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SEC Eliminates the Ban on General Solicitation, and Disqualifies Participation by "Bad Actors," in Certain Private Securities Offerings

LILY J. LU AND THERESA NGUYEN

This article summarizes the final rules adopted by the Securities and Exchange Commission eliminating the ban on general solicitation and general advertising for private securities offerings, the proposed rules on Regulation D offerings, and discusses some of the more important practical effects of the final rules — particularly permitting general solicitation and general advertising — on market participants, including start-up and emerging companies, private funds, registered broker-dealers, and issuers and underwriters who engage in concurrent U.S. and offshore private securities offerings.

Recently, the Securities and Exchange Commission ("SEC") adopted final rules ("Final Rules") eliminating the ban on general solicitation and general advertising for private securities offerings under Rule 506 of Regulation D under the Securities Act ("Regulation D") and Rule 144A under the Securities Act ("Rule 144A"). The Final Rules also make Rule 506 unavailable for offerings if the issuer or any related "covered person" is a "bad actor" (i.e., has engaged in a "disqualifying event"). The adoption of these rules by the SEC was required under Section 201(a) of the Jumpstart Our Business Startups

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Act (“JOBS Act”) and Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), respectively. The Final Rules became effective on September 23, 2013.

In connection with the adoption of the Final Rules, the SEC also proposed certain rule amendments that, if adopted, would impose significant new requirements on Regulation D offerings. These proposed amendments stem from concerns raised by commentators and SEC commissioners that permitting general solicitation and general advertising in private securities offerings, without additional protections, is inconsistent with the goal of investor protection and will result in an increase in fraudulent activity in the private placement market.

The adoption of the Final Rules represents a significant shift from the SEC’s longstanding view that securities may only be sold pursuant to SEC registration, or otherwise privately, with substantially no solicitation or advertising. This article summarizes the Final Rules and proposed rules and discusses some of the more important practical effects of the Final Rules — particularly permitting general solicitation and general advertising — on market participants, including start-up and emerging companies, private funds, registered broker-dealers and issuers and underwriters who engage in concurrent U.S. and offshore private securities offerings.

ELIMINATION OF BAN ON GENERAL SOLICITATION FOR CERTAIN RULE 506 OFFERINGS

Background

An issuer who seeks to offer and sell securities in the United States must either register the offering under the Securities Act of 1933 (“Securities Act”) by filing a registration statement with the SEC or rely on an exemption from the registration requirements of the Securities Act. Section 4(a)(2) of the Securities Act (formerly Section 4(2) of the Securities Act) exempts securities offerings by issuers that do not involve a “public offering.” The courts and the SEC have developed a substantial body of judicial interpretations and administrative guidance interpreting the phrase “not involving a public offering.” One factor is whether the issuer engaged in any general solicitation or general advertising relating to the securities being offered and sold. Examples of general solicita-

tion and general advertising include advertisements published in newspapers and magazines, communications broadcast over television and radio, information available on unrestricted Web sites, and seminars where attendees have been invited by means of general solicitation or general advertising. Forms of general solicitation and general advertising that may find more utilization after effectiveness of the Final Rules include social media, forms of short-term static advertising such as kiosks, and offers to potential investors who have no "preexisting, substantive relationship" with the issuer or its agent.[1]

The SEC adopted Regulation D in 1982 to provide issuers with a non-exclusive safe harbor from the registration requirements of the Securities Act. An issuer that makes a securities offering in compliance with Regulation D can be confident that the offering does not in fact "involve a public offering," and is therefore exempt from the registration requirements of the Securities Act. In addition, because the Regulation D safe harbor has historically been non-exclusive, the issuer could rely on the registration exemption under Section 4(a)(2) of the Securities Act even if the offering failed to satisfy all of the requirements of Regulation D.

Prior to the effectiveness of the Final Rules, Regulation D included three available safe harbors from the registration requirement of the Securities Act, as follows:

- For offerings up to US$1 million under Rule 504 of Regulation D;
- For offerings up to US$5 million under Rule 505 of Regulation D; and
- For offerings without regard to dollar amount under Rule 506 of Regulation D.

Historically, issuers have relied on the Rule 506 safe harbor most frequently, which permitted an issuer to offer and sell an unlimited amount of securities without registration under the Securities Act if (among other things):

- The issuer sells the securities to an unlimited number of "accredited investors" (as defined in Rule 501(a) of Regulation D);
- The issuer sells the securities to not more than 35 investors who are not accredited investors but meet certain requirements for being sophisticated investors; and

- Neither the issuer nor any person acting on its behalf offers or sells the securities through any form of general solicitation or general advertising.

