Corporate Finance Alert

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August 2013

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Shout It From the Rooftops! SEC Removes Ban on General Solicitation and Advertising for Certain Private Placements

On July 10, 2013, the Securities and Exchange Commission (SEC) eliminated the restriction on general solicitation and general advertising in certain private placements, providing increased flexibility for marketing and other communications with investors in connection with these offerings. The SEC also took other actions related to private placements. The final rules will become effective on September 23, 2013.

Specifically, the SEC:

- **Adopted final rules to implement the Jumpstart Our Business Startups Act of 2012 (the JOBS Act) requirement to eliminate the prohibition against general solicitation and general advertising** in private offerings made in reliance on Rule 506 of Regulation D or Rule 144A under the Securities Act of 1933 (Securities Act);[1]
- **Proposed rules that would, if adopted, enhance the SEC's ability to evaluate market practices in Rule 506 offerings** and provide, as needed, additional investor protections as the Rule 506 market evolves;[2] and
- **Adopted rules to disqualify certain securities offerings involving "bad actors" from reliance on Rule 506 whether or not general solicitation and general advertising are used**, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[3]

The new and proposed rules have the potential to transform the private placement market. The final rules attempt to strike a balance between facilitating capital formation and protecting investors, while implementing congressional mandates. While the proposed rules aim for the same balance, they may be criticized for imposing significant new compliance burdens on issuers and private funds, including multiple expanded Form D filings, that may deter the use of the new marketing flexibility. Based on the number and tenor of the public comments received during the rulemaking process and comments made during the SEC's open meeting on July 10, 2013, the debate over whether these measures, in fact, will strike the correct balance is sure to continue.

A summary of adopted amendments to Rule 506, Rule 144A and Form D appears on the next page.

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Summary of Adopted Amendments to Rule 506, Rule 144A and Form D

	Prior to Amendments	As Amended
Rule 506	• An issuer is not permitted to offer or sell securities through any form of general solicitation or general advertising* • Safe harbor does not disqualify securities offerings in which certain felons and other "bad actors" are involved • Issuers may sell securities to up to 35 non-accredited investors who meet certain sophistication requirements	• An issuer (including a privately offered fund) is permitted to use general solicitation and general advertising to offer and sell securities under new Rule 506(c) (General Solicitation Exemption) as long as: – The issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;** – All purchasers of securities are accredited investors because they fall within one of the categories of persons that qualify as an accredited investor (under Rule 501) or the issuer reasonably believes that they fall within one of the categories at the time the securities are sold; and – The sales otherwise satisfy the definitional, integration and resale provisions of the Regulation D safe harbor. • Existing safe harbor under Rule 506 is not otherwise impacted, and is redesignated as Rule 506(b) (No General Solicitation Exemption) • Issuers that use the General Solicitation Exemption may not sell securities to any non-accredited investors; however, under the No General Solicitation Exemption, issuers may sell securities to up to 35 non-accredited investors who meet certain sophistication requirements • Safe harbor (either the General Solicitation Exemption or No General Solicitation Exemption) unavailable for securities offerings in which certain felons and other "bad actors" are involved
Form D* **	• Form D due no later than 15 calendar days after first sale of securities; Form D filing is required by rule but not a condition to exemption under Rule 506 • Form includes a single box to check indicating reliance on Rule 506 • Form does not require certification that a Rule 506 offering does not involve certain felons and other "bad actors"	• Form D due no later than 15 calendar days after first sale of securities; Form D filing required by rule, but not a condition to exemptions under Rule 506 (either the General Solicitation Exemption or No General Solicitation Exemption) • Form will include separate boxes to check for issuers if they are claiming the General Solicitation Exemption or, alternatively, the No General Solicitation Exemption • Form will require certification that a Rule 506 offering is not disqualified from relying on Rule 506 (as a result of the new "bad actor" provisions)
Rule 144A** **	• Although no express limitation against general solicitation and general advertising, offers of securities under Rule 144A limited to QIBs • Form D not applicable to Rule 144A offerings • Offerings not subject to "bad actor" disqualification	• Securities may be **offered** to persons other than QIBs, including by means of general solicitation and general advertising, 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 • General solicitation and general advertising in connection with resales by financial intermediaries (initial purchasers) will not affect the validity of the exemption for the initial sale by the issuer to the financial intermediaries • Form D not applicable to Rule 144A offerings • Offerings not subject to "bad actor" disqualification
Section 4(a)(2) (formerly Section 4(2))	• Offerings subject to the prohibition against general solicitation and general advertising • Offerings not subject to "bad actor" disqualification	• No changes – Offerings remain subject to the prohibition against general solicitation and general advertising – Offerings not subject to "bad actor" disqualification

* General solicitation and general advertising are not defined under current or amended Regulation D or elsewhere. Current Rule 502(c) does set forth examples of general solicitation and general advertising, including "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio" and "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising," subject to limited exceptions, such as publication of a notice pursuant to Rule 135c. The adopting release related to new Rule 506(c) also notes the SEC interpretations confirming that other uses of publicly available media, such as unrestricted websites, are also deemed to constitute general solicitation and general advertising.

** An "accredited investor" is: a bank, insurance company, registered investment company, business development company, or small business investment company; an employee benefit plan (within the meaning of the Employee Retirement Income Security Act) if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million; a tax exempt charitable organization, corporation or partnership with assets in excess of $5 million; a director, executive officer, or general partner of the company selling the securities; an enterprise in which all the equity owners are accredited investors; an individual with a net worth of at least $1 million, not including the value of his or her primary residence; an individual with income exceeding $200,000 in each of the two most recent calendar years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or a trust with assets of at least $5 million, not formed only to acquire the securities offered, and whose purchases are directed by a person who meets the legal standard of having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment.

