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Legal Update
July 17, 2013

SEC Eliminates General Solicitation and General Advertising Prohibitions from Certain Private Placements

On July 10, 2013, the US Securities and Exchange Commission adopted rules eliminating the prohibition against general solicitation and general advertising in certain offerings of securities pursuant to Rule 506 of Regulation D under the Securities Act of 1933 and in offerings pursuant to Rule 144A under the Securities Act.[1] The changes were mandated by Title II of the Jumpstart Our Business Startups Act enacted on April 5, 2012, or the JOBS Act, and did not stray far from the rules as proposed by the SEC on August 29, 2012.[2] The rule changes become effective 60 days after publication in the *Federal Register*, and until that date general solicitations and general advertising in connection with a Rule 506 or Rule 144A offering continues to be prohibited.

Rule 506 of Regulation D provides a limited offering "safe harbor" exemption under Section 4(a)(2) of the Securities Act of 1933 from registration of securities under the Securities Act, while Rule 144A permits private resales of unregistered securities to "qualified institutional buyers," or "QIBs." Rule 506 is frequently relied upon by issuers raising capital on a private placement basis, including private pooled investment funds, and permits 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 are met. Rule 144A is frequently relied upon for secondary market transactions in unregistered, restricted securities, particularly debt securities. Accordingly, these rule changes have the potential to result in significant changes to capital formation practices within the United States.

At the same time, the SEC amended Rule 506, in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, to disqualify certain issuers associated with "bad actors" from relying on Rule 506 in the offering of securities. For more information on the general solicitation and advertising amendment, see our Legal Update dated July 17, 2013, entitled "SEC Disqualifies 'Bad Actors' from Participating in a Rule 506 Offering."[3]

Summary

In particular, the changes adopted by the SEC:

- Amend Rule 506 to provide that the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D does not apply to offers and sales of securities made pursuant to new Rule 506(c), provided that:
  - all purchasers of the securities are accredited investors;
  - the issuer takes "reasonable steps to verify" that purchasers of the securities are accredited investors; and
  - the other applicable conditions of Regulation D are satisfied;

- Include in new Rule 506(c) four non-exclusive and non-mandatory methods an issuer may use to verify that a natural person is an accredited investor;
- Amend Form D to add a separate box for issuers to check to indicate whether they are using general solicitation or general advertising in a Rule 506 offering; and
- Amend Rule 144A 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 believe are QIBs.

New Rule 506(c)

New Rule 506(c) does not mandate any specific procedures that issuers must follow to be assured that the steps they have taken to verify that the purchasers of its securities are accredited investors are reasonable. 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 its 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.

In response to the concerns of many commenters on the proposed rules, in new Rule 506(c) the SEC added the four following specific non-exclusive methods of verifying accredited investor status for natural persons that will be deemed to meet the "reasonable steps to verify" requirement:

- 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, Schedule K-1 of Form 1065 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 person or entity 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 Rule 506(b) private placement as an accredited investor prior to the effective date of new Rule 506(c) and

remains an investor of that issuer, for any Rule 506(c) offering conducted by the same issuer, an 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.

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 an issuer takes to verify accredited investor status, the SEC stated that "it will be important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor."

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 also revised Rule 500(c) of Regulation D to make clear that the flexibility with respect to general solicitation now provided by new Rule 506(c) does not extend to Section 4(a)(2) offerings that are made outside of the new Rule 506(c) exemption. As a result, an issuer engaging in a Section 4(a)(2) offering, other than a Rule 506(c) offering, will still not be able to engage in a general solicitation or general advertising with respect to that offering.

As amended, Rule 506 contains two alternative methods of compliance. Issuers may continue to conduct an offering subject to the prohibition on general solicitation and general advertising but allows and preserve the ability to make offers and sales to 35 non-accredited investors, or to persons who the issuer reasonably believes are not accredited investors (without being subject to the verification requirement), who meet certain sophistication requirements. Alternatively, issuers can conduct an offering under the new rules permitting general solicitation and general advertising that does not permit sales to non-accredited investors, and requires an issuer to take reasonable steps to verify the accredited investor status of purchasers. The "reasonable steps to verify" requirement must be satisfied even if all purchasers happen to be accredited investors.

- Accordingly, if an issuer wishes to engage in general solicitation and/or general advertising, it may not make offers and sales to non-accredited persons, including employees, pursuant to the same offering; it would have to make a separate offering to such persons pursuant to some other available exemption that will not be integrated with the Rule 506(c) offering.
- With respect to transition matters, for an ongoing offering under Rule 506 that commenced before the effective date of Rule 506(c), the issuer may choose to continue the offering after the effective date in accordance with old Rule 506(b) (e.g., continue to be subject to the prohibition against general solicitation and general advertising) or in accordance with new Rule 506(c).
- Importantly, regarding verification, the SEC has affirmatively stated its view that an issuer will *not* have taken 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. Thus the mere receipt of representations regarding accredited investor status in a subscription agreement may be insufficient absent additional proof or other facts. 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 to verify, 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.

In the adopting release, the SEC provided, or repeated, helpful guidance to be considered when applying new Rule 506(c). 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."

