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SEC ADOPTS JOBS ACT PRIVATE PLACEMENT PROVISIONS: LIFTS BAN ON GENERAL SOLICITATION AND ADVERTISING IN PRIVATE PLACEMENTS

On July 10, 2013, the Securities and Exchange Commission ("SEC") approved by a vote of 4-1 final rules that eliminate the prohibition against general solicitation and advertising in certain private offerings of securities. In addition, the SEC approved a final rule to disqualify issuers from relying on Rule 506 of the Securities Act of 1933 if certain felons and other "bad actors" are participating in such offering. Finally, the SEC proposed rules for comment in relation to their ability to evaluate the development of market practices in Rule 506 offerings.

Amendments to Rule 506 and Rule 144A to Lift General Solicitation and Advertising Ban

Companies, private equity funds, venture capital funds or hedge funds seeking to raise capital through the sale of securities must either register the offering with the SEC, or rely on one of the many exemptions from registration. Under current Rule 506 of Regulation D, the most widely-used exemption, an issuer may sell an unlimited amount of securities to an unlimited number of "accredited investors" and up to 35 non-accredited investors. Under this exemption, however, the issuer cannot offer or sell such securities through any form of general solicitation or general advertising.

Section 201(a)(1) of the Jumpstart Our Business Startups Act ("JOBS Act") required the SEC to remove this long standing prohibition on general solicitation and advertising provided that sales are limited to accredited investors and an issuer takes reasonable steps to verify that all purchasers of the securities are accredited investors. Last August, the SEC proposed amendments to Rule 506 in accordance with this requirement. The SEC adopted the final rules, as described below, largely as proposed.

<u>New Rule 506</u>

Under new Rule 506(c), issuers are permitted to engage in general solicitation and general advertising when offering their securities as long as:

- All terms and conditions of Rule 501[1] and Rules 502(a)[2] and 502(d)[3] are satisfied;
- All purchasers of the securities are accredited investors; and
- The issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors.

[1] Rule 501 sets forth the definitions of terms used in Regulation D, such as "accredited investor." A person qualifies as an accredited investor if he has either (i) an individual net worth or joint net worth with a spouse that exceeds $1 million at the time of purchase, excluding the value of a primary residence, or (ii) an individual annual income that exceeded $200,000 in each of the two most recent years or a joint annual income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year.

[2] Rule 502(a) addresses the question of integration of successive Regulation D offerings.

[3] Rule 502(d) provides that, for resale purposes, securities acquired in a Regulation D offering have the status of "restricted securities" and cannot be sold without registration or an exemption from registration.

"*Reasonable Steps to Verify Accredited Investor Status*"

Consistent with the proposed rules, the final rule release stated that the determination of the reasonableness of the steps taken to verify accredited investor status is a principle-based determination by the issuer based on the facts and circumstances of the transaction. The SEC listed the following factors that issuers should consider in making this determination:

- The nature of the purchaser and the type of accredited investor the purchaser claims to be;
- The amount and type of information that the issuer has about the purchaser; and
- The nature of the offering, such as 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.

The SEC stated that because the burden is on the issuer to demonstrate that it is entitled to an exemption from registration, the issuer should keep adequate records regarding the steps taken to verify that a purchaser was an accredited investor.

Additionally, in response to comments on the proposed rules, the final rules contain four specific *non-exclusive* methods of verifying accredited investor status for natural persons. New Rule 506(c) states that an issuer will be considered to have satisfied the verification requirement if it does any of the following:

- If determining on the basis of income, reviews any IRS forms that reports the person's income for the last two years, and obtains a written representation from such person that he has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;
- If determining on the basis of net worth, reviews one or more of the following types of documentation, and obtains a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed: (for assets) bank statements, brokerage statements, certificates of deposit, tax assessments and (for liabilities) a credit report.
- Obtains written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the past three months and has determined that such person is an accredited investor.
- Obtains a certification from a prior accredited investor purchaser (and still current holder) in an issuer's Rule 506(b) offering (prior to the effectiveness of the new Rule 506(c)) that he qualifies as an accredited investor.

The SEC makes clear that the use of any of these four methods is not mandatory and actually expects that most issuers will choose to use the "principles-based" method of verification, "in light of its flexibility and efficiency."

Note that issuers who do not wish to engage in general solicitation and general advertising in their private placement offerings can still use Rule 506(b) (and will not be subject to the new verification requirement).

The SEC also amended Form D to add a box for issuers to check if they are relying on the new Rule 506(c) exemption.

Amendments to Rule 144A

The SEC also adopted amendments to Rule 144A[4]. Although Rule 144A does not include an express prohibition against general solicitation, currently, offers of securities can only be made to QIBs, which has the same practical effect. The amendments to Rule 144A will allow issuers to offer securities to persons other than QIBs, including by means of general solicitation and advertising, as long as the securities are only sold to persons that the seller reasonably believes is a QIB.

Integration with Offshore Offerings

The SEC also reaffirmed its position taken in the August proposing release that concurrent offshore offerings that are conducted in compliance with Regulation S[5] will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as amended.

These final rules are effective on September 23, 2013.

"Bad Actor" Disqualification in Rule 506 Offerings

In connection with the Rule 506 amendments and as required by Section 926 of the Dodd-Frank Act, the SEC also adopted final rules that disqualify issuers from using the Rule 506 exemption if felons and certain "bad actors" are involved in the offering.