*** Additional changes to Form D and Regulation D and changes to Rule 156 were proposed. Comments on the proposed rule amendments are due by September 23, 2013.

**** In the typical Rule 144A transaction, an initial purchaser acquires the securities from the issuer in a primary offering exempt from registration pursuant to Section 4(a)(2) or Regulation S (both of which prohibit the use of general solicitation and general advertising or directed selling efforts, as the case may be) and then resells the securities to QIBs in reliance on Rule 144A.

Final Rules Removing the Ban on General Solicitation and Advertising for Certain Private Placements

Background

Issuers traditionally have relied on the Securities Act exemptions under Rule 506 of Regulation D and/or Rule 144A to raise capital in a private placement. Prior to the recent SEC amendments, under Rule 506, issuers were not permitted to offer or sell securities through any form of general solicitation or general advertising (which are not defined under Regulation D but are generally understood to include advertisements, articles, notices or other traditional or electronic public communications, as well as public seminars or meetings). Further, although Rule 144A does not include an express limitation against general solicitation, prior to the recent SEC amendments, offers of securities under Rule 144A were limited to qualified institutional buyers (QIBs), and general solicitation and general advertising were not used in 144A offerings.

The JOBS Act directed the SEC to revise Rule 506 and Rule 144A to provide issuers with the ability to communicate freely to attract capital so long as issuers do not use the new freedoms to sell securities to investors that are not qualified to participate in such offerings.

Final Rules

Rule 506

The safe harbor from Securities Act registration provided by Rule 506 has been amended to permit an issuer to use general solicitation and general advertising to offer and sell securities, provided that:

- The issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;
- All purchasers of securities are accredited investors, or the issuer reasonably believes that they are accredited investors at the time the securities are sold; and
- The sales otherwise satisfy the definitional, integration and resale provisions of the Regulation D safe harbor.

The amendments were adopted largely in the form proposed on August 29, 2012. However, in response to commenters' requests for more guidance on the types of verification that would be considered reasonable under new Rule 506(c) (General Solicitation Exemption), the final rule, in addition to confirming that "reasonable steps" to verify investor status will be an objective determination by the issuer based on the SEC's principles-based guidance, includes a non-exclusive list of methods that issuers may use to satisfy the verification requirement for investors that are natural persons.

Practice Note

The final rule aims to provide issuers and market participants sufficient flexibility to adopt different approaches to verification depending on the particular circumstances of a transaction, market practices and innovations, such as the development of third-party databases of accredited investors. Because an issuer has the burden of demonstrating that its offering satisfies the conditions of a particular safe harbor or exemption from registration, issuers and any verification service providers should maintain complete and accurate records regarding verification steps taken in connection with a particular offering.

With respect to the SEC's principles-based approach, issuers should consider the facts and circumstances of the transaction, including, among other things, the following factors:

- The type of purchaser and the 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, including:
  - 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 noted that information gained from these factors will help an issuer determine whether there is a reasonable likelihood that a potential purchaser is an accredited investor. In turn, this will assist the issuer in determining which steps will be reasonable to verify a purchaser's status as an accredited investor.

Practice Note

If an issuer solicits new investors from the public (through, for example, a website accessible to the general public or social media), the SEC noted that the issuer likely will be required to take greater verification measures than if the issuer solicits new investors from a database of pre-screened accredited investors. Based on the adopting release, a questionnaire permitting a person to check a box as to accredited investor status would not be sufficient verification of its status absent other information about the purchaser indicating accredited investor status. That is, the issuer would need to obtain additional information about the investor or otherwise take reasonable steps sufficient to establish a reasonable belief that the purchaser is an accredited investor.

At the proposing stage, the SEC had expressed concern that providing a specified list of verification methods would be impractical, burdensome and potentially ineffective and that, even a non-exclusive list of methods might be viewed, in effect, as a required list. However, upon further consideration, the SEC concluded that the general verification requirement, combined with a non-exclusive list of methods that issuers may use to satisfy the verification requirement for investors that are natural persons, would properly maintain flexibility to adapt to changing market practices while providing clarity with respect to satisfaction of the requirement.

The non-exclusive list is a welcome change that should provide helpful guidance for ensuring that the verification process has been satisfactorily conducted with respect to natural persons. Included in the non-exclusive list are four methods of verification:

Verifications Methods for Natural Persons
• Reviewing statements that evidence sufficient income (as specified in Rule 506(c)), such as copies of any IRS form that reports the income of the purchaser and obtaining a written representation that the purchaser has a reasonable expectation of earning the necessary income in the current year.
• Reviewing statements or other documents that evidence sufficient net worth, such as a combination of bank statements and a consumer report from at least one nationwide consumer reporting agency, and obtaining a written representation that all liabilities necessary to make a net worth determination have been disclosed.
• Receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that such entity or person has taken reasonable steps to verify the purchaser's accredited status.
• Obtaining a certification at the time of sale that the purchaser is an accredited investor, but only with respect to a natural person who is an existing investor who previously purchased securities in an offering of the issuer under the No General Solicitation Exemption as an accredited investor before the effective date of the General Solicitation Exemption.

Practice Note

An issuer will not lose the ability to rely on the new General Solicitation Exemption for an offering where an investor purchased securities after providing false information or documentation relating to its accredited investor status, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and the issuer had a reasonable belief that such person was an accredited investor at the time the securities were sold.

