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INVESTMENT MANAGEMENT GROUP

SEC TAKES SIGNIFICANT ACTIONS WITH RESPECT TO BAN ON GENERAL SOLICITATION AND ADVERTISING IN PRIVATE PLACEMENTS; FINALIZES DISQUALIFICATION FOR CERTAIN "BAD ACTORS"; AND PROPOSES SIGNIFICANT CHANGES TO FORM D AND PRIVATE PLACEMENT PROCESS

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On July 10, 2013, in an open meeting of the Securities and Exchange Commission ("SEC"), the SEC took certain actions that will significantly alter the current private placement landscape. Specifically, the SEC adopted final rules implementing Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"), which will eliminate the prohibition on general solicitation and advertising for certain offerings made under Rule 506 of Regulation D of the Securities Act of 1933 (the "Securities Act") and for certain offerings made pursuant to Rule 144A under the Securities Act. In connection with this issuance, the SEC also adopted certain changes to Form D to accommodate the elimination of the prohibition on general solicitation and advertising.

During the open meeting, the SEC also adopted a final rule that will preclude issuers from relying upon Rule 506 with respect to certain securities offerings conducted by or involving certain felons and other "bad actors." The SEC implemented this final rule in furtherance of a mandate imposed by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Finally, the SEC also issued a proposed rule that will, if adopted, among other things, amend Regulation D, Form D and Rule 156 under the Securities Act. These rule proposals are intended to enhance the SEC's ability to evaluate changes in the market and to address the development of practices in Rule 506 offerings, particularly with respect to private offerings involving general solicitation conducted pursuant to Rule 506(c), which we discuss below.

Current Landscape and Overview of Rule 506(c)

Under the current law, issuers conducting private placements are precluded from attracting potential investors by means of general solicitations or general advertising, including, without limitation, communications in newspapers, television or radio broadcasts, and unsecured website publications, and from conducting seminars where attendees have been invited by means of general solicitation or advertising. The JOBS Act, which was signed into law by President Obama on April 5, 2012, was intended, in part, to permit businesses to gain less restrictive access to sufficient sources of capital by removing the ban on general solicitations and advertising with respect to Rule 506 private placements. Issuers will still be permitted to conduct private placements pursuant to current Rule 506(b), which prohibits general solicitation and advertising in connection with private placements. As discussed in more detail below, issuers may wish to continue with current Rule 506(b) offerings rather than availing themselves of Rule 506(c) for various reasons, such as preservation of other regulatory exemptions that may not be available with Rule 506(c) offerings or administrative and financial costs involved in complying with various requirements of Rule 506(c) offerings.

In order to implement Section 201(a) of the JOBS Act, the SEC has promulgated Rule 506(c), which will permit issuers to conduct private placements by means of general solicitation and advertising, provided that all purchasers of the securities issued in such private placements are accredited investors and issuers take reasonable steps to verify that such purchasers are accredited investors. The SEC's final rules note that the "reasonable steps" requirement is separate and distinct from the requirement that only accredited investors may participate in the offering (even if all purchasers actually happen to be accredited investors).

Reasonable Steps Requirement of Rule 506(c)

Whether an issuer takes reasonable steps to verify the accredited investor status of purchasers 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." The SEC's final rules describes this determination as a principles-based approach that would permit issuers to consider a number of factors, including:

1) the nature of the purchaser and the type of investor;

2) the amount and type of information that the issuer has about the purchaser; and

3) the nature of the offering.

The SEC's final rules provide certain illustrations of this principles-based approach. For instance, the final rules note that in certain circumstances, purchasers able to meet high minimum investment requirements may suggest that such purchasers are accredited investors and would, therefore, mean that it "may be reasonable for the issuer to take fewer steps to verify or, in certain cases, no additional steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by a third party." Additionally, the final rules provide that issuers conducting wide-ranging general solicitations and advertising (e.g., widely disseminating e-mails and/or using social media solicitation) will likely be obligated to use more detailed measures to verify the accredited investor status of purchasers. Of particular import, the final rules expressly provide that simply relying upon a check-the-box representation or signature form will not satisfy the reasonable verification requirement absent additional information relating to the purchaser.

