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ALERT

SEC ADOPTS RULES PERMITTING GENERAL SOLICITATION AND ADVERTISING IN RULE 506 OFFERINGS AND DISQUALIFYING CERTAIN ISSUERS FROM ENGAGING IN RULE 506 OFFERINGS

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On July 10, 2013, the United States Securities and Exchange Commission (SEC) adopted final rules:

- permitting general solicitation and general advertising in securities offerings pursuant to Rule 506 of Regulation D under the Securities Act of 1933, as amended (Securities Act);
- disqualifying issuers and other market participants from relying on the private placement exemption provided by Rule 506 of Regulation D if felons or other bad actors are participating in the offering; and
- permitting securities sold pursuant to Rule 144A under the Securities Act to be offered to persons other than qualified institutional buyers or "QIBs," including by means of general solicitation, provided that the securities are sold only to persons that the seller, and any person acting on behalf of the seller reasonably believes, are QIBs.

The rules were adopted substantially as proposed and will become effective 60 days after they are published in the Federal Register. The new rules are expected to have a positive impact on fundraising activities, particularly for early and mid-stage private companies seeking to access the capital markets.

GENERAL SOLICITATION AND GENERAL ADVERTISING PERMITTED

Section 201(a) of the Jumpstart Our Business Startups Act, or JOBS Act, directed the SEC to amend Rule 506 of Regulation D to permit general solicitation and general advertising in offerings under Rule 506 so long as all purchasers are accredited investors. In response, the SEC adopted new Rule 506(c). See SEC Release Nos. 33-9415 (Adopting Release).

The Rule

Rule 506(c) permits issuers to engage in general advertising and general solicitation in conducting Rule 506 offerings so long as:

- all terms and conditions of Rules 501, 502(a) and 502(d) of Regulation D are satisfied;
- all purchasers of securities in the offering are "accredited investors" within the meaning of Rule 501(a) of Regulation D; and
- the issuer takes reasonable steps to verify that such purchasers are accredited investors.

The conditions of Rule 506(c) are significant in two respects. First, issuers who intend to sell to sophisticated purchasers that are not accredited investors in a Rule 506 offering cannot engage in general solicitation. Second, and more importantly, issuers must proactively "take reasonable steps to verify" that an investor is an "accredited investor." This is separate and independent from the requirement that all purchasers are accredited investors. As a result, an issuer cannot simply rely on an investor's representation that he or she is an accredited investor.

Rule 506(c) provides four non-exclusive and non-compulsory methods for an issuer to verify a natural person's status as an accredited investor. These methods are deemed to satisfy the requirement that issuers take "reasonable steps to verify" such status unless the issuer or its agents have knowledge that such person is not an accredited investor. These methods consist of:

- relying on any IRS form that reports the purchaser's income for the two most recent years, such as Forms W-2, 1099, 1040 or Schedule K-1 to Form 1065;
- reviewing documents such as bank statements, brokerage statements or consumer reports dated within three months prior to the date of sale;
- obtaining written confirmation from a registered broker/dealer, registered investment advisor, licensed attorney or CPA that based on recent verification efforts, the purchaser is an accredited investor; and
- permitting any purchaser who purchased securities in an issuer's previous Rule 506(b) offering who qualified as an accredited investor at that time and continues to hold such securities, to participate in such issuer's 506(c) offering so long as such purchaser certifies that he or she qualifies as an accredited investor at the time of the purchase.

Issuers that do not rely on one of the foregoing methods must take other reasonable steps to verify the accredited investor status of purchasers. Whether the steps taken are reasonable will be based on an objective determination of the issuer's actions based on the particular facts and circumstances of the transaction. In making this determination, issuers should consider:

- the nature of the purchaser and 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, the manner in which the purchaser was solicited and the terms of the offering, such as a minimum investment amount.

The SEC confirmed that the reasonable belief standard in the definition of accredited investor will apply to offerings conducted under Rule 506(c). As a result, issuers will not lose the ability to rely on the exemption provided by Rule 506(c) if a purchaser turns out not to be an accredited investor so long as the issuer (i) took reasonable steps to verify that the purchaser was an accredited investor; and (ii) had a reasonable belief that such person was an accredited investor at the time of the sale.

As issuers will have the burden of demonstrating their entitlement to rely on the registration exemption provided by Rule 506(c), issuers are well advised to engage in careful due diligence and retain adequate records establishing that they have taken reasonable steps to verify that each purchaser was an accredited investor.

The Details

Existing Exemption Unchanged. Issuers will maintain the ability to conduct Rule 506 offerings under Rule 506(b) subject to the prohibition against general solicitation. Such issuers will continue to be able to offer and sell securities to up to 35 non-accredited investors that are "sophisticated purchasers" and will not become subject to the requirement to take

reasonable steps to verify the accredited investor status of purchasers in such offerings.

Revised Form D. Form D has been revised to include a new check the box item to identify Rule 506(c) offerings and renames current "506" offerings as "506(b)" offerings. Issuers that engage in general solicitation will be required to check the 506(c) box and will be precluded from checking the 506(b) box as such offerings remain subject to the prohibition against general solicitation.

Impact on Current Offerings. Any issuer that is currently conducting a Rule 506 offering may continue to conduct the offering as is or may continue the offering with the benefit of general solicitation pursuant to Rule 506(c) without affecting the exempt status of offers and sales made under Rule 506 prior to the effective date of Rule 506(c).

