

# The Practical Implications of the SEC's Recent Changes to Regulation D

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Recent amendments to Regulation D, the rules governing the limited offer and sale of securities without registration under the Securities Act of 1933 (the “Securities Act”), have the potential to result in significant changes to capital formation practices within the United States. Rule 506 under Regulation D (“Rule 506”) provides a limited offering “safe harbor” exemption from the requirement to register the offer and sale of securities under the Securities Act. Rule 506 is frequently relied upon by issuers, including private funds, raising capital on a private placement basis. Historically, Rule 506 permitted an unlimited dollar amount of securities to be sold to an unlimited number of accredited investors and up to 35 non-accredited investors, as long as specified conditions of that rule were met. One of these conditions is that there be no general solicitation or advertising.

## Background

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On July 10, 2013, the Securities and Exchange Commission (the “SEC”) adopted two long-awaited changes to Regulation D.<sup>1</sup> In the first change, the SEC eliminated the prohibition against general solicitation and general advertising in certain offerings pursuant to Rule 506.<sup>2</sup> In the second change, the SEC disqualified certain issuers associated with “bad actors” from relying on Rule 506 in an offering of securities.<sup>3</sup> Both of these changes became effective September 23, 2013.

Also on July 10, 2013, the SEC proposed amendments to Regulation D, Securities Act Rule 156 and Form D (*i.e.*, the notice filed with the SEC pursuant to Regulation D).<sup>4</sup> The proposed amendments are intended to allow the SEC to better evaluate the development of market practices in offerings of securities pursuant to Rule 506 and to address concerns that may arise in connection with allowing issuers to engage in general solicitations.



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## Elimination of Prohibition Against General Solicitation

Under new Rule 506(c), issuers may make offers and sales to any person provided that all purchasers of the securities are accredited investors and the issuer takes “reasonable steps to verify” that purchasers of the securities are accredited investors. In addition, the other applicable conditions of Regulation D must be satisfied.

This means that an issuer relying on Rule 506(c) will be able to communicate with prospective investors by widely disseminating information about their offerings, such as through the internet, television, advertisements, mass mailings and at conferences. Depending on how it is used, this could represent a significant change to historical private placement practice.

The most challenging aspect of the new rule is expected to be the requirement that the issuer take reasonable steps to verify that purchasers of securities are accredited investors as this is something that issuers have not been concerned with in the past.

### Verification of Accredited Investors

Rule 506(c) does not mandate the specific procedures that issuers must follow to be assured that reasonable steps have been taken to verify that the purchasers of its securities are accredited investors. In the adopting release, the SEC said that “[w]hether the steps taken are ‘reasonable’ will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction.” The SEC highlighted the following factors that issuers should consider in a facts and circumstances analysis:

- The nature of the 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, 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 created the following four specific non-exclusive methods that will be deemed to meet the “reasonable steps to verify” requirement when considering the status of natural persons:

- When verifying whether a natural person is an accredited investor on the basis of income, an issuer can review copies

of any form filed with the Internal Revenue Service that reports income, such as a W-2, Form 1099 and a filed Form 1040, for the two most recent years, and obtain a written representation from the person that he or she has a reasonable expectation of reaching the necessary income level during the current year;

- When verifying whether a natural person is an accredited investor on the basis of net worth, an issuer can review any of the following documents dated within the last three months and obtain a written representation from the person that all liabilities necessary to make a determination of net worth have been disclosed:
  - For assets – bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and
  - For liabilities – a consumer credit report from at least one nationwide consumer reporting agency (e.g., Equifax, Experian or TransUnion);
- An issuer can obtain a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant that such third party has taken reasonable steps to verify that the person is an accredited investor within the prior three months and has determined that the person is an accredited investor; and
- With respect to any natural person who invested in an issuer’s private placement as an accredited investor prior to September 23, 2013, and remains an investor, for any subsequent offering conducted by the same issuer, the issuer can obtain a certification from the person at the time of sale in the new offering that he or she qualifies as an accredited investor.

The SEC did not create any similar safe harbors with respect to investors that are not natural persons.

Rule 506(c) only requires that issuers have a reasonable belief that an investor is accredited. In appropriate circumstances, issuers can rely on third-party service providers to perform this function. Issuers should monitor whether third-party service providers offer to verify the status of accredited investor as an outsourced service and analyze whether these service providers are able to provide sufficient comfort regarding their verification procedures and accredited investor status conclusions.

Because an issuer has the burden of demonstrating that its offering is entitled to an exemption from the Securities

Act registration requirements, regardless of the steps the issuer takes to verify accredited investor status, it will be important for issuers to retain adequate records. At a minimum, the records should document the steps taken and the documents reviewed as part of the verification process. In addition, it will be important for issuers to create policies and procedures for the creation, retention and ultimate destruction of these records.

