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SEC Adopts Rule Changes Allowing General Solicitation in Private Placements Under Rule 506 of Regulation D and Rule 144A

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On July 10, 2013, the US Securities and Exchange Commission (the "SEC") adopted rule changes that will permit general solicitation and general advertising in securities offerings under Rule 506 of Regulation D and Rule 144A. The rule changes fulfill a requirement of the Jumpstart Our Business Startups Act (the "JOBS Act")[1] and are expected to become effective in mid-September. The SEC also adopted rule changes that disqualify felons and other bad actors from being able to rely on the Rule 506 safe harbor. In addition, the SEC proposed new data collection measures that would impose expanded filing requirements on offerings conducted under Rule 506.

Changes to Rules Governing Private Sales of Securities Under Rule 506

Securities offerings that comply with the non-exclusive safe harbor of Rule 506 have long been exempt from Securities Act registration requirements provided that the securities are not offered in a general solicitation or through general advertising[2], and are sold only to accredited investors and up to 35 sophisticated investors.

1 On August 29, 2012, the SEC issued proposed rule changes to Rule 506 and Rule 144A in response to Section 201(a) of the JOBS Act, which required the SEC to adopt rule changes that would permit general solicitation and advertising in Rule 506 and Rule 144A offerings. Our prior publication describing the proposed rule changes can be found here.

2 Although neither "general solicitation" nor "general advertising" is defined, Rule 502(c) of Regulation D provides qualifying examples including newspaper and magazine advertisements, television and radio broadcasts, and seminars. The SEC has also interpreted "general solicitation" and "general advertising" to include the use of unrestricted websites.

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The rule changes add a new Rule 506(c) that will permit the use of general solicitation and advertising under Rule 506 as long as the issuer takes "reasonable steps" to verify that all purchases are made by accredited investors or by purchasers reasonably believed to be accredited investors at the time of sale. Although the rule changes do not define "reasonable steps," Rule 506(c) as adopted, in a modification from the proposed rules, lists methods an issuer may use to verify accredited investor status of a natural person that are deemed to be "reasonable." The list, which is non-exhaustive, includes:

- Receipt of certain documentation of levels of income or net worth of the purchaser (such as tax returns, bank statements, and credit reports);
- Verification of accredited investor status from certain third-parties, such as a registered broker-dealer, a registered investment adviser, a licensed attorney, or a certified public accountant; or
- In a form of grandfathering, for existing investors in a Rule 506 offering by the issuer, simply the receipt of a certification from the purchaser that such investor is an accredited investor.

The SEC release states that what steps are "reasonable" will be "an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction." Issuers still may conduct offerings in reliance on "old" Rule 506 (now Rule 506(b)) and not be subject to the new verification rules if they do not use general solicitation or advertising, in so-called "quiet" offerings. Similarly, "old" Rule 506 offerings may still accept up to 35 sophisticated non-accredited investors, which is not the case for offerings under new Rule 506(c). The action by the SEC does not extend to private placements conducted in reliance on Section 4(a)(2).

As was proposed, the SEC also adopted a rule change that will amend Rule 506 to disqualify securities offerings involving felons and other "bad actors" from reliance on the safe harbor exemption from registration provided by Regulation D, in accordance with a mandate contained in Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Unlike the proposed rules, the final rules provide that the disqualification will apply only to persons whose final order or conviction occurs after the date of effectiveness of the rule changes (although the conduct may have taken place before that), but the rules do require disclosure of a pre-effectiveness triggering event. The final rules also depart from the proposed rules by limiting the definition of "officers" to executive officers and other officers who participated in the offering and limit the rule's application to securityholders to those that own at least 20% of the issuer's outstanding voting securities as measured by voting power.[3]

[3] The application of the "bad actor" rule to large securityholders unaffiliated with the issuer or its sponsors will pose a variety of practical challenges, notably, in terms of identification, as ownership is not always clear, how to apply continuing diligence and what remedies might be available if an issue arises.

Changes to Rule 144A Governing Resales

Before the rule changes, Rule 144A provided an exemption from the registration requirements of the Securities Act if offers and sales of securities by persons other than the issuer were made to "qualified institutional buyers" ("QIBs") or persons reasonably believed to be QIBs.

