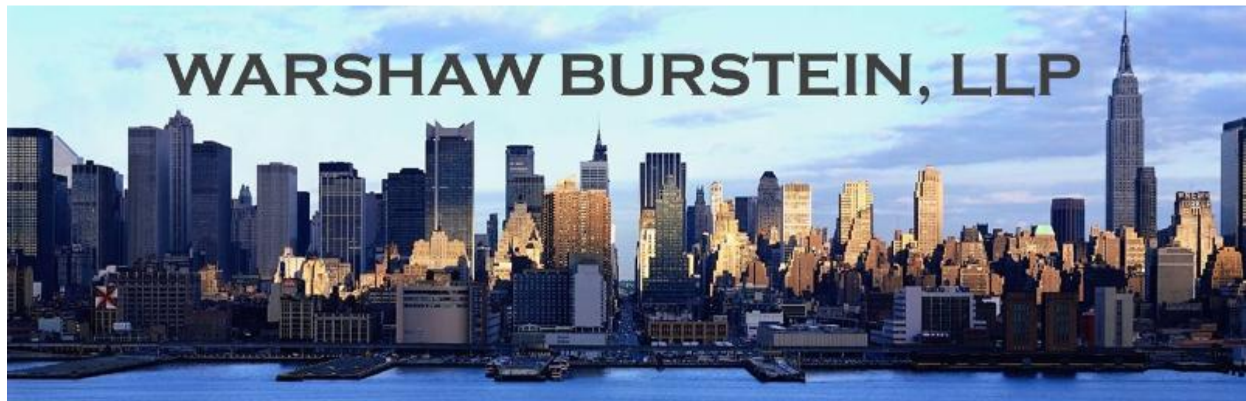

July 23, 2013

CLIENT ALERT

SEC Adopts Rules that Eliminate the Prohibition on General Solicitation for Certain Private Offerings and Disqualify "Bad Actors" from Rule 506 Offerings; and Proposes Rules to Provide Enhanced Information for Rule 506 Offerings.

The Securities and Exchange Commission ("SEC") adopted final rule amendments that (1) eliminate the prohibition against general solicitation and general advertising in connection with certain securities offerings made pursuant to Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act"), as mandated by Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act");[1] and (2) prohibit certain "bad actors" from participating in securities offerings made under Rule 506.[2] In addition to the foregoing final rule amendments, the SEC also proposed rule amendments, relating primarily to Form D, which would require that certain enhanced information be filed in connection with offerings under Rule 506 ("Proposing Release").[3]

1. Elimination of the Prohibition on General Solicitation and General Advertising

Under new Rule 506(c), private issuers (including hedge funds, private equity funds and other non-public issuers) may engage in general solicitation and general advertising in connection with an offering of unregistered securities provided: (a) all purchasers of the

[1] The rule permitting general solicitation and advertising, SEC Release No. 33-9415, is available at http://www.sec.gov/rules/final/2013/33-9415.pdf.
[2] The rule disqualifying "bad actors,", SEC Release No. 33-9414, is available at http://www.sec.gov/rules/final/2013/33-9414.pdf.
[3] The Proposing Release, SEC Release No. 33-9416, is available at http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

securities are “accredited investors;”[4] and (b) the issuer takes “reasonable steps to verify” that such purchasers are “accredited investors.” Previously, issuers were prohibited from engaging in general solicitation and general advertising in connection with offerings of unregistered securities in reliance on Regulation D.

The SEC did not define precisely what constitutes “reasonable steps to verify,” but it stated that whether the steps taken are “reasonable” is an objective determination to be made by the issuer in the context of the particular facts and circumstances of each purchaser and transaction. In addition to a principles based method of verification, the SEC also set forth four specific non-exclusive methods an issuer may use to satisfy the verification requirement for natural persons. The methods that an issuer may use include: (a) reviewing IRS forms that report the previous two years of an investor’s income; (b) reviewing bank statements, brokerage statements, and other statements of securities holdings dated within the prior three months; (c) obtaining written confirmation from a registered broker dealer, SEC-registered investment adviser, attorney or certified public accountant, certifying that such person took reasonable steps to verify the investor’s accredited investor status within the prior three months; and (d) with respect to an existing investor who invested in the issuer’s previous Rule 506(b) offering as an accredited investor and remains an investor of the issuer, for any Rule 506(c) offering conducted by the same issuer, obtaining a certification by such person at the time of sale that he or she still qualifies as an accredited investor. However, none of these methods will satisfy the verification requirements if the issuer knows that the purchaser is not an accredited investor.