### General Solicitation in Other Private Offerings

Section 4(a)(2) exempts “[t]ransactions by an issuer not involving any public offering.” This has typically been interpreted by the courts and practitioners to preclude general solicitation and general advertising in offerings relying on the Section 4(a)(2) exemption. The SEC has revised Rule 500(c) of Regulation D to make clear that the flexibility with respect to general solicitation now provided by Rule 506(c) does not extend to Section 4(a)(2) offerings that are made outside of the Rule 506(c) exemption. As a result, an issuer engaging in a private placement offering, other than in reliance on Rule 506(c), will still not be able to engage in a general solicitation or general advertising with respect to that offering.

### Alternative Safe Harbors under Rule 506

As amended, Rule 506 now contains two alternative safe harbors. As an alternative to Rule 506(c) discussed above, issuers may continue to conduct an offering in reliance on Rule 506(b), which will be subject to the prohibition on general solicitation and general advertising. Rule 506(b) al-

## *Recent amendments to Regulation D ... have the potential to result in significant changes to capital formation practices within the United States.*

lows and preserves the ability to make offers and sales to 35 non-accredited investors, or to persons who the issuer reasonably believes are not accredited investors, who meet certain sophistication requirements. Offerings made in reliance on Rule 506(b) are not subject to the verification requirement of new Rule 506(c).

### Practice Points

If an issuer wishes to engage in general solicitation and/or general advertising in connection with an offering, it may not

make offers and sales to non-accredited investors, including employees; it would have to make a separate offering to such persons pursuant to some other available exemption and it will have to do so in a manner such that the offering will not be integrated with the Rule 506(c) offering.

For an ongoing offering under Rule 506 that commenced before September 23, 2013, the issuer may choose to continue the offering in accordance with old Rule 506(b) (*i.e.*, continue to be subject to the prohibition against general solicitation and general advertising) or in accordance with Rule 506(c). If an issuer chooses to continue the offering in accordance with the requirements of Rule 506(c), any general solicitation that occurs after September 23, 2013 will not affect the exempt status of offers and sales of securities that occurred prior to that date. Before making any decision to switch to relying on Rule 506(c) for the continuation of the offering, issuers will want to consider the status of the existing offering and the accredited investor status of potential investors they intend to target going forward.

Regarding verification, the SEC has affirmatively stated that an issuer will *not* have satisfied its responsibility to take reasonable steps to verify accredited investor status if it, or those acting on its behalf, requires only that a person check a box in a questionnaire or sign a form, absent other information about the investor's status. This could represent a significant change in procedure, as it has been common practice to have investors check a box in a subscription document claiming accredited investor status, without providing additional information. No longer will the mere receipt of

representations regarding accredited investor status in a subscription agreement be sufficient absent additional proof or other facts to support a conclusion that an issuer has taken reasonable steps to verify an investor's status. The additional facts

will depend on the facts and circumstances. For instance, the SEC noted that in certain circumstances, such as where an offering required a high minimum purchase amount, if the investor can meet such amount, the likelihood that the purchaser satisfies the definition of “accredited investor” may be quite high such that, absent facts indicating the person is not accredited, it may be reasonable for the issuer to take few steps, or, in some cases no steps, to verify accredited investor status, other than to confirm that the investor's purchase was not being financed by a third party. Issuers intending to rely

on Rule 506(c) should review the procedures they have in place and determine what changes are necessary to be able to comply with the SEC's new requirements.

### SEC General Solicitation Guidance

The SEC provided helpful guidance for practitioners to consider. First, "[a]n issuer that solicits new investors through a website accessible to the general public or through a widely disseminated email or social media solicitation, or through print media, such as a newspaper, will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party."

Privately offered funds, such as hedge funds, venture capital funds and private equity funds, in addition to relying on an exemption from the registration requirements of the Securities Act (*e.g.*, Rule 506), also typically rely on one of two exclusions from the definition of investment company, as set forth in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act"), to avoid being subject to the regulatory provisions of that act. Under the Investment Company Act, an issuer may rely on such exclusions provided it is not making and does not propose to make a public offering. The SEC historically has regarded Rule 506 offerings as non-public offerings. In the adopting release, the SEC stated that an issuer may continue to rely on Sections 3(c)(1) and 3(c)(7) notwithstanding the ability to engage in a general solicitation in compliance with Rule 506(c).