Second, the SEC also provided its views regarding the application of new Rule 506(c) to privately offered pooled investment funds, such as hedge funds, venture capital funds and private equity funds. These 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, to avoid being subject to the regulatory provisions of the Investment Company Act. Under the Investment Company Act, an issuer may rely on such exclusions provided they are not making and do not propose to make a public offering. The SEC historically has regarded Rule 506 offerings as non-public offerings for purposes of Section 3(c)(1) and 3(c)(7). In the adopting release, the SEC reaffirmed its position 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). This is also significant for structured finance issuers that also rely on these Investment Company Act exclusions and regularly engage in Rule 144A offerings, including, for example, for insurance-linked securities, CLOs and other asset backed securities.

In addressing several comments that suggested content and other restrictions be imposed on forms of general solicitation for pooled investment funds, the SEC indicated that they would continue to monitor and study the development of advertising by pooled investment funds. The SEC further cautioned that investment advisers to pooled investment 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 intend to engage in a general solicitation.

Third, the SEC addressed the interplay between concurrent offerings made outside the United States in reliance on Regulation S and inside the United States made in reliance on Rule 506 or Rule 144A where there is a general solicitation or general advertising. Of particular concern is the requirement in Regulation S that there be no directed selling efforts in the United States. The SEC reaffirmed its position that an offshore offering conducted in compliance with Regulation S would not be integrated with a concurrent domestic unregistered offering that is conducted in compliance with Rule 506 or Rule 144A, even if there is a general solicitation or general advertising. This position is consistent with the SEC's views regarding integration of concurrent offshore offerings made in compliance with Regulation S and registered domestic offerings.

Amendment to Form D

As amended, Form D requires that issuers conducting an offering in reliance on new Rule 506(c) must indicate on the form that they are relying on the Rule 506(c) exemption by checking the new box on the form.

Amendment to Rule 144A

As amended, Rule 144A(d)(1) only requires that securities sold in reliance on the rule be sold to a QIB, or to a person that the seller and any person acting on behalf of the seller reasonably believes is a QIB. The SEC also noted that the general solicitation now permitted by Rule 144A will not affect the availability of the Section 4(a)(2) exemption or Regulation S for the initial sale of securities by the issuer to the initial purchaser.

The SEC also clarified that for ongoing Rule 144A offerings that commenced before the effective date of the new rules, offering participants will be entitled to conduct the portion of the offering following the effective date of the new rules using a general solicitation, without affecting the availability of Rule 144A for the portion of the offering that occurred prior to the effective date.

Practical Considerations

For an ongoing offering under Rule 506(b), the SEC is permitting an issuer to choose to continue the offering in accordance with the requirements of either Rule 506(b) or new Rule 506(c). If an issuer chooses to continue the offering in accordance with the requirements of new Rule 506(c), any general solicitation that occurs after the effective date of the new rules will not affect the exempt status of offers and sales of securities that occurred prior to the effective date of new Rule 506(c). 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.

Today it is common for issuers relying on Rule 506(b) to have investors check a box in a subscription document claiming accredited investor status, but not provide additional information supporting their status. In most situations, this likely will not be sufficient under new Rule 506(c) to support an argument that an issuer has taken reasonable steps to verify an investor's status. As a result, issuers intending to rely on new Rule 506(c) should review the procedures they have in place and determine what changes are necessary to be able to show that they have taken reasonable steps to verify accredited investor status. The adopting release provides a number of examples of steps that may be sufficient depending on the specific facts and circumstances of an investor, and should be reviewed in determining whether to implement one or more of them or to make other changes.

Although as noted above, the SEC did provide guidance to pooled investment funds that rely or seek to rely on the exceptions from the definition of investment company in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, similar guidance has not yet been provided under the Commodity Exchange Act with respect to commodity pool operator status. In response to recent rule changes made by the Commodity Futures Trading Commission, many managers of pooled investment 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.

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 the United States component of the offering including general advertising may run afoul of local rules in other jurisdictions.

Under new Rule 506(c)(2)(i), the SEC reaffirmed its view that issuers only need to have

a reasonable belief that the investor is accredited. It is therefore very important for issuers to take reasonable steps to verify that an investor is an accredited investor at the time of sale. In addition, because issuers making an offering in reliance on Rule 506(c) should keep records documenting the reasonable steps they have taken to form a reasonable belief as to accredited investor status and the basis for concluding that an investor is accredited, it will be important for issuers to create policies and procedures for the creation, retention and ultimate destruction of these records.

Issuers should monitor whether third-party service providers begin to offer the verification of accredited investor status as an outsourced service, analyze whether these service providers are able to provide sufficient comfort regarding their verification procedures and accredited investor status conclusions, and determine whether the use of these third-party service providers would be beneficial in their offerings of securities.

Finally, issuers should also be mindful of any future rules the SEC may adopt, or interpretations it may provide, concerning offerings made pursuant to Rule 506(c). In particular, on July 13, 2013, the SEC proposed various rule changes that could impact Rule 506(c) offerings.4 The status of these proposals should be monitored to determine their impact on Rule 506(c) offerings.

If you have any questions regarding the bad actor disqualification rule or Regulation D, please contact the author of this Legal Update, Michael L. Hermsen, at +1 312 701 7960, or any of the lawyers listed below, or any other member of our Corporate & Securities group.

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Endnotes

1 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.

2 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9354 (proposed August 29, 2012), available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

3 Available at http://www.mayerbrown.com/SEC-Disqualifies-Bad-Actors-from-Participating-in-a-Rule-506-Offering-07-17-2013

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