Although the SEC established a principles-based approach as to whether an issuer has fulfilled the reasonable steps requirement, the SEC also provided a non-exclusive list of methods that issuers may use to verify the accredited investor status of natural persons, because, as the SEC notes in its final rules, verifying the status of natural persons may present more uncertainty. These methods, which are expressly set forth in Rule 506(c), will be deemed to have satisfied the reasonable verification requirement if the issuer or its agent does not have knowledge that the applicable investor is not an accredited investor. These non-exclusive methods include, without limitation,

1) verifying an investor's income by utilizing certain tax-related forms (e.g., Forms W-2, Schedules K-1), along with obtaining written representation from the investor that the investor will satisfy the accredited investor requirements;

2) verifying an investor's net worth by reviewing certain documentation dated within three months (e.g., bank statements, certificates of deposit, tax assessments, consumer reports), along with obtaining written verification from the investor that all liabilities needed to determine accredited investor status have been disclosed;

3) obtaining written verification from certain persons (e.g., broker-dealers, SEC registered investment advisers, licensed attorneys or certified public accountants) that such persons have taken reasonable steps within the prior three months to verify, and have verified, that the purchaser is an accredited investor; and

4) with respect to any natural person who invested in an issuer's old Rule 506(b) offering prior to the effective date of Rule 506(c) and remains an investor of the issuer, the issuer will be deemed to satisfy the reasonable verification requirement by obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

The SEC expressly stated that the reasonable verification requirement does not negate the reasonable belief standard set forth in the definition of accredited investor provided in Regulation D. Importantly, this means that even where an investor does not actually meet the accredited investor standard, an issuer would not necessarily lose the protection of Rule 506(c). As the SEC stated, "We believe that [an] issuer will not lose the ability to rely on Rule 506(c) for [an] offering, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale."

Importantly, the SEC's final rules note that issuers may utilize the services of third parties, including, but not limited to, those set forth in point 3 of the non-exclusive methods list set forth above, to verify the accredited investor status of purchasers, so long as the issuers have a reasonable basis to rely upon such third-party verification. The SEC was careful to note, however, that the burden of proving the availability of Rule 506(c) (as with other exemptions from the registration requirements under the Securities Act) falls on the issuer and that it is imperative that issuers (and/or their service providers) maintain adequate records regarding the steps taken to verify the accredited investor status of purchasers. The SEC further specified that it will carefully monitor the usage of Rule 506(c) and the steps that issuers take to verify the accredited investor status of purchasers.

The SEC's final rules will also permit issuers to conduct general solicitation and general advertising in securities offerings pursuant to Rule 144A, provided that the purchasers in such offering are limited solely to qualified institutional buyers ("QIBs"). Importantly, the SEC also expressly provided that concurrent offshore offerings that are conducted in compliance with Regulation S of the Securities Act "will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as amended." This statement is particularly helpful for advisers to domestic and offshore private funds where the domestic

funds offer interests in compliance with Rule 506 and the offshore funds offer interests outside of the United States in compliance with Regulation S.

Transition

The SEC's final rules note that for ongoing offerings (e.g., for hedge funds that still permit subscriptions and private equity funds and venture capital funds that are still in their admission periods) that commenced prior to the effectiveness of Rule 506(c), issuers may choose to continue the offering after the effective date in accordance with either Rule 506(c) or current Rule 506(b). The SEC also noted that for issuers choosing to conduct general solicitation and advertising in accordance with Rule 506(c), any such general solicitation and advertising conducted after the effective date will not affect the status of offers and sales conducted pursuant to old Rule 506(b) prior to such effective date.

Form D Amendments

Under Rule 503 of Regulation D, issuers availing themselves of the Rule 506 private placement exemption (as well as the private placement exemptions provided by Rules 504 and 505 under Regulation D) must file a Form D with the SEC that contains certain publicly available information relating to the issuer. In connection with the promulgation of Rule 506(c), the SEC has amended Form D to incorporate a reference to Rule 506(c), as well as certain additional conforming changes. The SEC's final rules also provide that issuers will not be able to claim exemption under old Rule 506(b) and Rule 506(c) simultaneously. The SEC plans to use the amended Form D as a method to track the effectiveness of Rule 506(c) and, in particular, any effects that the Rule may have on capital raising activities.