However, similar guidance has not yet been provided under the Commodity Exchange Act with respect to commodity pool operator ("CPO") status. In response to recent rule changes made by the Commodity Futures Trading Commission (the "CFTC"), many managers of private funds have been required to claim relief from registration as a CPO based on CFTC Rule 4.13(a)(3), or take advantage of lighter regulation under CFTC Rule 4.7. These rules each require, among other things, that offerings be made without marketing to the public in the United States. Absent further guidance from the CFTC, it does not appear that a fund whose CPO is relying on CFTC Rules 4.13(a)(3) or 4.7 would be able to take advantage of the general solicitations permitted in a Rule 506(c) offering.

Many critics of Rule 506(c) suggested that content and other restrictions be imposed on forms of general solicitation for private funds. The SEC indicated that it would monitor

and study the development of advertising by private funds. The SEC further cautioned that investment advisers to private funds should carefully review their policies and procedures regarding, among other things, the nature and content of private fund sales literature to carefully determine whether they are reasonably designed to prevent the use of fraudulent or materially misleading advertising and make appropriate amendments to those policies and procedures, particularly if the funds they advise intend to engage in a general solicitation.

The SEC also addressed the interplay between concurrent offerings made outside the United States in reliance on Regulation S and inside the United States in reliance on Rule 506(c). Of particular concern is the requirement in Regulation S that there be no directed selling efforts in the United States. The SEC stated that an offshore offering conducted in compliance with Regulation S would not be integrated with a concurrent domestic unregistered offering that is conducted in reliance on Rule 506, even if there is general solicitation or general advertising in the domestic offering. This position is consistent with the SEC's views regarding integration of concurrent offshore offerings and registered domestic offerings. However, issuers that plan to conduct an offering within the United States in reliance on Rule 506(c), while also conducting an offering outside the United States, should also carefully consider whether general solicitation in the United States will run afoul of local rules in foreign jurisdictions.

### Bad Actor Disqualification Rule

Under new Rule 506(d) of Regulation D, if any covered person has had a disqualifying event, an issuer would be prohibited from relying on the safe harbor for private securities offerings provided by Rule 506. The disqualification provisions are substantially similar to those already contained in Rule 262 of Regulation A under the Securities Act, one the rules providing a safe harbor from the registration requirements for offerings up to \$5,000,000.

#### Covered Persons

The covered persons whose actions could give rise to disqualification are:

- The issuer and predecessor and affiliated issuers;
- Directors and executive officers of the issuer, other officers of the issuer participating in the offering and general partners or managing members of the issuer;

- 20 percent beneficial owners of the issuer, calculated based on voting power;
- Promoters connected with the issuer in any capacity at the time of the sale;
- If the issuer is a private fund, its investment manager(s) and any director, executive officer, participating officer, general partner or managing member of any such investment manager, as well as any director, executive officer or participating officer of any such general partner or managing member; and
- Persons compensated for soliciting investors and any director, executive officer, participating officer, general partner or managing member of any such solicitor, as well as any director, executive officer or participating officer of any such general partner or managing member.

### Participation in an Offering

The SEC did not define what it means to be participating in the offering. However, for purposes of determining whether an officer is “participating” in an offering, the SEC noted that this must entail more than mere “transitory or incidental involvement.” Rather, the SEC explained that this “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.”

### Voting Power

In explaining the 20 percent voting power standard, the SEC stated that voting power in this context would include securityholders that “have or share the ability ... to control or significantly influence the management and policies of the issuer through the exercise of a voting right.” This voting right would apply not only to the ability to vote for the election of directors (or their equivalent) but also the ability to vote to approve significant transactions such as acquisitions, dispositions or financings. However, securities conferring voting rights limited solely to approval of changes to the rights and preferences of the class of securities would *not* be considered voting securities for these purposes.

### Disqualifying Events

The SEC established the following eight categories of disqualification:

- **Criminal Convictions**—Criminal felony or misdemeanor convictions within ten years (five years for issuers and

their predecessor and affiliated issuers) in connection with the purchase or sale of any security, involving any false filing with the SEC or arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;