The rule amendment described above affects only new Rule 506(c) offerings. It does not affect Rule 506(b) offerings, which the SEC retained and which continues to prohibit general solicitation. Issuers that choose not to use general solicitations may continue to rely on Rule 506(b), subject to the prohibition against general solicitation. Also, new Rule 506(c) does not include the exception to the accredited investor requirement of Rule 506(b) offerings, which permits an issuer to sell its interests to accredited investors plus to up to 35 unaccredited investors (provided there were no general solicitations).

In deciding whether to avail themselves of new Rule 506(c), issuers should consider whether, as a business matter, general solicitation and advertising, including, among other things, through print media, the Internet, social media, speaking at seminars and other forums, and making its website more accessible to the public, would benefit their marketing efforts sufficiently so as to warrant subjecting themselves to the additional burden of verifying the accredited status of investors, relinquishing the ability to sell their interests to up to 35 unaccredited investors and possibly subjecting themselves to the additional disclosure requirements set forth in the Proposing Release.

The SEC also revised Form D to require issuers to indicate on the Form, whether their offering is a Rule 506(b) offering that does not permit general advertising or a Rule 506(c) offering, which does.

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[4] For a natural person, an accredited investor is defined as a person (1) whose individual net worth, or joint net worth with that person’s spouse, exceeds $1 million, excluding the value of the person’s primary residence (the “net worth test”); or (2) who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year (the “income test”).

2. Disqualification of "Bad Actors"

The SEC also adopted new Rule 506(d), which disqualifies "felons and other 'bad actors'" from relying on the registration exemption provisions of Rule 506 of Regulation D. Bad actor disqualification requirements, sometimes called "bad boy" provisions, disqualify securities offerings from relying on exemptions if the issuer or other relevant persons (including, underwriters, placement agents, directors, executive officers and shareholders of 20% or more of any class of the issuer's outstanding voting equity securities) have been convicted of, or are subject to court or administrative sanctions for securities fraud or other violations of specified laws.

Under new Rule 506(d), an issuer cannot rely on the exemption provided by Rule 506, meaning, it will not be able to engage in Rule 506 exempt private securities offerings if it, or other relevant persons has a disqualifying event. Disqualifying events include, among other things, certain criminal convictions, injunctions relating to securities-related activities and certain orders of financial industry regulators and SROs.

Disqualification under Rule 506(d) applies only to events occurring after the effective date of the rule amendments. Pre-existing events, while not disqualifying events, nevertheless are subject to mandatory disclosure to investors.

These final rule amendments become effective 60 days after publication in the Federal Register.

3. Proposed Amendments Relating to Elimination of the Prohibition on General Solicitation

In addition to the final rule amendments described above, the SEC, in the Proposing Release, proposed rules that would amend Regulation D and Form D and would enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings and to address issues relating to general solicitations and advertising (the "Proposed Rules"). If adopted, the Proposed Rules, among other things, would require a Form D filing at least 15 days prior to engaging in a general solicitation in connection with a new Rule 506(c) offering and a closing Form D amendment filing within 30 calendar days following conclusion of a Rule 506 offering. The Proposed Rules would also require that certain legends and other disclosures be included on general solicitation materials used in Rule 506(c) offerings and that such materials be submitted to the SEC on a two-year temporary non-public basis. Failure of an issuer to comply with Form D filing requirements within the preceding five years, would disqualify such issuer from relying on Rule 506 for one year. The Proposed Rules would require an issuer to include in Form D, additional information about offerings conducted in reliance of Rule 506.

Comments on the Proposed Rules are due on or before 60 days after publication in the Federal Register.

Please consult with the undersigned or your regular Warshaw Burstein attorney to discuss any questions you may have about these rule amendments.

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