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Client Alert

Current Issues Relevant to Our Clients

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SEC Lifts Prohibition on General Solicitation and Adopts Bad Actor Disqualifications

The Securities and Exchange Commission (the "SEC") recently lifted the longstanding prohibition against using general solicitation and general advertising in certain private offerings of securities, as mandated by the Jumpstart Our Business Startups Act (the "JOBS Act"). Rule 506(c) allows issuers, including private funds, to use public media, such as newspapers, television and the Internet to advertise private securities offerings, as long as: (i) all purchasers of securities are accredited investors; (ii) the issuer takes "reasonable steps" to verify the accreditation of all purchasers; and (iii) all other applicable terms and conditions of Regulation D are satisfied. It is anticipated that Rule 506(c) will increase the visibility of private companies and funds allowing for access to a broader audience of potential investors.

The SEC also amended Rule 144A under the Securities Act to effectively create opportunities to publically advertise the private resale of restricted shares by allowing offers to be made to persons other than qualified institutional buyers ("QIBs"). The SEC Release, "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," adopting the final Rule 506(c) and amending Rule 144A may be found here. (the "General Solicitation Release"). For a summary of the proposed Rule 506(c) and amendments to Rule 144A, please see our September 2012 Client Alert, available here. For more information regarding the JOBS Act, please see our April 2012 Client Alert, available here.

In a separate release on July 10, 2013, the SEC adopted Rule 506(d) of Regulation D (the "Bad Actor Rule"). The Bad Actor Rule disqualifies securities offerings involving certain felons and other bad actors from relying on Rule 506 exemptions. The "Disqualification of Felons and Other 'Bad Actors' from Rule 506 Offerings" stems from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). A copy of the Bad Actor Rule Release is available here (the "Bad Actor Release"). For more information regarding the Bad Actor Rule proposal, please see our May 2011 Client Alert available here.

New Rule 506(c)

Currently, issuers commonly rely on Rule 506(b) to conduct private offerings, which theoretically allows issuers to raise unlimited capital from an unlimited number of accredited investors. While the SEC has preserved Rule 506(b), the introduction of Rule 506(c) allows an issuer to use general solicitation in an offering without requiring registration of the transaction, so long as certain conditions are met. The JOBS Act required the SEC to adopt Rule 506(c) to permit the use of general solicitation in private securities offerings where:

- Sales of securities are exclusively made to accredited investors;
- The issuer takes reasonable steps to verify the accredited investor status of all purchasers; and
- The issuer complies with all other terms and conditions of Rules 501, 502(a) and 502(d) of Regulation D.

While, there are several different types of accredited investors, as set forth in Rule 501(a) of Regulation D; the comments received on the proposed Rule 506(c) highlighted the difficulty of determining the accreditation of natural persons. Currently, natural persons are deemed to be accredited investors if: (i) the person's individual net worth or joint net worth with a spouse exceeds $1 million, excluding the value of the person's primary residence (the *"Net Worth Test"*); or (ii) the person's individual income is in excess of $200,000 in each of the past two years, or the joint income of the spouses exceeds $300,000 in the past two years, and the person has a reasonable expectation of achieving the same income level in the current year (the *"Income Test"*).

Safe Harbors for Issuers

Traditionally, issuers raising capital in a Regulation D offering request purchasers make a "check-the-box" representation that they are accredited as of the execution of the Subscription Agreement. However, the SEC rejected this approach for Rule 506(c) offerings, requiring issuers to verify the representations of each purchaser. The SEC initially proposed a flexible standard, choosing not to promulgate a list of acceptable methods to verify the accreditation of the purchaser. Rather, the SEC set forth a "principles based" approach that suggested an issuer consider:

- The nature of the purchaser and the type of accredited investor the purchaser claims to be;
- The amount and type of information the issuer has about the purchaser; and
- The nature of the offering including, without limitation, how the purchaser was solicited, the terms of the offering and the minimum investment amount.