- **Court restraining orders and injunctions**—Court orders within five years that, at the time of sale by the issuer, restrain or enjoin the covered person from engaging in any conduct in connection with the purchase or sale of any security, involving any false filing with the SEC or arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- **Final regulatory orders**—Final orders from a state securities commission, state banking regulator, state insurance commission, federal banking agency, the CFTC or the National Credit Union Administration that either at the time of a sale by the issuer bars the person from association with an entity regulated by such authority, from engaging in the securities, insurance or banking business or from engaging in savings association or credit union activities, or that constitutes a final order entered within ten years, based on a violation of a law or regulation that prohibits fraudulent, manipulative or deceptive conduct;
- **SEC disciplinary orders**—SEC disciplinary orders that, at the time of sale by the issuer, suspend or revoke the person’s registration as a broker, dealer, municipal securities dealer or investment adviser, limit the activities of such person or bar such person from being associated with any entity or from participating in any “penny stock” offering; with censures and orders to pay civil money penalties, assuming they are paid in accordance with the order, not being disqualifying events;
- **SEC cease and desist orders**—SEC cease and desist orders within five years that, at the time of the sale by the issuer, order the person to cease and desist from violating either scienter-based anti-fraud provisions of federal securities laws or the Section 5 registration requirements of the Securities Act;
- **SRO suspension or expulsion**—Suspension from membership in, or association with, a registered national securities exchange or registered securities association for conduct inconsistent with just and equitable principles of trade;

- **SEC stop orders**—SEC stop orders relating to a registration statement or Regulation A offering statement filed with the SEC within five years, or at the time of such sale by the issuer being the subject of a stop order investigation; and
- **Postal Service false representation orders**—United States Postal Service false representation orders entered within five years, or at the time of sale by the issuer, being subject to a temporary restraining order or preliminary injunction for conduct alleged by the postal service to constitute a scheme for obtaining money or property through the mail by means of false representations.

### Exceptions

Triggering events that occurred before September 23, 2013 will *not* disqualify an offering from relying on Rule 506. Instead, any such pre-existing disqualifying events must be prominently disclosed to purchasers in writing a reasonable time prior to a sale, regardless of whether the purchasers are accredited investors. If an issuer is relying on Rule 506 after September 23, 2013 and there is a covered person that had an event that would have triggered disqualification had it occurred after that date, the issuer must draft appropriate disclosure and determine its placement and delivery method.

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If an issuer establishes that it did not know that a disqualifying event existed and that, even with the exercise of reasonable care, it could not have known that a disqualifying event existed, an offering otherwise eligible to rely on Rule 506 will be able to rely on the exemption notwithstanding the existence of a disqualifying event. The SEC declined to specify what constitutes reasonable care, stating in the adopting release that “the steps an issuer should take to exercise reasonable care will vary according to the particular facts and circumstances.” However, an issuer will not be able to establish that it has exercised reasonable care unless it has made a factual inquiry into whether any disqualifying event exists.

### Practice Points

Issuers and financial intermediaries that anticipate being involved in private placements relying on Rule 506 should develop due diligence procedures in advance of an offering to determine that no covered persons for such offerings have any disqualifying events. Each covered person should be asked to confirm, ideally in writing, that such person did not suffer a disqualifying event. In some cases it may be sufficient to make an inquiry of an entity, such as a registered broker-dealer acting as placement agent, with respect to specific officers and controlling persons. To the extent that an issuer is engaged in a private placement that is ongoing in nature, it should develop an updating procedure to confirm that no disqualifying events have arisen or been identified after the initial inquiry.

To assure consistency, issuers should consider drafting questionnaires to elicit information regarding bad actor disqualifications from covered persons. In addition, issuers should also consider drafting provisions to include in employment or other applicable contracts with a covered person requiring that such information be certified and updated.

Because reasonable care is a matter of facts and circumstances, in some situations it may be prudent for an issuer to go beyond direct questioning of the covered persons. For example, selected court or regulatory records and publicly available databases could be searched.

The adopting release also indicated that the “timeframe for inquiry should also be reasonable in relation to the circumstances of the offering and the participants.” For ongoing offerings, the reasonable care procedures need to be updated from time to time. While frequency and degree of updating will depend on the circumstance of the issuer, the offering and the participants, the SEC stated that it “would expect that periodic updating could be sufficient.” However, if an issuer has notice suggesting that closer monitoring is warranted, such as knowledge that a covered person is subject to a judicial or regulatory proceeding or that weaknesses exist in screening procedures, more frequent updating may be needed. The SEC expects that issuers will manage this reasonable care requirement through “contractual covenants from covered persons to provide bring-down representations, questionnaires and certifications, negative consent

letters, periodic re-checking of public databases, and other steps, depending on the circumstances.”

Financial intermediary entities involved in private placements should monitor their principals and key employees on an ongoing basis for events that could disqualify a private placement from being able to rely on Rule 506. While SEC-registered investment advisers (and “exempt reporting advisers”) already may ask personnel a variety of questions for purposes of disclosing disciplinary events on Form ADV, these questionnaires should be reviewed to ensure they cover all of the relevant disqualifying events for Rule 506.