Application to Private Investment Funds. Private investment funds generally rely on the exemptions provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 and raise capital pursuant to Rule 506. Both exemptions are conditioned on the private fund not engaging in any public offering of its securities. The SEC has confirmed that such private funds can engage in general solicitation and general advertising in compliance with Rule 506(c) without losing either of the forgoing exemptions under the Investment Company Act.

BAD BOY DISQUALIFICATIONS

Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act directed the SEC to adopt rules to disqualify certain securities offering from reliance on Rule 506 that are substantially similar to the so called "bad boy" provisions set forth in current Rule 262 applicable to Regulation A offerings. In response, the SEC adopted new Rules 506(d) and 506(e). See SEC Release No. 33-9414 (Adopting Release).

The Rules

Rule 506(d) prohibits issuers whose "covered persons" are subject to certain "disqualifying events" from conducting offerings under Rule 506. Importantly, disqualification will only arise from triggering events that occur after the effective date of Rule 506(d). The rule looks to the timing of the triggering event (i.e., date of criminal conviction or court order) rather than the date of the underlying conduct. Accordingly, a triggering event that occurs after the effective date of the rule that relates to conduct that occurred before the effective date will result in disqualification.

With regard to triggering events occurring prior to the effective date of Rule 506(d), issuers will be required to disclose in writing a description of such triggering events a reasonable time prior to any sale under Rule 506. Such disclosure will be required in all offerings under Rule 506 even if all offerees or purchasers are accredited investors. The SEC expects issuers to give "reasonable prominence" to such disclosure, and the SEC expressed the view that failure to make the required disclosure will not be considered an "insignificant deviation" from the requirements of Regulation D. As a result, failure to provide such disclosure will result in the loss of the Rule 506 exemption for the offering at issue.

The SEC also made clear that the new rule applies only to sales made after the effective date of Rule 506(d). Accordingly, sales of securities made prior to the effective date will not be subject to the disqualification or disclosure requirements even if such sales are part of an offering that continues after the effective date. Similarly, "disqualifying events" occurring during the pendency of an offering will not affect sales made prior to the triggering event, but sales made after the occurrence of the triggering event will not be permitted under Rule 506. However, disqualifying events that existed at the commencement of an offering and discovered later will result in loss of the exemption, unless the issuers can satisfy the

reasonable care exception. See "**The Exceptions**" below.

The signature block of the Form D has been amended to include a check the box certification pursuant to which issuers claiming a Rule 506 exemption will confirm that the offering is not disqualified under Rule 506(d).

The Exceptions

Disqualification will not apply if:

- the issuer establishes that it did not know, and in the exercise of reasonable care, could not have known, that a triggering event existed or that a prior bad act had occurred;
- the issuer obtains a waiver from the SEC's Division of Corporate Finance; or
- the court or regulatory authority that entered the relevant order, judgment or decree advises in writing that disqualification under Rule 506 should not arise as a consequence of such order, judgment or decree.

Determining whether "reasonable care" has been taken will be based on the specific facts and circumstances of the particular issuer and offering. At a minimum, issuers should conduct careful due diligence including obtaining questionnaires, certifications, contractual representations, covenants and/or undertakings from "covered persons." This will have particular significance for continuous and long lived offerings as issuers will be required to exercise reasonable care in updating the factual inquiry on a reasonable basis determined based upon the facts and circumstances of the issuer, offering and participants involved.

The Details

"Covered Persons" consist of:

- the issuer and any predecessor of the issuer or affiliated issuers;
- any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any investment manager of an issuer that is a pooled investment vehicle;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of securities in the offering;
- any general partner or managing member of any such investment manager or solicitor; or
- any director, executive officer or other officer participating in the offering of any such investment manager or solicitor.

"Disqualifying Events" apply to all "covered persons" and consist of:

- conviction within 10 years before such sale (or five years in the case of issuers, their predecessors and affiliated issuers) of a felony or misdemeanor in connection with the purchase or sale of any security, the making of a false filing with the SEC; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- being subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security, making of any false filing with the SEC, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

- being subject to any final order of any state securities commission, state banking, credit union, or insurance regulator, federal banking agency, the US Commodity Futures Trading Commission or the National Credit Union Administration that at the time of such sale, bars the person from association with any entity regulated by the regulator issuing the order, from engaging in the business of securities, insurance banking, savings association or credit union activities, or constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct entered within 10 years before such sale;
- being subject to an order of the SEC that, at time of the sale, suspends or revokes a person's registration as a broker, dealer, municipal securities dealer or investment adviser, places limitations on the activities, functions or operations of such person or bars such person from being associated with any entity or from participating in the offering of any penny stock;
- being subject to order of the SEC entered within five years before such sale that at the time of such sale, orders the person to cease and desist from committing or causing a future violation of any scienter based anti-fraud provision of the federal securities laws or Section 5 of the Securities Act;
- being suspended or expelled from membership in, or suspended or bared from association with a member of, a registered national securities exchange or a registered national or affiliated securities association;
- filing or serving as an underwriter in any registration statement or Regulation A offering statement that within five years before such sale was the subject of a refusal order, stop order, or order suspending the Regulation A exemption or is, at the time of such sale, the subject of an investigation or proceeding to determine whether such a stop or suspension order should be issued; or
- being subject to a U.S. Postal Service false representation order, including temporary or preliminary orders entered within the last five years.

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