In April 2012, Congress passed the JOBS Act, which required, among other things, that the SEC eliminate the ban on general solicitation and general advertising in private securities offerings under Rule 506 of Regulation D. The intention underlying this mandate in the JOBS Act is to facilitate capital raising by permitting issuers to use previously unavailable solicitation and advertising methods to seek investors and thereby encourage the creation of new jobs.

NEW RULE 506(C) OF REGULATION D PERMITTING USE OF GENERAL SOLICITATION

On July 10, 2013, the SEC adopted new Rule 506(c) of Regulation D, which now provides an additional safe harbor from the registration requirements of the Securities Act for issuers that use general solicitation or general advertising to seek investors.[2] Issuers will be permitted to use general solicitation and general advertising to offer securities under new Rule 506(c) of Regulation D if:

- All of the purchasers of the securities are accredited investors (or reasonably believed to be accredited investors at the time of sale); and
- The issuer takes "reasonable steps to verify" that the purchasers are accredited investors.

Whether an issuer has taken "reasonable steps to verify" that an investor is an accredited investor will depend on the particular facts and circumstances of each investor and transaction. Factors include the nature of the investor and the type of accredited investor that the investor claims to be (e.g., an individual, an investment company or a broker-dealer), the amount and type of information that the issuer has about the investor and the nature of the offering (e.g., the minimum investment amount). The SEC also identified four non-exclusive, non-mandatory methods of verifying accredited investor status for natural persons that, if used, will be deemed to satisfy the verification requirements of new Rule 506(c):

- Reviewing a copy of an Internal Revenue Service form that reports income of the purchaser for the two most recent years and obtaining a written representation from the purchaser that he or she reasonably expects to reach the necessary income level during the current year;
- Reviewing certain listed types of documentation, dated within the prior three months, showing assets and liabilities and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed;
- Relying on a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, an attorney or a certified public accountant regarding the purchaser's accredited investor status; or
- Relying on a certification from an existing investor who previously invested in the issuer's Rule 506(b) offering prior to the effective date of new Rule 506(c).

Issuers that conduct offerings without general solicitation and general advertising under the existing Rule 506(b) exemption need not comply with the new verification requirements.

In adopting new Rule 506(c), the SEC confirmed that private funds will be permitted to engage in general solicitation and general advertising in compliance with the requirements of Rule 506(c) without losing the exclusion from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, which requires, among other things, that an issuer relying on either exclusion not make a public offering of its securities.

Additional Proposed Rules that Would Apply to Regulation D Offerings

In connection with its adoption of new Rule 506(c) of Regulation D, the SEC also proposed rule amendments that would apply to Regulation D offerings. These amendments are intended to enhance the SEC's ability to monitor the private placement market after lifting the ban on general solicitation and general advertising and to address investor protection concerns related to the use of general solicitation and general advertising.[3] The proposals include, among other things:

- Requiring issuers to file a Form D with the SEC at least 15 calendar days before general solicitation or general advertising begins in reliance on new Rule 506(c) and a closing amendment to Form D no later than 30 days after the closing of a Rule 506 offering;
- Expanding the disclosure required on Form D;
- Requiring legends in written general solicitation materials that would inform potential investors of certain risks and the requirement that sales are limited to accredited investors;
- Requiring a private fund that includes information about past performance in its written general solicitation materials to include in its materials information on the limitations on the usefulness of that information;
- Temporarily requiring issuers to submit to the SEC written general solicitation materials;
- Disqualifying any issuer from eligibility to rely on Rule 506 in 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; this disqualification would end one year after required Form D filings are made; and
- Extending the antifraud guidance contained in Rule 156 under the Securities Act to the sales literature of private funds. Rule 156 provides guidance regarding when information in sales literature by an investment company registered with the SEC could be fraudulent or misleading for purposes of the federal securities laws.

These proposals are subject to an initial 60-day public comment period, which ended on September 23, 2013, and significant changes may be made to the proposed rule amendments prior to adoption of any final rules. Although many of the SEC commissioners appear to support the imposition of additional restrictions to protect investors following the elimination of the ban on general solicitation and advertising, it remains to be seen if these rule amendments (as proposed or modified) will be adopted.

