectively create two related exemptions within Rule 506; Rule 506(b) and the new Rule 506(c). The historical exemption provided by Rule 506 (which retains the prohibition on general solicitations) remains unchanged as Rule 506(b). Issuers can continue to use the traditional Rule 506(b) exemption without engaging in general solicitation.

New Rule 506(c) permits the use of general solicitation and general advertising to offer and sell securities, *provided that*:

- all purchasers of securities are accredited investors; and
- the issuer takes *reasonable steps to verify* that purchasers of the securities are accredited investors.

As noted above, the historical safe harbor provided by Rule 506 is preserved in Rule 506(b), so companies conducting offerings pursuant to Rule 506 without the use of general solicitation and general advertising are not subject to the new verification rule or the requirement to sell only to accredited investors.

"Bad actors" prohibited from participating in 506 offerings

The SEC also adopted the so-called "bad actor" rule, which was mandated by Section 926 of Dodd-Frank. This rule prohibits certain "felons and other 'bad actors'" from relying on the exemption from Securities Act registration provided by Rule 506. The disqualification provisions apply to participants in securities offerings (including issuers, certain executive officers, shareholders controlling at least 20 percent of the voting securities of an issuer, promoters and other entities involved in the offering or solicitation of prospective purchasers), and prohibit such participants from making offerings if they have been subject to certain legal actions, such as criminal convictions, court injunctions, broker-dealer disciplinary orders and other regulatory orders.

Disqualification applies only to triggering events that occur after effectiveness of the rule amendments. However, in certain circumstances, issuances that involve "bad actor" participants will be required to disclose triggering events that pre-date the effectiveness of the Revised Rule. The new rule was designed to provide additional protection against the potential for fraud involving private placements and applies to all 506 offerings, not just those under new Rule 506(c). Companies will need to establish processes and systems to conduct due diligence on their investors so as to determine if certain investors are prohibited from participating in an offering.

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6 These rules were adopted a year beyond the rulemaking deadline initially imposed by the JOBS Act, which was July 4, 2012. *See* Alston & Bird advisory at: http://www.alston.com/Files/Publication/fe8ed6c6-ac7e-47de-adaf-25f1f7665d82/Presentation/PublicationAttachment/169696df-b2c5-42af-b269-b08c184e9fd1/12-602%20SEC%20JOBS%20Act.pdf.

7 The new rules will be effective 60 days following publication in the Federal Register.

What Are "Reasonable Steps to Verify" Accredited Investor Status?

The key concept of "reasonable steps to verify" comes from the JOBS Act directives. Section 201(a) of the JOBS Act noted that issuers must "use such methods as determined by the Commission" when making this determination.

The final rules kept the "principle-based" approach for determining the reasonableness of the steps that an issuer takes to verify that a purchaser is an accredited investor that was included in the proposed rules. This approach requires issuers to consider the facts and circumstances of the transaction when determining what steps are required, including:

- the type of 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, meaning:
  - 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.

In response to requests from commenters for more clarity of the requirement, and in a departure from the proposed rules, the final rules also provide a list of four "non-exclusive and non-mandatory methods of verifying that a *natural person*" is an accredited investor. New Rule 506(c)(2)(ii) provides that an issuer "shall be deemed to take reasonable steps to verify" the accredited investor status of purchasers who are natural persons if:

- for accredited investors qualifying on the basis of income,[8] the issuer reviews any Internal Revenue Service (IRS) form used to report income (i.e., W-2s, 1099s, Schedule K-1s, 1040s, etc.) for the two most recent years and obtains a written representation that the purchaser has a reasonable expectation of achieving the necessary income level in the current year;
- for accredited investors qualifying on the basis of net worth,[9] the issuer obtains a written representation that all liabilities have been disclosed and reviews the following forms (each dated within three months):
  - for assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by third parties; and
  - for liabilities: a consumer report from at least one of the nationwide consumer reporting agencies;
- the issuer obtains a written confirmation from one of the following people that, within the past three months, such person has verified the purchaser's accredited investor status:
  - a registered broker-dealer;
  - an investment adviser registered with the SEC;
  - a licensed attorney (in good standing); or
  - a certified public accountant (duly registered and in good standing); or

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8 He or she meets the requirements of Rule 501 by having earned $200,000 a year for the last two years individually, or $300,000 a year for the last two years combined with his or her spouse, and has a reasonable expectation of reaching the same income level in the current year.

9 He or she meets the requirements of Rule 501 by having a personal net worth of at least $1 million, excluding the value of his or her primary residence.

- for purchasers who participated in a prior Rule 506 offering of an issuer as an accredited investor prior to the adoption of the new 506(c), and who continue to hold such securities, the issuer obtains a certification from the purchaser that he/she qualifies as an accredited investor at the time of the sale.

Although these steps are deemed to satisfy the requirements of the new rule, the adopting release emphasized that this is a non-exclusive list, and issuers may still rely on the principles-based approach for determining what steps are necessary to verify the accredited investor status of natural persons.

What Changes Were Made to Rule 144A?

The former Rule 144A requirement that securities are "offered" only to QIBs has been revised. Accordingly, sellers may use general solicitation or general advertising to offer securities to be resold pursuant to Rule 144A, provided that the securities are sold only to QIBs or persons whom the seller and any person acting on behalf of the seller reasonably believe is a QIB.