Private Funds

The SEC's final rules provide certain additional commentary relating to private funds and their advisers. Specifically, the SEC has reaffirmed its position stated in the SEC's initial rule proposal relating to Rule 506(c) (which we analyzed in a Lowenstein Sandler Investment Management Group Client Alert available here), that offerings conducted pursuant to Rule 506(c) will not be deemed "public offerings" under the federal securities laws and that, therefore, issuers conducting such offerings will not lose their applicable Investment Company Act registration exclusions provided by Section 3(c)(1) and 3(c)(7) of that Act. This means that private funds such as hedge funds, private equity funds and venture capital funds will, under certain circumstances, be able to avail themselves of Rule 506(c) and maintain their exclusionary status from regulation under the Investment Company Act. However, less certain is the effect that Rule 506(c) offerings would have on (i) the exemption from registration as a commodity pool operator ("CPO") provided under Commodity Futures Trading Commission ("CFTC") Rule 4.13(a)(3), which also prohibits "public offerings" and (ii) the exemption from certain heightened disclosure requirements for registered CPOs provided under CFTC Rule 4.7, which refers to offerings qualifying for exemption from the registration requirements of the Securities Act pursuant to section 4(2) of that Act or pursuant to Regulation S. Rule 4.13(a)(3), which, among other things, requires a fund sponsor to trade commodity interests within certain *de minimis* limits, is often relied on by private fund managers, as is Rule 4.7.

The SEC's final rules expressly state that the SEC will monitor and study the development of private fund advertising and undertake a review to determine whether any further rulemaking action is necessary. Additionally, the SEC reminded advisers to private funds of their obligations under the anti-fraud rules of the Investment Advisers Act and stated their belief that advisers to private funds should carefully review their policies and procedures "to determine whether they are reasonably designed to prevent the use of fraudulent or materially misleading private fund advertising and make appropriate amendments to those policies and procedures, particularly if the private funds intend to engage in general solicitation activity."

Disqualification of Felons and Other "Bad Actors"

As mentioned above, on July 10, 2013, the SEC also adopted final rule amendments to Rules 501 and 506 of Regulation D that will preclude issuers from relying upon Rule 506 with respect to certain securities offerings conducted by or involving certain felons and other "bad actors." The SEC's final rules provide the following:

1) The disqualification triggers will apply only for certain acts that occur after the effective date of the amended rules, provided that certain pre-existing matters will be subject to mandatory disclosure by subject issuers.

2) The disqualifying events will be limited to executive officers of an issuer and officers of an issuer who participate in the offering.

3) The disqualifying events will also apply to persons that have been or will be paid remuneration for soliciting purchasers, executive officers of such solicitors and officers of such solicitors who participate in the offering.

4) The disqualifying events will cover beneficial owners of 20 % or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power.

5) For issuers that are private funds, the final disqualifying events will cover the funds' investment managers and their principals.

6) Disqualification will not apply if the regulatory authority issuing the relevant triggering directive or statement advises the SEC that disqualification from reliance on Rule 506 should not arise as a result of the directive or statement.

The SEC's final rules also provide an exception from disqualification for offerings where an issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. With respect to continuous offerings (e.g., for hedge funds that still permit subscriptions and private equity funds and venture capital funds that are still in their admission periods), reasonable care would include updating the factual inquiry as to whether any such disqualifications exist on a reasonable basis, with the frequency and degree of updating depending upon the circumstances of the issuer, the offering and the participants involved.

Proposed Amendments to Form D and Rule 156 Under the Securities Act

In addition to the final rules relating to the JOBS Act and the Dodd-Frank Act that are discussed above, on July 10, 2013, the SEC also issued certain proposed rules that, if promulgated, would have significant effects with respect to the conduct of private placements under Rule 506 and with respect to the information required to be included on Form D. As the SEC stated in its proposed rules, the "proposed amendments are intended to enhance the [SEC'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." Specifically, these proposals would:

1) require issuers to file an advance Form D in Rule 506(c) offerings before the issuer engages in general solicitation and advertising (or, where applicable, amend a current Form D for issuers conducting a continuous offering in reliance upon Rule 506(b) and switching to Rule 506(c));

2) require issuers conducting a Rule 506(c) offering to file an amendment to their advance Form D filing within 15 calendar days after the date of first sale of securities in the offering, which amendments would provide additional information relating to the offering;

3) require all issuers to file a closing amendment to Form D after the termination of any Rule 506 offering;

4) require the temporary submission to the SEC, on a confidential basis, of written general solicitation and advertising materials used in Rule 506(c) offerings;[1]