ELIMINATION OF BAN ON GENERAL SOLICITATION FOR RULE 144A OFFERINGS

Section 4(a)(1) of the Securities Act (formerly Section 4(1) of the Securities Act) exempts from the registration requirements of the Securities Act transactions by any person "other than an issuer, underwriter, or dealer." Rule 144A is a non-exclusive safe harbor from the registration requirements of the Securities Act pursuant to Section 4(a)(1) of the Securities Act. The Rule 144A safe harbor permits persons other than the issuer to resell securities without registration if the transaction meets certain specified conditions. Prior to the effectiveness of the Final Rules, one of the conditions was that the securities be "offered or sold" only to persons the seller and any person acting on the seller's behalf reasonably believe are qualified institutional buyers ("QIBs"). As a result, Rule 144A effectively prohibited general solicitation and general advertising.

By its terms, Rule 144A is available solely for resale transactions. However, market participants frequently use Rule 144A to facilitate capital-raising by issuers through a primary offering of debt or equity securities to one or more financial intermediaries (commonly called "initial purchasers") in a transaction exempt from registration requirements pursuant to Section 4(a)(2) of the Securities Act or Regulation S under the Securities Act, followed by the immediate resale of these securities by the initial purchasers to QIBs in reliance on Rule 144A.

Section 201(a)(2) of the JOBS Act directed the SEC to revise Rule 144A to permit offers to persons other than QIBs, if the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Following the effectiveness of the Final Rules on September 23, 2013, revised Rule 144A no longer refers to "offers" and "offerees" in the conditions to be met under paragraph (d)(1) of Rule 144A. Thus, sellers may now rely on revised Rule 144A even if the securities are offered to non-QIBs, and even if there has been general solicitation or general advertising, if the securities are sold only to QIBs or persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

"BAD ACTORS" AND RULE 506 OFFERINGS

Section 926 of the Dodd-Frank Act required the SEC to issue rules disqualifying certain felons and other "bad actors" from Rule 506 offerings. Section 926 further provided that the new rules must be "substantially similar" to the disqualification provisions set forth in Rule 262 of Regulation A under the Securities Act, but must also include certain other disqualifying events (including certain state regulatory orders and bars).

"Bad Actor" Disqualification from Reliance on Rule 506 of Regulation D

On July 10, 2013, the SEC adopted new Rule 506(d) of Regulation D.[4] Under new Rule 506(d), an issuer cannot privately place its securities in reliance on Rule 506 of Regulation D if the issuer or any other "covered person" engaged in a "disqualifying event" after September 23, 2013, which is the effective date of new Rule 506(d). New Rule 506(d) applies to all offerings intended to comply with Rule 506, including those that do not use general solicitation or general advertising.

The definition of "covered persons" under new Rule 506(d) is substantially the same as under Rule 262, with some exceptions, including the following:

- The beneficial ownership threshold was raised from 10 percent to 20 percent so that the definition of "covered persons" under new Rule 506(d) includes any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities; and
- The definition of "covered persons" under new Rule 506(d) includes any investment manager to an issuer that is a pooled investment fund and any person compensated (directly or indirectly) for soliciting investors on behalf of the issuer.

"Disqualifying events" under new Rule 506(d) generally include securities-related bad acts, such as criminal convictions in connection with the sale or purchase of any security, bars by certain federal or state regulators from engaging in the business of securities, insurance or banking or from savings association or credit union activities, certain cease-and-desist and other orders by the SEC and certain suspensions, expulsions or bars from association

with a registered national securities exchange. The "look-back" periods for disqualifying events generally cover the past five or ten years, although for certain events, the injunction, order, investigation or similar event must be in effect and continuing at the time of the Rule 506 sale.

An issuer will not be disqualified if it establishes that it did not know and, in the exercise of "reasonable care" could not have known, that a disqualifying event existed. To exercise "reasonable care," an issuer must have engaged in a factual inquiry, and facts and circumstances affect the steps an issuer should take in its factual inquiry. Examples of steps an issuer may take to exercise "reasonable care" include the use of questionnaires or certifications, contractual representations and warranties and/or searches of publicly available databases (e.g., Financial Industry Regulatory Authority, Inc.'s BrokerCheck). In addition, in offerings made on a continuous basis under Rule 506, such as offerings by hedge funds, "reasonable care" will require updating the factual inquiry on a reasonable basis, depending on the facts and circumstances. Unless the issuer is aware of facts that would merit closer monitoring (e.g., the issuer has notice that a "covered person" is the subject of an applicable judicial or regulatory proceeding), periodic updating should be sufficient.

Rule 506(d) includes a waiver provision, under which the Director of the SEC's Division of Corporation Finance may waive disqualification upon a showing of good cause. Additionally, any court or regulatory authority entering an order, judgment or decree that would cause an actor to be disqualified under the rule may advise in writing that disqualification should not arise as a consequence of the order, judgment or decree, and as a result, disqualification will not arise.