If a court or regulatory authority issuing an order specifies that disqualification under Rule 506 should not be a consequence of that order, the order will not be a disqualifying event. In addition, the SEC has the power to waive a disqualifying event if, upon a showing of good cause (and without prejudice to any other action the SEC may be taking), it determines that it is not necessary under the circumstances to deny the availability of an exemption under Rule 506. The SEC declined to articulate standards for granting such waivers although it left the door open for it to do so in the future after the SEC and its staff “have developed experience in handling waiver requests under the Rule 506(d) disqualification rules.”

Events relating to affiliates of issuers will not be disqualifying events for Rule 506 purposes if they pre-date the affiliate relationship as long as the affiliated entity in question is neither in control of the issuer nor under common control, together with the issuer, by a third party that controlled the affiliated entity at the time of the disqualifying events. While Rule 506(d) does not provide different treatment for entities that have undergone a change of control or implemented changes in policies and procedures designed to prevent the occurrence of activities that gave rise to disqualification (even where such policies and procedures have been approved by a regulator or a court), the SEC expects that the “staff will adopt procedures for the prompt issuance of waivers of Rule 506 disqualification upon a proper showing that there has been a change of control and the persons responsible for the activities resulting in a disqualification are no longer employed by the entity or exercise influence over such entity.” It may be advisable for acquisition due diligence to include inquiry as to the existence of any events that could disqualify reliance on the Rule 506 exemption and whether there may be any basis for a waiver request.

## Proposed Changes to Regulation D, Rule 156 and Form D

When adopting Rule 506(c), the SEC noted that a number of critics expressed concerns that the elimination of the prohibition on general solicitation in an offering of securities pursuant to Rule 506(c) “would attract both accredited and non-accredited investors and could result in an increase in fraudulent activity in the Rule 506 market, as well as an increase in unlawful sales of securities to non-accredited investors.” To better assess the impact that the SEC’s changes to Rule 506 will have on investor protection and capital formation, as well as to assist the enforcement efforts of federal and state regulators, the SEC has proposed a number of additional changes to Regulation D, Rule 156 and Form D. Although as of the date of this writing final rules have not been adopted, issuers should monitor developments in this area as changes could adversely impact the desire to rely on certain provisions of Regulation D, particularly Rule 506(c).

### Summary of Proposed Changes

The rule proposals would, among other things:

- Require the filing of a Form D in offerings of securities conducted in reliance on Rule 506(c) at least 15 calendar days before the issuer engages in a general solicitation, as opposed to the current rule of filing within 15 calendar days after the date of first sale;
- Require the filing of a closing amendment to Form D within 30 calendar days after the termination of any offering conducted in reliance on Rule 506;
- Require written general solicitation materials used in an offering of securities to include certain legends and other disclosures;
- For a two-year temporary basis, require written general solicitation materials prepared by or on behalf of the issuer and used in an offering of securities to be submitted to the SEC;
- Disqualify an issuer from relying on Rule 506 for future offerings of securities for one year if the issuer, or any predecessor or affiliate of the issuer, did not comply within the last five years with a Form D filing requirement in an offering of securities pursuant to Rule 506;
- Extend the anti-fraud guidance contained in Rule 156 to the sales literature used to sell interests in private funds engaged in a general solicitation; and

- Require an issuer to include significant additional information in a Form D about offerings conducted in reliance on Regulation D and particularly Rule 506.

### Other Changes Possible

The SEC has indicated that it had directed the staff to execute a comprehensive work plan to review and analyze the use of Rule 506(c). Implementation of the work plan will assist the SEC in evaluating the development of market practices in offerings made in reliance on Rule 506(c) and whether the SEC should consider additional changes related to Rule 506(c), consistent with the SEC's mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation.

### Conclusion

The changes to Rule 506 are already effective. Although it is too soon to draw any conclusions on how these amendments will affect capital raising, interested persons will want to monitor developments in response to the new rule changes. It will be interesting to see whether, and when, issuers will take advantage of the flexibility now available to them under Rule 506(c) as it has the potential to substantially impact private placement practices. Similarly, it will be interesting to observe the extent to which the bad actor disqualification provisions actually impact private placements.

#### ENDNOTES

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<sup>1</sup> At the same time, the SEC also amended Rule 144A under the Securities Act to provide that securities may be offered to persons other than qualified institutional buyers, or QIBs, 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. A discussion

of this change is outside the scope of this article.

<sup>2</sup> Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415 (July 10, 2013), available at <http://www.sec.gov/rules/final/2013/33-9415.pdf>.

<sup>3</sup> Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414 (July 10, 2013), available at <http://www.sec.gov/rules/final/2013/33-9414.pdf>.

<sup>4</sup> See Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Securities Act Release No. 9416 (proposed July 10, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>.