5) require issuers to include certain legends and other disclosures on materials used with respect to offerings conducted pursuant to Rule 506(c) (which, with respect to offering materials relating to private funds would include legends disclosing that the funds' securities are not subject to the protections of the Investment Company Act and additional disclosures with respect to offering materials that include performance data);

6) disqualify issuers from relying on Rule 506 for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering;[2]

7) require all issuers that conduct Rule 506 (as well as Rule 504 and Rule 505) offerings to include additional information relating to their offerings on Form D;[3] and

8) extend the anti-fraud guidance contained in Rule 156 of the Securities Act to the sales literature of private funds.[4]

Effective Dates; Links to Rules and Comment Date

The effective dates for the final rules relating to the elimination of the prohibition with respect to general solicitation and advertising and the final rules relating to disqualifications of felons and other "bad actors" are each 60 days after publication of the applicable rules in the *Federal Register*, which effective dates are expected to be in September 2013. Links to these final rules are available here and here, respectively. Public comments with respect to the SEC's proposed rules relating to amendments to Regulation D, Form D and Rule 156 under the Securities Act will be accepted until 60 days after publication of the proposed rules in the *Federal Register*. A link to the SEC's rule proposal is available here.

Conclusion and Next Steps

Upon effectiveness, the new rules will significantly change the way some businesses raise capital through private placement offerings. For advisers to private funds, a determination must first be made as to whether such advisers wish to market their funds through means of general solicitation and advertising, and whether such means are feasible from a regulatory perspective, particularly in light of such advisers' (and their respective affiliates') other viable exemptions, such as exemptions from registration as CPOs. Such advisers may wish to consider how potential investors will react to requests for additional personal information that may be needed to verify their accredited investor status, the costs of complying with Rule 506(c) verification requirements in relation to the expected amount of investor inflows that a Rule 506(c) offering is likely to contribute, the marketing budget that can be devoted to a Rule 506(c) offering and whether a Rule 506(c) offering could be expected to reach the desired capital base in a cost-effective manner. Many advisers are likely to take a wait-and-see approach as a result of the SEC's expanded Rule 506

proposals discussed in this alert and the uncertainty of Rule 506(c)'s effect on CFTC Rule 4.13(a)(3) and, to a lesser extent, CFTC Rule 4.7.

For those issuers that can conduct, and choose to conduct, private placements through general solicitation and advertising, significant assessment of policies and procedures to address the requirements of Rule 506(c) must be made. Moreover, the SEC's actions present a significant opportunity for all advisers to review their policies and procedures relating to marketing, whether or not such advisers wish to utilize Rule 506(c) with respect to their advised private funds. All advisers should be aware that the current anti-fraud rules under both federal and state securities laws will continue to apply to all private placement offerings and the means through which such advisers conduct private placement offerings. Specifically, these anti-fraud rules (i) prohibit any person from engaging in manipulative, fraudulent or deceptive activities and (ii) require disclosure of all material information regarding an investment.

We also recommend that our clients consider commenting on the SEC's proposed rules with respect to the revisions to Form D and Rule 156 under the Securities Act. Since these proposals, if passed, could significantly affect disclosures relating to private placements and the Form D filings process, clients may wish to make their views regarding the proposals known to the SEC. Comments to the SEC's rule proposal may be made here.

Lowenstein Sandler's Investment Management Group will keep you advised of further developments regarding this important legislation and other regulatory proposals. Please contact any of the attorneys listed, or any other member of Lowenstein Sandler's Investment Management Group, for further information on the matters discussed in this Client Alert.

[1] The SEC's proposed rules do not detail the scope of what would be included in these materials; instead such proposed rules refer only to "any written communication that constitutes a general solicitation or general advertising."

[2] This disqualification would be for a period of one year after all required Form D filings are made.

[3] Such information would include, without limitation, website identification; names and addresses of control persons; information relating to revenues or net asset value to the extent that the issuer makes such information publicly available elsewhere; information relating to the types of purchasers that have participated in the offering; with respect to private funds, the name and SEC file number of each investment adviser that functions as a promoter of the issuer; and information relating to the means of accredited investor verification for those issuers utilizing Rule 506(c).

[4] Rule 156 provides certain guidance with respect to sales literature being materially misleading if it (1) contains an untrue statement of a material fact or (2) omits to state a material fact necessary in order to make a statement made, in the light of the circumstances of its use, not misleading.

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