Mandatory Disclosure of "Disqualifying Events" That Existed Before Effectiveness of the "Bad Actor" Disqualification Rule

If any "disqualifying event" existed before September 23, 2013, which is the effective date of new Rule 506(d), then new Rule 506(e) now requires the issuer offering securities under Rule 506 to disclose the "disqualifying event" to investors within a reasonable time prior to sale. In the view of the SEC, any failure to provide adequate disclosure of a pre-existing "disqualifying event" is not an "insignificant" deviation from the requirements of Regulation D and could result in the loss of the exemption. However, an issuer may rely on Rule

506 if it 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. Like the "reasonable care" exception to disqualification, this "reasonable care" exception to mandatory disclosure will require factual inquiry.

EFFECT OF THE FINAL RULES

The elimination of the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A offerings will permit issuers, including start-up and emerging companies, to use a number of previously unavailable solicitation and advertising methods. For example, issuers who previously would only offer securities to a potential investor with which the applicable issuer has a "preexisting, substantive relationship" — or would be required to engage a financial intermediary or solicitor to offer its securities to potential investors with which the financial intermediary or solicitor has a "preexisting, substantive relationship" — to avoid engaging in a general solicitation may, after September 23, 2013, use other methods of offering securities to different and larger pools of potential investors (e.g., purchasing from third parties' pre-screened lists of potential investors that are accredited investors and meet other eligibility criteria and cold calling and/or communicating with new clients or contacts (including from purchased pre-screened lists)). However, the utility of this change to most issuers' capital raising efforts remains to be seen and will likely be somewhat limited.

First, the SEC has the power to impose additional obligations on issuers relying on the private placement safe harbor of Regulation D, and, as evidenced by the SEC's proposals on July 10, 2013, it appears that the SEC will adopt additional obligations that will be particularly burdensome on issuers using general solicitation and general advertising in offerings under Rule 506(c) of Regulation D.

Secondly, the SEC has made clear that the ban on general solicitation and general advertising remains a condition for reliance on the statutory registration exemption under Section 4(a)(2) of the Securities Act. Accordingly, if an issuer engages in any general solicitation or general advertising in an offering that is intended to be made in compliance with the requirements of Rule 506(c) of Regulation D, but the offering loses the safe harbor under Rule 506(c) because of a significant compliance failure, the issuer will also be unable to rely on the

statutory exemption under Section 4(a)(2) of the Securities Act.

Thirdly, engaging in any general solicitation or general advertising in an issuer's private securities offering will preclude reliance on "self-executing" exemptions under many state Blue Sky laws and may therefore increase the costs and expenses associated with the offering. Although securities issued in Rule 506 offerings are exempt from registration requirements under state Blue Sky laws, issuers are subject to notice filing requirements under applicable state Blue Sky laws. Many state Blue Sky laws also provide exemptions for certain *de minimis* offerings that do not require a filing with the applicable state securities commissioner, but these exemptions are often available only for securities offered without the use of general solicitation or general advertising. Therefore, securities offered under new Rule 506(c) in certain states will no longer be eligible to rely on this exemption, and the only available exemption will require a notice filing (and the payment of related fees).

The Final Rules adopted by the SEC on July 10, 2013, will have additional effects on certain types of market participants, including private funds, registered broker-dealers and issuers and underwriters who engage in concurrent U.S. and offshore private securities offerings.

Effect on Private Funds

Under current law, private funds and their investment advisers are subject to significant regulatory requirements, and these requirements likely limit the ability of many private funds and their investment advisers to take advantage of the new rules and engage in any general solicitation or general advertising in connection with private securities offerings. First, many private funds that invest in or trade commodity interests (including swaps) rely on the exemption from registration as a commodity pool operator under Commodity Futures Trading Commission ("CFTC") Rule 4.13(a)(3), and the continued availability of this exemption is conditioned on, among other things, the private funds not being "marketed to the public in the United States." In the absence of any new guidance from the CFTC, the use of general solicitation and general advertising in a private securities offering by a private fund that relies on CFTC Rule 4.13(a)(3) may be prohibited. Secondly, an investment adviser who wishes to be exempt from the registration requirements under applicable state law or the Investment Advisers Act of 1940 ("Advisers Act") must generally not hold

itself out to the public as an investment adviser. If such an investment adviser engages in general solicitation or general advertising to offer and sell securities of a private fund that it manages, it may be deemed to be holding itself out to the public as an investment adviser, thereby requiring such investment adviser to register with the SEC or one or more states. Thirdly, all investment advisers (whether registered or unregistered) remain subject to anti-fraud provisions, and therefore, additional care must be given to the scope and content of any general solicitation or general advertising materials used by an investment adviser on behalf of the private fund that it manages to ensure compliance.[5]