The existing safe harbor under Rule 506 is not otherwise affected by the rule amendments, and is redesignated as Rule 506(b) (No General Solicitation Exemption). Issuers who want to conduct offerings without the use of general solicitation and general advertising will not be subject to the investor verification requirements; rather, they may verify investor status in the same manner as before the rule amendments, including, in certain cases, using accredited investor (self certification) questionnaires. Further, under the No General Solicitation Exemption, issuers may continue to sell securities to up to 35 non-accredited investors who the issuer reasonably believes meet certain sophistication requirements.

In addition, the amendments address only the rule-based safe harbors under Rule 506 and Rule 144A, and do not affect offerings conducted solely under the statutory exemption under Section 4(a)(2) (formerly Section 4(2)). Section 4(a)(2) offerings remain subject to the prohibition against general solicitation and general advertising. Also, the SEC did not address the private resale exemption under so-called Section 4(1½).

When engaging in general solicitation or general advertising in connection with an offering under the General Solicitation Exemption, issuers must be careful to comply with all requirements under such rule, as Section 4(a)(2) will not be available as a "fall-back" exemption as would be the case in certain traditional Rule 506 offerings.

Form D

The final rules amend Form D, which issuers conducting a Rule 506 offering are required to file with the SEC no later than 15 calendar days after the first sale of securities in the offering. The form has been revised to include a separate box for issuers to check if they are claiming the General Solicitation Exemption.

Practice Note

Although the filing of a Form D is required under Rule 503(a) within 15 calendar days after the first sale of securities in an offering under Rule 506 (and in offerings under Rules 504 and 505), the SEC has made clear that it is not a condition to the availability of the exemptions under either the No General Solicitation Exemption or the General Solicitation Exemption (accordingly, there will be no Section 5 violation solely because an issuer did not file a Form D).

Specific Issues for Private Funds

Privately offered funds (such as private equity funds, hedge funds and venture capital funds) are precluded from relying on two critical statutory exclusions from the definition of "investment company" under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act) if they make a public offer of securities.

Consistent with the historical treatment of Rule 506 offerings as non-public offerings with respect to Sections 3(c)(1) and 3(c)(7) and the language in Section 201(b) of the JOBS Act, which provides that offers and sales under revised Rule 506 will not be deemed public offerings, the adopting release makes clear that private funds may offer and sell securities under the General Solicitation Exemption without losing either of the exclusions under the Investment Company Act. It should be noted that neither the new rules nor the adopting release address whether the offer and sale of securities under the General Solicitation Exemption would satisfy existing Commodity Futures Trading Commission (CFTC) private

marketing restrictions. For example, a private fund whose adviser relies on the *de minimis* exemption from commodity pool operator (CPO) registration under Rule 4.13(a)(3) still will be prohibited from publicly marketing that fund's interests,[4] as the *de minimis* exemption requires as a condition of eligibility that the fund's interests be "offered and sold without marketing to the public in the United States." Accordingly, an adviser to a private fund that anticipates taking advantage of the General Solicitation Exemption will need to consider whether such activities would violate the conditions of its existing exemption from CPO registration. Private funds also would need to consider the restriction on general solicitation in Rule 4.7, which provides certain relief for registered CPOs. Rule 4.7 incorporates by reference the prohibition on general solicitation and general advertising in Section 4(a)(2) of the Act, which, as discussed above, has not been amended by the JOBS Act.

Presumably, in order for a private fund adviser to benefit from the increased marketing flexibility under the General Solicitation Exemption, either the CFTC or its staff would need to provide relief from these existing marketing restrictions. Further, as a general matter, because many private fund offerings target a narrow investor class, it is unclear whether there will be any significant shift in how these offerings are marketed.

Practice Note

The SEC believes that investment advisers to private funds should carefully review any policies and procedures regarding, among other things, the nature and content of private fund sales literature, including general solicitation materials, that have been implemented "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."

Rule 144A

Under the final rules, securities sold pursuant to Rule 144A may be *offered* to persons other than QIBs, including by means of general solicitation and general advertising, 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. Accordingly, issuers conducting a Rule 144A offering no longer will be subject to the limitations in Rule 135c under the Securities Act when publicly disseminating written communications related to the offering.

Practice Note

Press releases in Rule 144A offerings and offerings made in reliance on the General Solicitation Exemption will be able to contain information not otherwise permitted by Rule 135c, such as the names of underwriters and commentary and quotes from company management regarding an offering. In addition, offering participants will be able to discuss an offering during an earnings call, industry conference and in other public arenas and distribute widely via email an offering memorandum. As market practices develop, underwriters may seek indemnification for statements made in reliance on the general solicitation and general advertising exemptions.

Further, the adopting release confirms that general solicitation in connection with resales by financial intermediaries (initial purchasers) will not affect the validity of the exemption for the initial sale by the issuer to the financial intermediaries.[5]

Impact on Regulation S – Integration With Offshore Offerings

In response to concerns expressed by a number of commenters that the use by an issuer of general solicitation or general advertising in connection with a Rule 506 or Rule 144A offering might constitute "directed selling efforts" by that issuer for a side-by-side global offering under Regulation S, the SEC confirmed that, consistent with historical practices, concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with domestic offerings that are conducted in compliance with Rule 506 or Rule 144A, each as amended (*i.e.*, the use of general solicitation or general advertising will not constitute directed selling efforts that would threaten the validity of a concurrent Regulation S offering).

Regulation S only offerings, however, remain unchanged, and thus any general solicitation or general advertising in the United States could constitute prohibited directed selling efforts in the United States.

Blue Sky Issues

The lifting of the ban on general solicitation and general advertising raises a number of potential state blue sky issues.