New Rule 506(d) states that an issuer cannot rely on the Rule 506 exemption if certain persons (who are connected in some way to the issuer) are involved in a disqualifying event. The persons covered by the rule include:

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

[4] Rule 144A is a non-exclusive safe harbor exemption from registration for resales of certain "restricted securities' to Qualified Institutional Buyers ("QIBs", as they are commonly known).

[5] Regulation S provides a safe harbor for offers and sales of securities outside the United States.

Rule 506(d)(1) sets forth the disqualifying events. They include:

- A conviction, within 10 years before the sale of securities (or 5 years, in the case of issuers, their predecessors and any affiliated issuers), of any felony or misdemeanor, or court injunctions or restraining orders within 5 years of the sale of securities (A) in connection with the purchase or sale of any security, (B) involving the making of any false filing with the SEC, or (C) arising out of the conduct of the business of an underwriter, broker, dealer, investment adviser or paid solicitor of purchasers of securities;

- Is subject to a final order of a state securities, banking, or insurance agency, a federal banking agency, the U.S. Commodity Futures Trading Commission, or the National Credit Union Administration that (A) bars the person from associating with an entity regulation by such entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities; or (B) is based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered into within 10 years before the proposed sale of security;

- Is subject to an SEC order pursuant to the Securities Exchange Act of 1934 or of the Investment Advisers Act of 1940 that, at the time of the proposed sale, (A) suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser, (B) places limitations on the activities, functions or operations of such person, or (C) bars such person from being associated with any entity or from participating in the offering of any penny stock;

- Is subject to an SEC order entered into within 5 years that orders the person to cease and desist from committing or causing a violation of any scienter-based anti-fraud provision of the federal securities laws, or any violation of Section 5 of the Securities Act of 1933;

- Is currently suspended or expelled from membership of a registered national securities exchange for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

- Has filed, or was named as an underwriter in, any registration statement that was subject to a stop order or order suspending Regulation A exemption within 5 years before the proposed sale;

- Is subject to a U.S. Postal Services false representation order issued within the past 5 years.

Exceptions from Disqualification

Disqualifying events that occurred before the effective date of the final rules (September 23, 2013) will not be subject to the new disqualification rule. However, the issuer must disclose to prospective Rule 506 purchasers prior to the sale any events that would have triggered disqualification under Rule 506(d), but occurred before September 23, 2013.

Also, if the issuer can establish that it did not know, *in the exercise of reasonable care*, that a disqualification event existed, it will not be precluded from using the Rule 506 exemption. In order to establish that it exercised reasonable care, the issuer must have made a factual inquiry into whether any disqualification exists.

In addition, an issuer can seek a waiver from the SEC upon a showing of good cause. Finally, a disqualification will not apply if the court who issued the order, injunction or decree advises the SEC that it should not be a disqualification event under Rule 506(d).

SEC Proposals to Evaluate Rule 506 Market Practices and Provide Investor Protection

In addition to the adoption of final rules related to Rule 506, the SEC also proposed new rules that are designed to (i) enable the SEC to evaluate the development of private placement market practices once the prohibition on general solicitation is lifted and (ii) provide additional investor protection safeguards due to the fact that the solicitation ban will be lifted.

Proposed Amendments Related to Form D

The proposed rules would require issuers who intend to engage in general solicitation and advertising in reliance on Rule 506(c) to file a Form D no later than 15 days before engaging in such solicitation (currently an issuer must file a Form D within 15 days of the first sale of securities in a Regulation D offering).

In addition, the SEC proposes to revise Form D to require the disclosure of the following additional information:

- The issuer's website address;
- Information about any person who controls the issuer (for Rule 506(c) offerings);
- The trading symbol and security identifier (e.g. CUSIP number);
- Information about number and types of accredited investors in the offerings (for Rule 506 offerings);
- More detailed information about use of proceeds (for Rule 506 offerings);
- For Rule 506(c) offerings, the types of general solicitation used or to be used (e.g., mass mailings, social media, public websites);
- For Rule 506(c) offerings, the methods used or to be used to verify the accredited investor status of purchasers.

The SEC also proposed an amendment to Rule 507 that would disqualify issuers from using Rule 506 for future offerings if they have failed to file any required Form D report within the last 5 years. The disqualification would last for a period of one year after all required Form D filings are made.

Proposed Amendments Related to General Solicitation Materials

New Rule 509 was also proposed, which would require legends on any written general solicitation materials used in a Rule 506(c) offering. The legends would have to state the following: that securities can only be sold to accredited investors; that the securities are being offered under an exemption from registration and there are no specific disclosure requirements for this type of offering; that the SEC has not passed on the merits of the offering; that investing involves risk and investors should be able to bear the loss of their investment; and that the securities are subject to restrictions on transfer and resale and investors should not assume they will be able to resell their securities.

In addition, a temporary Rule 510T was proposed that would require issuers using Rule 506(c) to submit to the SEC their general solicitation materials by no later than the date of their first use. The materials submitted would not be made publicly available nor would they be considered furnished or filed under the Securities Act of 1933 or the Exchange Act of 1934. This temporary rule would expire two years from its effective date.

The SEC is accepting comments on all of these proposed rules until September 23, 2013.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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