However, during the public comment period, it became clear that this flexible standard also created ambiguity for issuers attempting to comply with the new exemption. Consequently, in addition to adopting the principles based approach in the final rule, the SEC established four non-exclusive, non-mandatory safe harbors on which issuers may rely:

- Income Verification: For a purchaser claiming accredited investor status pursuant to the Income Test, an issuer may rely on Internal Revenue Service forms that report income, including Form W-2, Form 1099, Schedule K-1 of Form 1065, and a copy of the filed Form 1040 for the two most recent years, along with a written representation from the purchaser that he or she has a reasonable expectation of reaching the income necessary to qualify as an accredited investor during the current year. If the purchaser is claiming accreditation based on joint income, then the issuer must obtain written representations regarding the present year's income from both the purchaser and the spouse.
- **Net Worth Verification**: For a purchaser claiming accredited investor status based the Net Worth Test, an issuer will be deemed to satisfy the verification requirement upon reviewing one or more of the following documents dated within the prior three months:
  - With respect to assets: (i) bank statements, (ii) brokerage statements or other statements of securities holdings, certificates of deposit, and tax assessments, or (iii) appraisal reports issued by an independent third party; and
  - With respect to liabilities: a credit report from a nationwide consumer reporting agency and a written representation from the purchaser that all liabilities have been disclosed. If the purchaser is claiming accredited investor status based on joint net worth, then both the purchaser and the spouse will be required to make the representations regarding the disclosure of liabilities.
- Third-Party Confirmation: An issuer may rely on the written confirmation of a registered broker-dealer, a SEC-registered investment adviser, a licensed attorney, or a certified public account that the professional has taken reasonable steps to verify that the purchaser was an accredited investor within the prior three months.
- **Prior Investments**: An issuer may rely on a written confirmation from a purchaser who invested in the issuer's previous offering pursuant to Rule 506(b) as an accredited investor, prior to the effective date of Rule 506(c), that certifies that he or she is still accredited.

The SEC noted that an issuer is not required to use one of these safe harbors and may use any method of verification as long as it is reasonable. The SEC has provided that the determination of reasonableness will be an 'objective determination by the issuer based on the facts and circumstances of the offering'. Significantly, the SEC stated that the reasonable belief standard does not require absolute certainty, nor does the later discovery that an investor is unaccredited destroy the Rule 506(c) exemption, *provided* that the issuer had a reasonable belief that the purchaser was an accredited investor at the time of the sale and took reasonable steps to verify that belief.

Rule 506(c) Effects on Private Funds

Historically, Rule 506(b) offerings have been popular with private entities. As the SEC noted in the General Solicitation Release, in 2012, operating companies raised approximately $173 billion in capital and private funds raised approximately $725 billion in capital pursuant to Rule 506(b), nearly matching the $1.2 trillion raised in registered offerings. It is anticipated that the use of general solicitation in Rule 506(c) offerings will increase the number of private capital raises and may heighten the visibility of private companies, especially funds, to the general public. As a result, the private offering market may surpass the public market with the implementation of Rule 506(c) and create new competition for investor dollars with public companies and publicly traded funds (*e.g.*, mutual funds). However, the SEC raised concerns regarding the potential fraud and transparency issues related to private funds using general solicitation. The SEC intends to monitor and study the use of advertising and general

solicitation by private funds conducting a Rule 506(c) offering to determine whether further rule making is necessary.

Significantly, in the General Solicitation Release, the SEC confirmed that relying on Rule 506(c) would not cause a private fund to lose commonly relied on exclusions from the definition of "investment company," pursuant to Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, which do not allow public offerings of securities. The SEC noted that one of the purposes of the JOBS Act was to allow private funds to engage in general solicitation and, consequently, the SEC would not deem a private fund to be an investment company for merely relying on Rule 506(c) to raise capital.

However, private funds may lose other commonly relied on exemptions under the commodities and securities laws. Conducting an offering in reliance on Rule 506(c) may subject a private fund or its advisor to other regulatory regimes, notably:

- Private funds investing in commodity interests (including certain derivatives), may lose the popular *de minimis* exemption from the definition of commodity pool operator under Commodity Exchange Act Rule 4.13(a)(3), which is conditioned on a private fund not being "marketed to the public." The Commodity Futures Trading Commission has not commented on the new rule and whether this exemption will continue to be available to a private fund conducting a Rule 506(c) offering.

- Private fund advisors may be required to register as investment advisers if they are deemed to be holding themselves out to the public as investment advisers as a result of a Rule 506(c) offering. Regardless of registration, investment advisers and private funds will still be subject to state and federal anti-fraud provisions.

- Registered investment advisers, who may only charge a performance fee to qualified clients, may unwittingly attract investors who, while accredited, are not qualified clients, potentially limiting opportunities to charge performance fees.

In addition, the SEC has proposed extending the anti-fraud guidance in Rule 156 of the Securities Act to sales literature for private funds conducting an offering in compliance with Rule 506(c). The proposed rules would also require private funds to provide certain disclosures regarding the limited usefulness of discussions of past performance in offering materials. The SEC is accepting comments on the proposed rules through September 23, 2013.

