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Legal Alert

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SEC Lifts Ban on General Solicitation and Disqualifies Felons and other Bad Actors from Certain Private Offerings, and Proposes Rule Amendments to Enable SEC to Monitor Private Offering

On July 10, 2013, the Securities and Exchange Commission ("SEC") approved rules that:

- eliminate prohibitions against general solicitation and general advertising in certain Rule 506 and Rule 144A offerings1; and
- disqualify securities offerings that involve certain felons and other "bad actors" from relying on Rule 506 in connection with private offerings.2

The new rules will become effective on September 23, 2013, which is the sixtieth day after the date (July 24, 2013) the rules were published in the Federal Register.

The SEC also proposed amendments to Regulation D, Form D and Rule 156, which amendments are likely to be adopted later this summer. The amendments would enhance the SEC's ability to evaluate changes in the private offering market and to address the development of practices in Rule 506 offerings.

The new rules (both those that were adopted and those that were proposed) will affect how issuers raise capital in private offerings of securities under Regulation D. Highlights of these new rules are described below.

1 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings. SEC Release 33-9415 (July 10, 2013). These changes to Rule 506 and Rule 144A were mandated by Section 201(a) of the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §201, 126 Stat. 306, 313-15 (2012) (the "JOBS Act").

2 Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings. SEC Release 33-9414 (July 10, 2013. This rule change was mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, 1851-52 (2010) (the "Dodd-Frank Act").

I. General Solicitation Ban Repealed ("New" Section 506(c))

New Rule 506(c) will permit the use of general solicitation and general advertising3 if:

- the issuer takes "reasonable steps to verify" that purchasers are accredited investors; and
- all purchasers are accredited investors or the issuer reasonably believes that they are within one of the categories of persons that are accredited investors at the time of the sale of the securities.

Under Rule 506(c), offers may be made to any potential investor, whether or not an accredited investor. However, sales of securities may be made only to accredited investors. The final rules also permit securities offered pursuant to Rule 144A to be offered to persons other than Qualified institutional buyers ("QIBs"), including by means of general solicitation, but the securities may only be sold to persons whom the seller and any person acting on the seller's behalf reasonably believe to be QIBs.

As a result of the rule changes, there will be two types of Rule 506 offerings: offerings under "old" Rule 506(b), and offerings under "new" Rule 506(c):

Rule 506(b) Offering: an offering to an unlimited number of accredited investors and up to 35 non-accredited (but sophisticated) investors, without any general solicitation. The issuer must have a reasonable belief as to each investor's status as an accredited investor at the time of sale. Essentially, this is a private offering under the "old" Rule 506, and "old" Rule 506 is re-numbered 506(b).

Rule 506(c) Offering: an offering only to purchasers who are accredited investors (or whom the issuer reasonably believes to be accredited investors) and whom the issuer has taken reasonable steps to verify are accredited investors.

Thus, issuers who do not wish to engage in any general solicitation, and who do not want to become subject to the requirement to take reasonable steps to verify the accredited investors status of purchasers, as well as those who wish to sell to any non-accredited investors who meet Rule 506(b) sophistication requirements, are likely to rely on Rule 506(b) and not on Rule 506(c).

"Reasonable Steps to Verify" Accredited Investor Status.

Section 201(a)(1) of the JOBS Act mandates that issuers using general solicitation in Rule 506 offerings "take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods are determined the Commission." Taking reasonable steps to verify status is an independent requirement of Rule 506(c) that must be satisfied even if all purchases happen to be accredited investors. Whether verification steps are reasonable depends on facts and circumstances, and the SEC suggested some relevant factors, including:

- the nature of the purchase and the type of accredited investors 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, and the terms of the offering, such as a minimum investment amount.