How Do the Revised Rules Impact the Regulation S Safe Harbor for Offshore Offerings?

The short answer is that the Revised Rules do not impact an issuer's ability to use the Regulation S safe harbor for a concurrent offshore offering. Regulation S provides a safe harbor for offers and sales of securities outside the United States, as long as (i) the securities are sold in an offshore transaction and (ii) there are no directed selling efforts in the United States.

A general solicitation such as placing an advertisement in a publication with a United States circulation is regarded as a "directed selling effort." However, the SEC stated that concurrent offshore offerings that are conducted in compliance with Regulation S would not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as amended.

What Changes Were Made to Form D?

The Revised Rules amend Form D, which issuers must file with the SEC when they sell securities under Regulation D, to add a checkbox denoting that an issuer has engaged in general solicitation and is claiming the new Rule 506(c) exemption from registration. The checkbox provision is intended to allow the SEC to monitor the use of general solicitation and to assess the impact of the changes on the market, including the effectiveness of various verification practices used by issuers.

In addition, in relation to the new "bad actors" rule, the signature block on Form D will now contain a certification whereby issuers claiming a Rule 506 exemption will confirm that the offering is not disqualified from reliance on Rule 506.

What Additional Changes Were Proposed Relating to the Form D Requirements?

Although not included on the meeting agenda that was published, the SEC proposed additional rules at the open meeting that would have a significant impact on the Form D reporting requirements. The proposed rules are "intended to enhance the Commission's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to engage in general solicitation and general advertising under new paragraph (c) of Rule 506." The proposed rules would require:

- the filing of a Form D at least 15 days in advance of the first use of general solicitation in a Rule 506(c) offering;
- the filing of a final amendment to Form D within 30 days after termination of any Rule 506 offering;
- additional disclosure requirements, primarily in regard to offerings conducted in reliance on Rule 506, including:
  - identification of the issuer's website by all Form D filers;
  - the name and address of any person who directly or indirectly controls an issuer conducting a Rule 506(c) offering;
  - specification of the issuer's industry group for all filers (without reliance on the "other" category, as currently permitted);
  - information on the issuer's size (i.e., revenues or net asset value of a fund) for all filers that make such information otherwise available to the public (such as those that provide such information in their general solicitation materials used pursuant to Rule 506(c));
  - the trading symbol or other security identifier for the offered securities, if applicable, for all Form D filers;
  - information about the number and types of investors participating in any 506 offering (i.e., accredited vs. nonaccredited investors and natural person vs. legal entity investors) and the amounts raised from each category of investors;
  - information about the use of proceeds from any 506 offering, including amounts used to (1) repurchase securities, (2) pay offering expenses, (3) acquire assets, (4) finance business acquisitions, (5) fund working capital, and (6) discharge indebtedness;
  - the name of the exchange and Exchange Act file number for any class of an issuer's securities that are listed on an exchange and information regarding whether the offered securities are the same class or convertible into or exercisable for such class;
  - information on the types of general solicitation used in 506(c) offerings, including whether solicitation materials were filed with FINRA; and
  - the methods used to verify the accredited investor status of investors in 506(c) offerings.

In addition, if an issuer (or any predecessor or affiliate) did not comply with all of the Form D filing requirements in the past five years,[10] the proposed amendment to Rule 507 would disqualify that issuer from relying on Rule 506 for future offerings for a period of one year. This disqualification period would end one year after the required Form D filings are made, and would not affect offerings of an issuer or affiliate that are ongoing at the time of the filing

[10] This look-back period would not extend past the effective date of the rule. As proposed, disqualification would only arise with respect to non-compliance with the Form D filing requirements that occurred after the effectiveness of new Rule 507(b).

non-compliance. The proposed rules provide that an issuer would be able to rely on a cure period (30 days) for a late or technically non-compliant Form D filing and, in certain circumstances, could request a waiver from the staff to avoid such disqualification.

What Other Rule Changes Were Proposed?

In addition to the proposed changes to the Form D requirements, there were two additional proposals that would impact Rule 506 offerings. First, the SEC proposed a temporary rule that would require an issuer who takes advantage of the ability to use general solicitation in reliance on new Rule 506(c) to submit a copy of the solicitation materials it intends to use to the SEC no later than the date of the first use of such materials. These materials would be submitted through an intake page on the SEC's website, and would not be made publicly available.

Additionally, the SEC proposed a new Rule 509 that would require issuers to include legends in their 506(c) offerings to notify potential purchasers that (1) only accredited investors are permitted to purchase the securities; (2) securities are offered in reliance on an exemption from registration and are not required to comply with specific disclosure requirements; (3) the SEC has not reviewed or approved the securities, offering terms or offering materials; (4) the securities are subject to transfer restrictions; and (5) purchasing the securities involves potential risks, including loss of their investment. This rule would also require additional warnings and cautionary statements on solicitation materials distributed by private funds, including disclosure of the fact that the securities being offered are not subject to the protections of the Investment Company Act of 1940.

Finally, the proposed amendments would extend Rule 156 antifraud guidance to the sales literature of private funds.

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