Issues Effecting Broker-Dealers

While issuers have generally embraced Rule 506(c), broker-dealers may encounter increased liability related to these offerings. Broker-dealers participating in a Rule 506(c) offering may have difficulty complying with certain FINRA rules, including rules related to the use of sales literature and advertisements. In particular, general solicitation will likely raise issues of whether materials provided to the public: (i) comply with the approval, record keeping and content standards set forth in FINRA Rules 2201 and 5123; or (ii) are deemed to be a "recommendation" of the security by the broker-dealer under FINRA Notice to Members 11-02. Furthermore, a broker-dealer who is not a part of an offering, but agrees to confirm the accredited investor status of a purchaser, pursuant to the safe harbor discussed in the General Solicitation Release, may be exposed to SEC scrutiny and potential liability. Practically, this role transfers the obligation that the issuer has to verify the status of the purchaser, along with the associated risk, to the broker-dealer, leaving the broker-dealer vulnerable to SEC investigations and lawsuits in the event that a confirmation is inaccurate. Consequently, broker-dealers may limit their participation in Rule 506(c) offerings or require heightened indemnification provisions or increased fees to participate in such an offering.

Revisions to Form D

The SEC is currently revising Form D to add Rule 506(c) to the list of exemptions in order to monitor the usage of the new rule. In addition, the SEC proposed several additional rules regarding filing a Form D and conducting an offering in reliance of Rule 506(c), including: (i) requiring issuers to submit a Form D 15 days *before* the first sale of a security and file a closing amendment 30 days after the closing of the offering; (ii) requiring legends on materials used in general solicitation informing potential investors of risks associated with the offering; and (iii) temporarily requiring issuers to file written materials used in a Rule 506(c) general solicitation offering. The public comment period for the proposed rule ends September 23, 2013.

Blue Sky Considerations

Similar to Rule 506(b), securities issued pursuant to a Rule 506(c) offering will be deemed "covered securities" for the purposes of Section 18(b)(4)(E) of the Securities Act. As a result, the SEC stated in the General Solicitation Release that state blue sky registration requirements will not apply to securities issued or sold in compliance with a Rule 506(c) offering. Notably, state securities agencies may still require a notice filing and fee similar to the current state notice requirements for Regulation D offerings. In addition, states will retain anti-fraud authority over offerings of securities in their respective state.

Proposed Amendment to Rule 507

The SEC has proposed adopting Rule 507(b), which would disqualify an issuer from relying on Rule 506(b) or (c) for one year, if during the prior five years the issuer (or any predecessor or affiliate) failed to comply with all of the Form D filing requirements in Rule 503. Under the proposed rule, the disqualification period will start upon the issuer coming current with all Form D filings. This is an expansion of the current the rule 507 disqualification, which is only applicable to issuers with court orders or judgments enjoining the issuer, its predecessor or an affiliate for failure to comply with the filing requirements of Rule 503. The SEC has proposed a cure period of 30 days for late filings and a waiver provision for issuers showing good cause.

Rule 144A Changes

Rule 144A, a safe harbor for Section 4(a)(1), exempts certain resales of securities from registration. Unlike Regulation D, Rule 144A did not have an express prohibition on general solicitation. Nevertheless, the prior rule limited offers to QIBs, which had the same practical effect as prohibiting general solicitation. Generally, a QIB is an institution that, in the aggregate, owns and invests on a discretionary basis at least $100 million in securities of unaffiliated issuers (or $10 million for broker-dealers). Some financial institutions, including banks, must also have a net worth of at least $25 million. The amendments to Rule 144A allow for offers of these restricted securities to be made to the general public as long as sales are restricted to QIBs. Significantly, unlike the issuer verification provision of Rule 506(c), Rule 144A transactions do not require the sellers to conduct a "verification" of the purchaser's QIB status.

No Integration with Regulation S Off-Shore Offerings

In the General Solicitation Release, the SEC confirmed that it would not integrate Rule 506(c) or Rule 144A offerings with concurrent Regulation S offerings, allowing issuers to maintain a Regulation S exemption even if general solicitation is used in an on-shore offering. Pursuant to Regulation S, off-shore issuers have a safe harbor for offers and sales of securities made outside of the United States. Generally, two conditions apply: (i) the securities must be sold in an off-shore transaction; and (ii) there can be no direct selling efforts in the United States, including general solicitation. The relief provided in the General Solicitation Release ensures that the use of general solicitation in a Rule 506(c) or Rule 144A on-shore offering will not trigger "direct selling efforts" in the United States, allowing for a concurrent off-shore offering under Regulation S.