Rule 506

First, while offerings under the General Solicitation Exemption will be deemed "covered securities" offerings under Section 18(b)(4)(E) of the Securities Act and thus not subject to registration or qualification under state blue sky laws, some state securities administrators may require notice filings together with fees for an offering under the General Solicitation Exemption, consistent with any existing requirements applicable to offerings under the No General Solicitation Exemption and as permitted by Section 18. In states where an exemption from state notice filings and fees exists but is premised upon the absence of any general solicitation or general advertising, issuers and their advisors may need to adjust their practices until such time, if ever, that the state exemption is aligned with the new flexibility under the General Solicitation Exemption.

Second, the scope of the federal preemption that will apply to an offering under the General Solicitation Exemption does not currently extend to any potential broker-dealer registration issues under state securities laws. That is, persons who solicit or find potential purchasers for an offering under the General Solicitation Exemption (including issuers) will need to assess the availability of state level exemptions from broker-dealer registration and qualification that require that the issuer not engage in general solicitation. Action may be required in certain states (which may include New York) to align existing state securities laws or guidance with the amendments to Rule 506.

Rule 144A

The use of general solicitation or general advertising in connection with a Rule 144A offering by an SEC reporting issuer would not trigger any state blue sky issues given the scope of the federal preemption in Section 18(b)(4)(D).

Rule 144A offerings by non-reporting issuers, however, would not qualify as "covered securities" offerings and thus would not benefit from federal preemption. Further, the traditional state blue sky exemptions relied upon by non-reporting issuers in 144A offerings would not be available where offers were made or deemed to have been made to non-QIBs, which may call into question the ability of non-reporting issuers to take advantage of the flexibility to use general solicitation or general advertising in connection with Rule 144A offerings. However, given the level of sophistication of the participants in the Rule 144A marketplace, we do not believe that state securities administrators generally would be inclined to pursue issuers or market participants that employ the use of general solicitation and general advertising.

Timing of Implementation and Transition Matters

The final rules will become effective on September 23, 2013. Until the effective date of the new rules, the current versions of Rule 506 and Rule 144A remain in effect, which means that issuers may not use general solicitation or general advertising in a Rule 506 or Rule 144A offering.

For a Rule 506 offering that began before the effective date of the General Solicitation Exemption, and is ongoing after such effective date, an issuer may decide to continue the offering under the General Solicitation Exemption or under the existing No General Solicitation Exemption. If, after the effective date of the General Solicitation Exemption, the issuer decides to continue the offering under that exemption, any general solicitation or general advertising conducted after the effective date will not affect previous reliance on the No General Solicitation Exemption for sales that occurred before the effective date.

For a Rule 144A offering that began before the effective date of amended Rule 144A, and is ongoing after such effective date, offering participants may engage in general solicitation and general advertising in connection with the portion of the offering conducted after the effective date, without jeopardizing their ability to rely on Rule 144A with respect to the portion of the offering conducted prior to the effective date of amended Rule 144A.

Proposed Amendments to Regulation D, Form D and Rule 156

Background

In response to comments received in the rulemaking process, the SEC proposed related rule amendments to Regulation D, Form D and Rule 156 under the Securities Act. The proposed rules (none of which will impact Rule 144A offerings) are intended to enhance the SEC's understanding of market practices in Rule 506 offerings and to address investor concerns related to the removal of the prohibition against general solicitation in offerings under the General Solicitation Exemption.[6] Of particular note, the proposed rules would require, in connection with an offering relying on the General Solicitation Exemption, disclosure of the methods used for verification of accredited investor status, methods used for general solicitation or general advertising and the persons controlling (directly or indirectly) the issuer.

Proposed Amendments

Additional Form D Informational Requirements

The proposed rules would require issuers to provide additional information in Form D filings, including the issuer's website, more information about the issuer and who controls (directly or indirectly) the issuer, the securities offered, types of investors, use of proceeds, the type of general solicitation used and accredited investor verification methods used. These informational requirements would apply primarily to offerings under Rule 506, although certain requirements would apply to all Regulation D offerings, and others would apply only to offerings under the General Solicitation Exemption.

Advance and Post-Offering Form D Filings

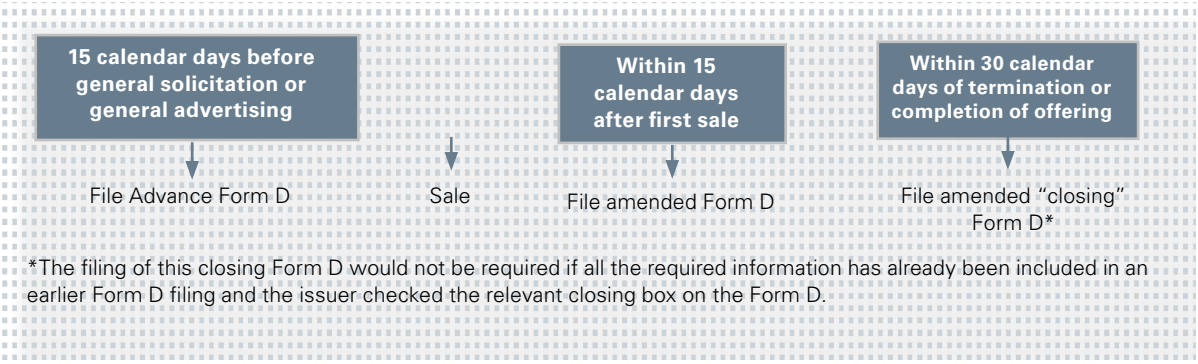
Currently an issuer offering or selling securities in reliance on Rule 504, Rule 505 or Rule 506 is required to file a Form D within 15 calendar days after the first sale of securities in the offering (although this requirement is not a condition to availability of the exemptions). The proposed rules would amend Rule 503 to compel issuers to file a Form D in an offering pursuant to the General Solicitation Exemption at least 15 calendar days before engaging in general solicitation or general advertising (a so-called Advance Form D). This proposed Advance Form D could be filed without contemplating a specific offering or describing any general solicitation or general advertising activities, and the issuer would still have the flexibility to engage in such activities.