The adopted rule changes will amend Rule 144A(d)(1) to remove references to the words "offer" and "offeree." Consequently, sellers (or persons acting on their behalf) will be able to benefit from the exemption from registration provided by Rule 144A regardless of who is the offeree (i.e., QIBs or non-QIBs) as long as only QIBs or persons reasonably believed to be QIBs purchase the securities. The adopting release helpfully clarifies that using general solicitation for resales under Rule 144A will not affect the availability of the Section 4(a)(2) private placement exemption for the initial sale by the issuer to the initial purchasers.

No Integration with Regulation S Offerings

The Regulation S safe harbor exemption from registration for certain offers and sales of securities outside the United States is available as long as there are no "directed selling efforts" in the United States. In the adopting release, the SEC confirmed its view, previously stated in the proposing release, that offerings done in compliance with Regulation S will not be integrated with domestic offerings that are conducted in compliance with Rule 506 or Rule 144A, as amended.

Effects on Private Funds

Much of the media and public interest in these provisions of the JOBS Act focused on the fact that hedge funds and other private funds will, for the first time, be able to engage in general advertising. It remains to be seen whether current practices in the private fund community will undergo anything more than incremental changes, as many hedge and private equity fund managers stress exclusivity and consciously seek to distinguish themselves from mass-market financial services providers. As discussed in the "Proposed Rules" summary below, fund managers may wish to assess potential issues relating to proposed requirements to file offering memoranda and other materials that constitute a general solicitation or advertising.[4]

Proposed Rules

The SEC announced proposed amendments to Regulation D, Form D and Rule 156 (relating to investment company sales literature) that are aimed at enhancing the SEC's ability to evaluate market practices in offerings conducted under Regulation D that use general solicitation and advertising and to monitor and evaluate the effect of the new rule changes on investors and the market. The proposed rules would impose additional filing and disclosure requirements on issuers using general solicitation and advertising in Rule 506 offerings.

Specifically, the proposed rules would, in addition to the current requirements, impose the following requirements for issuers using general solicitation and advertising in a Rule 506 offering:

- Filing a Form D no later than 15 calendar days in advance of the first use of general solicitation;
- Filing a closing Form D amendment within 30 calendar days after the termination of the offering;

[4] Certain funds also rely on registration exemptions overseen by the Commodity Futures Trading Commission ("CFTC") that contain parallel limits on public offering activity. There is as yet no confirmation from the CFTC that it likewise will accept the new public offering activity sanctioned by the SEC rules. Funds relying on certain CFTC exemptions therefore may find themselves caught between conflicting positions of these two regulators.

- Including in the Form D additional information concerning the offering, including the types of general solicitation used, the methods used to verify the accredited investor status of purchasers, categories of investors, and additional information about the issuer;
- Including certain legends in any written general solicitation materials; and
- If a private fund's general solicitation materials include performance data, additional disclosures for private funds, including a telephone number or a website where an investor may obtain current performance data.

Under the proposed rules, an issuer would be disqualified from using Rule 506 for future offerings if it, or its predecessors or affiliates, has failed to comply within the past five years with the Form D filing requirements in connection with a securities offering under Rule 506. The proposed disqualification would end one year after the required Form D filings are made. Also, the proposed disqualification would not affect reliance on Rule 506 for on-going offerings at the time of the filing non-compliance. Disqualification would apply to future offerings only. The proposals do provide for a cure period and a waiver process.

The proposed rules would also amend Rule 156, which provides guidance on the types of information in sales literature of investment companies that could be misleading to investors. The proposed rules would explicitly extend the application of the guidance in Rule 156 to the sales literature of private funds.

In addition, a proposed new temporary rule, Rule 510T, would require any issuer relying on new Rule 506(c) to file with the SEC its offering memoranda or other written communications that constitute a general solicitation or advertising. The filings would not be accessible by the public but, until the rule's expiration after two years, would allow the SEC to scrutinize the terms and disclosures of private offerings and compile data. Before relying on Rule 506(c), issuers may wish to assess the expenses and administrative burdens of such proposed SEC filing requirements.

Effectiveness of Rule Changes

The final rule changes to Rule 506 and Rule 144A will become effective 60 days after publication in the Federal Register, so we anticipate that the final rules will become effective in mid-September.

Rule Releases

- Final Rule Release – General Solicitation and Advertising: http://www.sec.gov/rules/final/2013/33-9415.pdf.
- Final Rule Release – Disqualification of "Bad Actors": http://www.sec.gov/rules/final/2013/33-9414.pdf.
- Proposed Rule Release – Filing and Disclosure: http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

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