If an investment adviser is considering offering and selling securities of a private fund it manages under new Rule 506(c), including by offering securities to potential investors with which neither it nor any placement agent or solicitor has a "preexisting, substantive relationship," then it should also consider the following:

- Investment advisers that are registered with the SEC are only permitted to charge performance fees to investors who are "qualified clients" (as defined in Rule 205-3 under the Advisers Act), and such investment advisers should consider whether the proposed method of general solicitation or general advertising is likely to attract prospective investors who are "qualified clients" (which would be a smaller subset of investors than accredited investors due to the higher net worth requirements).
- In addition, investment advisers should have adopted — or should adopt as soon as possible — appropriate policies and procedures to engage in the required factual inquiry (and periodic updates) to detect and monitor whether each of their private funds and the related "covered persons" (including placement agents, compensated solicitors and promoters) have engaged in any disqualifying event that may cause any of such private funds to become ineligible to offer securities in reliance on Rule 506(b) or 506(c) of Regulation D.

Effect on Broker-Dealers

For securities broker-dealers, the Final Rules and proposed rules have several implications. First, any broker-dealer that seeks to rely on the Final Rules

should carefully examine how a relevant offering would fit into its overall compliance program. Broker-dealers remain subject to laws, regulations, and Financial Industry Regulatory Authority, Inc., rules that require communications with the public to be fair and balanced, to be based on principles of fair dealing and good faith, and to provide a sound basis for evaluating the facts in regard to any particular security or type of security. In addition, broker-dealers should carefully review the procedures and techniques that they employ in order to ascertain that an investor meets the required qualification standards.

Finally, the SEC's release announcing the proposed rules notes that the staff will "execute a comprehensive work plan" to review the effects of eliminating the general solicitation ban. This work plan will involve all of the SEC's core divisions and offices, including the Office of Compliance Inspections and Examinations and the Division of Enforcement. It will examine, among other things, investor qualification and verification practices, the form and content of promotional materials and statements, and whether non-accredited investors end up with inappropriate investments. Accordingly, broker-dealers that seek to rely on new Rule 506(c) should expect a high degree of focus from regulators in the future.

Effect on Issuers Who Engage in Concurrent U.S. and Offshore Unregistered Securities Offerings, Including Issuers in the High-Yield Bond Markets and Offshore Private Funds

Issuers conducting concurrent Regulation S/Rule 144A offerings should not be affected by the rule change allowing general solicitation. Under the Regulation S safe harbor, offers and sales of securities outside of the United States are exempt from the registration requirements of the Securities Act, provided that: (i) the securities are sold in an offshore transaction; (ii) there are no directed selling efforts in the United States or to U.S. persons; and (iii) with respect to certain types of securities offerings, other offering and transaction restrictions are imposed to prevent the flow back of the offered securities into the United States.

In its adopting release, the SEC confirmed that the use of general solicitation and general advertising in a Rule 506(c) or Rule 144A offering will not cause a concurrent offshore offering under Regulation S of the Securities Act

to be integrated with the Rule 506(c) or Rule 144A offering. Although not expressly stated, it appears that general solicitation conducted in compliance with the Final Rules for the U.S. offering would not constitute "directed selling efforts" in the U.S. that would jeopardize a concurrent Regulation S offering in which the issuer or its underwriters use existing traditional methods to qualify sales to non-U.S. persons under Regulation S.

NOTES

[1] The SEC staff has offered guidance through no-action letters that an offer to a potential investor will not constitute a "general solicitation" if the issuer or its agent has a "preexisting, substantive relationship" with the potential investor at the time the offer is made. *See, e.g.*, Mineral Lands Research and Marketing Corp., SEC No-Action Letter (Dec. 4, 1985); E.F. Hutton & Co., SEC No-Action Letter (Dec. 3, 1985).

[2] *See* SEC Release No. 33-9415, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *available at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

[3] *See* SEC Release No. 33-9416, Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *available at* http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

[4] *See* SEC Release No. 33-9414, Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, *available at* http://www.sec.gov/rules/final/2013/33-9414.pdf.

[5] *See, e.g.*, Rule 206-4(8) under the Advisers Act.