The proposed rules also would amend Rule 503 to compel issuers to file an amended Form D within 30 calendar days of terminating or completing any Rule 506 offering, noting that the offering has ended and otherwise updating the information contained in any initial Form D filing.

Practice Note

Under the proposed rules, an issuer who wants to take advantage of the General Solicitation Exemption would have to file up to three Form Ds – an Advance Form D at least 15 calendar days before engaging in general solicitation or general advertising, an amended Form D within 15 calendar days after the first sale in the offering and a post-offering amended Form D within 30 calendar days of completing the offering. If an issuer who is relying on the No General Solicitation Exemption does not include all necessary information in its Form D filing, made within 15 calendar days after the first sale of securities, such issuer would have to file two Form Ds under the proposed rules (the second being the closing Form D).

The graphic below reflects the proposed timing for filing Form Ds in connection with an offering under the General Solicitation Exemption:



The costs and time involved with, and additional disclosure required by, these Form D filings may be viewed by some as outweighing any market evaluation benefit the SEC may receive and as a potential hurdle, deterring use of the General Solicitation Exemption. The Advance Form D filing may also be a deterrent as a company may be reluctant to file a Form D prior to the time it would want to make its plans known to the public. In any event, companies that intend to rely on or preserve the flexibility to conduct an offering under the General Solicitation Exemption, many of which otherwise would not have made any final determination to proceed with an offering until close in time to launch, would have to establish practices and procedures to ensure timely filing of the Advance Form D. We expect there will be a significant number of comments submitted to the SEC regarding the proposed Advance Form D filing.

Disqualification for Failure to Comply With Form D Filing Requirements

Proposed Rule 507(b) would disqualify an issuer from relying on either the General Solicitation Exemption or No General Solicitation Exemption 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 (subject to a cure period for certain late filings and, in certain circumstances, the ability to request a waiver). The disqualification would end one year after the missing or corrected Form D filings are made. The five-year look-back period would not extend beyond the effective date of the rule. Accordingly, disqualification would arise only in connection with filings due after effectiveness of proposed Rule 507(b).

The proposing release notes that a number of commenters suggested that the SEC require compliance with the Form D filing requirements in Rule 503 as a condition to reliance on any safe harbor provided by Regulation D, or at least as a condition to reliance on the General Solicitation Exemption. However, the SEC noted that the failure to comply with this condition could result in a violation of Securities Act Section 5 and certain state securities laws, which would be a result disproportionate to the violation and, therefore, determined not to propose making Form D filing a condition of Rule 506.

Practice Note

Because filing of a Form D is a requirement related to, but not a condition to, reliance on Rule 506, many issuers currently do not file Form Ds. If proposed Rule 507(b) is adopted as proposed, Form D filings will become standard market practice in order to prevent disqualification from reliance on the exemptions under Rule 506 for future offerings.

Legends and Cautionary Statements Required in Written General Solicitation Materials

Proposed Rule 509 would require issuers to include, "in a prominent manner," certain legends in written general solicitation and general advertising materials used in offerings under the General Solicitation Exemption to inform potential investors of risks and that the offering is limited to accredited investors. Specifically, the following legends would be required:

- The securities may be sold only to "accredited investors," which for natural persons are investors who meet certain minimum annual income or net worth thresholds;
- The securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act;
- The SEC has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials;
- The securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and
- Investing in securities involves risk, and investors should be able to bear the loss of their investment.

Private funds also would be required to include in written general solicitation and general advertising materials (i) a legend disclosing that the securities being offered are not subject to the protections of the Investment Company Act of 1940, and (ii) if the written materials include performance data, additional disclosure so that potential investors are aware that there are limitations on the usefulness of such data and the lack of comparability with past performance information of other funds.

The SEC recognized the potentially disruptive consequences that would result if an inadvertent error in, or omission of, the legends or other disclosures (as applicable) resulted in the loss of the General Solicitation Exemption and a violation of Section 5. Thus, the requirement to include legends and other information (as applicable) would not be conditions to the General Solicitation Exemption. However, the proposed rules would disqualify an issuer from relying on either the General Solicitation Exemption or No General Solicitation Exemption if the issuer, or any predecessor or affiliate of the issuer, has been subject to any order, judgment or decree of any court enjoining such person for failure to comply with the legending requirements of Rule 509. We expect there to be significant comments on the proposed rules as the legending requirements under certain circumstances could be significant impediments to utilizing the flexibility provided by the recently adopted amendments.

Nonpublic Submission of Written General Solicitation Materials to the SEC

Proposed Rule 510T would require all issuers to submit to the SEC on a temporary and nonpublic basis through an intake page designated on the SEC's website, written general solicitation materials used in any offering conducted under the General Solicitation Exemption, not later than the date of first use. The intention behind the proposed rule is to enable the SEC to monitor general solicitation and general advertising practices.[7] This temporary rule would expire two years after it becomes effective, and the materials would not be considered "filed" or "furnished" under the Securities Act or the Exchange Act, including for purposes of liability. It remains an open question, however, whether or not these materials could be obtained under the Freedom of Information Act.

As would be the case with the legending requirements discussed above, the proposed rules would disqualify an issuer from relying on either the General Solicitation Exemption or No General Solicitation Exemption if the issuer, or any predecessor or affiliate of the issuer, has been subject to any order, judgment or decree of any court enjoining such person for failure to comply with the submission requirements of Rule 510T.