New Rule 506(c) includes non-exclusive methods of verifying accredited investor status, including:

- reviewing recent IRS forms or pay stubs, to verify individual accredited investor status under the income test;

[3] Rule 502(c) provides that neither the issuer nor any person acting on its behalf shall offer or sell the securities by "any form of general solicitation or general advertising," and goes on to list prohibited forms of solicitation, including "any advertisement, article, notice of other communication published in any newspaper, magazine of similar media or broadcast over television or radio." Issuers who are relying on new Rule 506(c) will not be subject to Rule 502(c).

- reviewing certain bank, brokerage and similar documents to verify individual accredited investor status under the net worth test; and
- obtaining written confirmation of status from an SEC-registered broker dealer or investment adviser, and attorney or a CPA that has taken reasonable steps to verify that the purchase is an accredited investor.

The requirement to take reasonable steps to verify accredited investor status, and the requirement that all purchasers be (or the issuer have a reasonable belief that purchasers are) accredited investors are independent requirements and each must be met in order for Rule 506(c) to be applicable to an issuer in connection with an offering. The failure of either requirement will result in a failed offering.

Private Funds May Engage in General Solicitation.

The SEC confirmed that privately offered pooled investment vehicles relying of the qualified purchaser (Section 3(c)(7) or 100-holder (Section 3(c)(1) exclusions under the Investment Company Act of 1940 may engage in general solicitation under Rule 506(c).

No General Solicitation Allowed in a Section 4(a)(2) Private Placement.

Section 4(2) of the Securities Act (re-numbered Section 4(a)(2) by the JOBS Act) states that the registration requirements of the Securities Act do not apply to "transactions by an issuer not involving a public offering." Historically, an issuer whose unregistered offering failed to meet all of the requirements of Regulation D could still claim that the offering was exempt by reason of Section 4(a)(2). The SEC's position is that a failed Rule 506(c) offering (e.g., because it is determined that the issuer failed to take "reasonable steps to verify" purchaser status) cannot claim the Section 4(a)(2) exemption. The basis of this position is that Section 201(a) of the JOBS Act affected only the Rule 506 safe harbor from registration, and did not affect other private offerings, including those under Section 4(a)(2), and general solicitation is not permitted in connection with a Section 4(a)(2) offering.

II. Bad Actor Disqualification Adopted.

The SEC adopted rules to implement the ban of Section 926 of the Dodd-Frank Act on the participation by "bad actors" in all Rule 506 offerings, including offerings using general solicitation under new Rule 506(c). Under the new rules, which will be set out in Rule 506(d), an issuer will not be able to rely upon Rule 506 if certain individuals or entities (including directors and executive officers, other officers who participate in the offering, and 20% or greater beneficial owners of the Issuer's voting securities) have been subject to a disqualifying event, such as a conviction for securities fraud, during the 10 years prior to the offering. Disqualifying events that occurred before the effectiveness of the new rules would not count, but will be subject to mandatory disclosure. An issuer may nevertheless be able to rely on Rule 506 if it can show that it did not know and in the exercise of reasonable care could not have know that a disqualifying event existed.

III. Proposed Amendments to Private Offering Rules.

Proposed rules4 would, among things:

- require an issuer to file a Form 15 at least 15 calendar days before engaging in general solicitation for an offering and with 30 days after completion of the offering;
- disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, failed to comply, within the prior five years, with Form D filing requirements in a Rule 506 offering.

4 Amendments to Regulation D, Form D and Rule 156 under the Securities Act. SEC Release 3309416 (July 10, 2013).

In addition, new Rule 509 would require prescribed legends in any general solicitation in written form in a Rule 506(c) offering, and Form D may be further revised to expand the type and categories of information collected on the Form D, particularly information regarding the types of general solicitation used, (e.g., mass mailings, emails, public websites, social media and broadcast media), and the methods used to verify accredited investor status. Finally, proposed new Rule 510T would require issuers to submit any written general solicitation materials used in a Rule 506(c) offering to the SEC no later than the date the materials were first used. The submissions would not be available to the public and Rule 510T would expire two years after its effective date.

Contact:

If you any question about the new SEC rules or about other securities law matters, call Joseph P. Richardson at (602) 256-4452 or email him at jrichardson@gblaw.com.