Bad Actor Rule

Pursuant to the mandate in the Dodd-Frank Act, the SEC adopted rules disqualifying felons and other bad actors from certain securities offerings relying on Rule 506 of Regulation D. In the Bad Actor Release, the SEC stated that the following are "covered persons" for the purposes of determining who may be deemed a bad actor:

- The issuer, any predecessor of the issuer or an affiliated issuer;
- Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities;
- Any investment manager to an issuer that is a pooled investment fund, along with any director, executive officer, other officer participating in the offering, general partner or managing member of any such investment manager;
- Any promoter connected with the issuer at the time of sale of the securities; and
- Any person that has received or will receive remuneration for solicitation of purchasers in connection with the sales of securities in the offering and any director, executive officer, other officer participating in the offering, general partner or managing member of such a person.

Disqualifying events include:

- Criminal Convictions: Convictions within ten years before the sale (or five years, in the case of issuers), of any felony or misdemeanor involving the sale or purchase of any security, making of any false filing to the SEC or arising out of conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment advisor or paid solicitor;
- Court Orders: Court orders, judgments or decrees of any court, entered within the five years prior to the sale of the security, that restrains or enjoins a covered person from engaging in practices involving the sale or purchase of any security, making of any false filing to the SEC or arising out of conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment advisor or paid solicitor;
- SEC Orders: Disciplinary orders, including cease-and-desist orders, from the SEC entered within five years before the sale of the security for committing a violation of any scienter-based anti-fraud provision of

the federal securities laws or Section 5 of the Securities Act;

- SEC Stop Orders: Filing, or being named as an underwriter in, any registration statement or Regulation A offering statement filed with the SEC that, within five years of the sale of the securities, was subject to a refusal order, stop order or order suspending the Regulation A exemption or an investigation thereof;

- State Regulatory Orders: Certain final orders within the last ten years of the sale of the securities of a state securities commission, a state statutory authority that supervises or examines banks or similar financial institutions, an appropriate federal banking agency, the Commodity Futures Trading Commission or the National Credit Union Administration that: (i) bar a person from association with any entity regulated by such an agency; (ii) bar a person from engaging in a business regulated by such an agency; or (iii) are based on a violation of law that prohibits fraudulent or manipulative conduct; or

- Postal Service Orders: A United States Postal Service false representation order entered within the five years before the security sale.

In addition, disqualifying events involving covered persons other than the issuer include:

- SEC Orders: Being subject to an SEC order: (i) revoking or suspending registration as a broker, dealer, municipal securities dealer or investment adviser; (ii) placing limitations on such activities; (iii) barring the covered person from association with a securities entity; or (iv) barring the covered person from participating in an offering of penny stock; or

- Membership Revocation: A suspension or expulsion from membership in, or association with, a national securities exchange or registered national securities association for any act or omission to act constituting conduct inconsistent with just and equitable principals of trade.

Significantly, the disqualification provisions do not apply with respect to any disqualification event that occurred prior to the Bad Actor Rule becoming effective. However, prior to a sale of a security, issuers conducting a Rule 506 offering must provide a written disclosure to potential investors prior to the sale of a security discussing the events that would otherwise disqualify the issuer from relying on Rule 506 pursuant to the Bad Actor Rule.

Waiver Provisions

The SEC may waive the disqualification of "bad actors" under limited circumstances:

- Reasonable Care Exemption: The issuer must establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of another covered person. The SEC declined to establish steps an issuer should take to exercise reasonable care since the rule would encompass a wide variety of issuers; rather the SEC stated that reasonableness would depend on the individual facts and circumstances of the issuer.

- Waiver for Good Cause Shown: The SEC will waive the Bad Actor Rule provisions in limited circumstances, similar to relief provided under Regulation A and Rule 505. The SEC has not articulated a standard yet, but has provided a list of circumstances when relief may be appropriate, including a change of control or a change of supervisory personnel.

- Waiver based on Determination of Issuing Authority: The SEC will grant a waiver if a state regulator issuing an order determines that disqualification is not necessary under the circumstances. Even in the absence of a state waiver, the SEC may exercise discretion and grant a waiver in appropriate cases.

For More Information

If you would like to discuss any of these issues discussed in this Client Alert, please contact any attorney in our Corporate Finance and Securities Department or visit us online at www.chapman.com.