Rule 156 Proposed to be Extended to Private Funds

The SEC also would amend Rule 156 under the Securities Act, which interprets the antifraud provisions of the federal securities laws in connection with sales literature used by investment companies, to apply to the sales literature of private funds and has solicited comment on whether to mandate additional manner and content restrictions on written general solicitation materials used by private funds. The proposed rule release notes that private funds should now begin considering the guidance in Rule 156.

Staff Comprehensive Work Plan

The proposing release notes that the SEC has directed its staff to undertake a comprehensive work plan to review and analyze the use of the General Solicitation Exemption, which will assist the SEC in evaluating market practices in offerings conducted under the General Solicitation Exemption. The proposed amendments are intended to support this work plan. The staff will:

- Evaluate verification practices;
- Evaluate whether, after effectiveness of the General Solicitation Exemption, sales to non-accredited investors increase;
- Assess whether, after effectiveness of the General Solicitation Exemption, there is a shift in capital formation to offerings under the General Solicitation Exemption;
- Examine information relating to offerings under the General Solicitation Exemption submitted or available to the SEC;
- Monitor the General Solicitation Exemption offering market for increased fraudulent activity;
- Incorporate an evaluation of practices in offerings under the General Solicitation Exemption in the staff's examinations of registered broker-dealers and registered investment advisers; and
- Coordinate with state securities regulators on sharing information about offerings under the General Solicitation Exemption.

The definition of accredited investor as it relates to natural persons is also under review. Dodd-Frank has already changed the calculation of net worth for purposes of the definition of accredited investor to exclude the value of a person's primary residence.

Dissenting SEC Commissioners

One open question arising from the proposed rules, which we believe will draw significant comment, is whether the proposed rules in practice actually will end up deterring significantly use of the General Solicitation Exemption. Two SEC commissioners voted against adoption of the proposed rule amendments voicing concerns that the proposed amendments would unduly burden and restrict the capital formation process and undermine the congressional intent of spurring our economy and job creation. Commissioner Troy A. Paredes noted that the proposing release "charts a course for subjecting private offerings to a range of new regulatory demands and restrictions. The regulatory expansion would lead to considerable new burdens that issuers would have to shoulder when using Regulation D and is, in my view, at odds with the '33 Act's longstanding regard for a vibrant private securities market that affords issuers and investors a meaningful alternative to the more costly public offering process."[8] Commissioner Daniel M. Gallagher noted that the "proposed rules would lead to smaller, more burdened private markets, their frictions mirroring those of our public markets, which have for years now been too costly and burdensome for all but the largest companies."[9]

Comment Period

Comments on the proposed rule amendments are due by September 23, 2013.

Final Rules Disqualifying Bad Actors From Private Placements Under Rule 506

Background

Section 926 of Dodd-Frank requires the SEC to adopt rules that would make the Rule 506 private placement safe harbor unavailable for securities offerings in which certain felons and other "bad actors" are involved. Prior to the new rules, Rule 506 did not contain any bad actor disqualification provisions.[10] Under Section 926 of Dodd-Frank, these new disqualification rules must be "substantially similar" to the disqualification provisions set forth in Rule 262, which is applicable to securities offerings under Regulation A (an exemption from registration for certain small offerings), and also include the specific events listed in Section 926(2) of Dodd-Frank.[11] In connection with the SEC's open meeting on July 10, 2013, Commissioner Walter noted the importance of having these bad actor protections in place when the ban on general solicitation and general advertising is lifted in an effort to reduce some of the perceived risks associated with lifting such ban.

Final Rules

The final rules disqualify securities offerings involving certain "felons and other 'bad actors'" from reliance on the safe harbor provided by Rule 506 of Regulation D (regardless of whether general solicitation is used). These bad actor disqualification provisions will disqualify securities offerings from reliance on the Rule 506 exemption if any of the issuer or other specified persons (such as underwriters, placement agents and the directors, executive officers and certain other officers and certain larger beneficial owners of the issuer) has been convicted of, or is subject to court or administrative sanctions for, securities fraud or other violations of specified laws. The new rules, which do not apply to Rule 144A offerings, are set forth in new paragraph (d) of Rule 506 and were adopted largely as proposed on May 25, 2011, except they will apply only to disqualifying events occurring after effectiveness of the new rules (with pre-existing events subject to mandatory disclosure) and reflect certain limited changes to the list of disqualification events and covered persons in response to comments.[12]

Covered Persons

The final disqualification rules apply to the following "covered persons":

- The issuer and any predecessor of the issuer or affiliated issuer;
- Any director, executive officer, other officer participating in the proposed 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, calculated on 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 a pooled investment fund (Investment Manager);
- Any person that has been or will be paid (directly or indirectly) for solicitation of purchasers in connection with sales of securities (*i.e.*, a placement agent) (Compensated Solicitor);
- Any general partner or managing member of any such Investment Manager or Compensated Solicitor; and
- Any director, executive officer or other officer participating in the offering of any such Investment Manager or Compensated Solicitor or general partner or managing member of such Investment Manager or Compensated Solicitor.

Practice Note

The determination of which persons participated in an offering is a question of fact. The adopting release (for purposes of the second bullet and last bullet set forth above) states that "[p]articipation in an offering would have to be more than transitory or incidental involvement, and could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, and communication with the issuer, prospective investors or other offering participants."

In addition, under the final rules, events relating to any affiliated issuer that occurred before the affiliation arose will not be considered disqualifying if the affiliated entity is not (i) in control of the issuer; or (ii) under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

Disqualifying Events

The final rules set forth the following types of disqualifying events applicable to "covered persons":

- **Criminal convictions** (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC, or (iii) 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 (collectively, Certain Financial Intermediaries). The criminal conviction must have occurred within 10 years before the proposed sale of securities (or five years, in the case of issuers, their predecessors and affiliated issuers).
- **Court injunctions and restraining orders** that restrain or enjoin a person from engaging or continuing to engage in any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC; or (iii) arising out of the conduct of the business of Certain Financial Intermediaries. The injunction or restraining order must have been entered within five years before the proposed sale of securities.
- **Final orders**[13] **of certain state regulators (such as state securities, banking and insurance regulators), federal regulators and the U.S. Commodity Futures Trading Commission** that, (A) at the time of the proposed sale of securities, bar[14] the person from (i) associating with a regulated entity, (ii) engaging in the business of securities, insurance or banking, or (iii) engaging in savings association or credit union activities or (B) are entered within 10 years before the proposed sale of securities and are based on violations of law that prohibit fraudulent, manipulative or deceptive conduct.
- **SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons** that, at the time of the proposed sale of securities, (i) suspend or revoke such person's registration as a broker, dealer, municipal securities dealer or investment adviser, (ii) place limitations on the activities, functions or operations of such person, or (iii) bar such person from being associated with any entity or from participating in the offering of any penny stock. Such orders will be disqualifying for so long as they are in effect.
- **SEC cease-and-desist orders**, entered within five years before the proposed sale of securities, related to violations of certain antifraud provisions and registration requirements of the federal securities laws.
- **Suspension or expulsion from membership in, or suspension or bar from associating with a member of, a registered national securities exchange or a registered national or affiliated securities association** for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade. The period of disqualification will equal the period of the suspension, expulsion or bar.

- **SEC stop orders and orders suspending a Regulation A exemption** issued within five years before the proposed sale of securities.
- **U.S. Postal Service false representation orders** issued within five years before the proposed sale of securities.

With more than 90 percent of the offerings made under Regulation D relying on Rule 506, the new rules could have a significant impact on the way private offerings are marketed. For example, an issuer will not be able to rely on the Rule 506 safe harbor if a director of the issuer or an executive officer or other officer of the issuer who is participating in the offering is subject to a disqualifying event. Also, because the ineligibility of an offering to be conducted in accordance with Rule 506 will result in the loss of "covered security" status under Section 18(b)(4)(D) of the Securities Act, the offering (absent an available state law exemption) would be subject to registration in each state where an offer/sale is made, which might be impractical.

Reasonable Care Exception and Waivers

The final rule includes a "reasonable care" exception, pursuant to which an issuer would still be able to take advantage of the Rule 506 safe harbor, even though a disqualifying event exists, if the issuer can establish that it did not know and, in the exercise of reasonable care, could not have known, of the disqualification. To establish reasonable care, the issuer would need to make a factual inquiry into whether any disqualifications exist. The nature and scope of such inquiry will depend, at least in part, on the facts and circumstances of the issuer and the other offering participants.

The adopting release notes that "the steps an issuer should take to exercise reasonable care will vary according to the particular facts and circumstances. For example, we anticipate that issuers will have an in-depth knowledge of their own executive officers and other officers participating in securities offerings gained through the hiring process and in the course of the employment relationship, and in such circumstances, further steps may not be required in connection with a particular offering. Factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement." It also may be considered reasonable to investigate publicly available databases under certain circumstances, while under other circumstances, additional or different steps may be required. The adopting release notes the expectation that financial intermediaries and other market participants will develop procedures to assist issuers in the necessary factual inquiries.

Some commenters raised concerns about application of factual inquiry procedures to continuous, delayed or long-lived offerings, suggesting that reasonable factual inquiry might be viewed as requiring burdensome, continuous, real-time monitoring. The adopting release confirms that, for these types of offerings, "reasonable care includes updating the factual inquiry on a reasonable basis," but that "the frequency and degree of updating will depend on the circumstances of the issuer, the offering and the participants involved." The adopting release clarifies that, absent facts indicating otherwise, "periodic updating could be sufficient."

Under the final rule, an issuer may also seek a waiver of disqualification if the issuer shows "good cause" and the SEC determines "that it is not necessary under the circumstances that an exemption be denied." At the urging of commenters, the final rules delegate authority to grant this type of waiver to the Division of Corporation Finance. The final rules also allow a court or regulatory authority that entered a disqualifying order, judgment or decree to advise in such document or separately in a writing to the SEC that disqualification under Rule 506 should not arise as a consequence of such order, judgment or decree. If a court or regulatory authority advises in this manner before the relevant sale, a separate waiver from the SEC will not be needed.

Practice Note

To comply with the new "bad actor" rules in connection with Rule 506 offerings, issuers and placement agents will need to put in place new procedures designed to uncover events that are, or may over time become, disqualifying, including for certain persons or entities over which the issuer does not have control. Steps that issuers could consider taking include:

- Expanding questions into questionnaires to be completed by D&Os and requiring questionnaires or applicable representations from 20 percent beneficial owners and other offering participants who are covered persons;
- Including representations in the placement agency agreement regarding the absence of disqualifying events; and
- With respect to continuous, delayed or long-lived offerings, conducting periodic updating diligence, absent facts indicating that closer monitoring is required.

Steps placement agents could consider taking include:

- Putting in place internal procedures to enable factual determinations regarding representations they may be asked to make in the placement agency agreement and for purposes of the disclosure requirements; and
- Conducting diligence on behalf of issuers to determine if there are any disqualifying events for purposes of disclosure or disqualification from reliance on Rule 506.

While the usual due diligence investigation in connection with a Rule 506 offering may uncover certain disqualifying events, issuers and/or placement agents on behalf of issuers may want to consider utilizing supplemental due diligence request lists that include specific questions and requests for documents relating to covered persons and disqualifying events and circulating such lists to relevant parties before any meaningful preparatory work on an offering begins.

To establish reasonable care under the new rules, the issuer bears the burden of making appropriate factual inquiry into whether any disqualifications exist. If a disqualification with respect to a covered person exists and the issuer is unable to satisfy the reasonable care standard, the issuer will not be able to rely on Rule 506 for a particular offering, which could result in lost time and money for any offering that is abandoned or delayed, as well as rescission rights for any investors that purchased in an illegal sale (if the issuer uses general solicitation or general advertising communications they would be unable to rely on the Section 4(a)(2) exemption as a fallback). These potential harsh consequences underscore the importance of uncovering disqualifying events early, before any significant amount of time and other resources are devoted to a potential offering.

Form D

The final rule amends Form D to require an issuer, in connection with a securities offering conducted in reliance on Rule 506, to certify that the offering is not disqualified from relying on Rule 506.

Not Applicable to Events That Predate the Final Rules; Mandatory Disclosure

The new disqualification provisions apply only with respect to disqualifying events that occur after the effective date of the final rules. However, events that occurred before the effective date of the final rules and that would have been disqualifying events under the final rules, must be disclosed in writing to each purchaser a reasonable time prior to the sale of securities. Procedures will need to be established to ensure accurate and timely disclosure of any such disqualifying events. Should an issuer fail to furnish this disclosure to investors, it can still avail itself of the Rule 506 exemption, if the issuer

establishes that "it did not know and, in the exercise of reasonable care, could not have known of the existence of the undisclosed matter or matters". This new mandatory disclosure requirement applies to all offerings under Rule 506.

Application to Ongoing Offerings

Sales of securities made before the effective date of the final rule will not be affected by any disqualification or disclosure requirement, even if part of an offering will continue after the effective date. Only sales of securities made after the effective date would be subject to disqualification and mandatory disclosure.

Disqualifying events that occur during the course of an offering should be analyzed in a similar way. Sales of securities made before any disqualifying event occurs will not be affected by it, but sales made after the event would be subject to disqualification.

Uniform Bad Actor Standards

The proposing release considered and requested comment on additional rule amendments that would result in bad actor disqualification rules that are more uniform, including with respect to offerings under Regulation A, Regulation E and Rules 504 and 505 of Regulation D. Some commenters voiced support for such uniformity, while others did not. The adopting release notes that the SEC will consider uniformity in this context at a later date and, at least in part, in connection with additional rulemaking with respect to two new exemptions from registration required by the JOBS Act, one for "crowdfunding" offerings and one for offerings up to $50 million in any 12-month period. The JOBS Act contemplates that these two new exemptions would include bad actor disqualification provisions similar to those required by Section 926 of Dodd-Frank.

Timing of Implementation

The final rules will become effective on September 23, 2013.

End notes appear on the next page.

END NOTES

1 The final rule release, Securities Act Release No. 33-9415 (July 10, 2013), is available here.

2 The proposed rule release, Securities Act Release No. 33-9416 (July 10, 2013), is available here.

3 The final rule release, Securities Act Release No. 33-9414 (July 10, 2013), is available here.

4 For ease of discussion, this assumes that the fund's CPO is the adviser, as opposed to the fund's general partner, managing member, board of directors, etc.

5 In the typical Rule 144A transaction, an initial purchaser acquires the securities from the issuer in a primary offering exempt from registration pursuant to Section 4(a)(2) or Regulation S, and then resells the securities to QIBs in reliance on Rule 144A.

6 SEC Commissioner Elisse B. Walter noted that, "we have an obligation to monitor the consequences of lifting the ban and to make a determination as to whether further action is appropriate. … It is imperative that investors have confidence that the private offering marketplace has not turned into the Wild West." The statement of Commissioner Walter is available here.

7 Similarly, with a view to better understanding market developments, the SEC has been collecting materials used by emerging growth companies to "test the waters" to determine interest in a particular securities offering.

8 The statement of Commissioner Paredes is available here.

9 The statement of Commissioner Gallagher is available here.

10 In addition, bad actor disqualification rules at the state level do not apply in connection with Rule 506 offerings because securities sold under Rule 506 are "covered securities" under Section 18(b)(4)(D) of the Securities Act.

11 Certain clarifying changes are reflected in the final rule when compared to Rule 262 under Regulation A and Section 926 of Dodd-Frank. For example, in the final rule, managing members are specifically included as "covered persons" to clarify the treatment of entities organized as limited liability companies and to address the types of financial intermediaries likely to be involved in a private placement under Rule 506, the term "underwriters" is replaced with "any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers."

12 Of particular note, investment managers to pooled investment funds were added to the list of covered persons; coverage of officers was narrowed such that only executive officers of covered entities and officers who participate in the offering are covered persons; and coverage of large security holders was revised such that only security holders that beneficially own 20 percent or more of the issuer's outstanding voting equity securities are picked up as compared to the standard in the proposed rule which would have picked up security holders that beneficially own 10% or more of any class of the issuer's equity securities.

13 Section 926 of Dodd-Frank does not define "final order". As adopted in the context of bad actor disqualification, final order means "a written directive or declaratory statement issued by a federal or state agency described in Section 230.506(d)(1)(iii) under applicable statutory authority that provides for notice and an opportunity for hearing, which constitutes a final disposition or action by that federal or state agency." In response to comments, the proposed definition of final order was revised so that ex parte orders that do not provide for notice and an opportunity for hearing will not result in disqualification.

14 A "bar" is disqualifying only for so long as it has continuing effect.

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