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SEC Adopts Final Rules Allowing General Solicitation in Rule 506 and Rule 144A Offerings and Disqualification of "Bad Actors"

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On July 10, 2013, the Securities and Exchange Commission (the "SEC") adopted final rules governing the use of general solicitation in Rule 506 and Rule 144A offerings and instituting a prohibition against using Rule 506 as an exemption from registration in offerings involving "bad actors."

Although the final rules governing general solicitation are almost one year overdue and the final rules barring the involvement of "bad actors" in Rule 506 offerings almost two years overdue, better late than never as it goes.

General Solicitation Under Rule 506 and Rule 144A

Under Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"), enacted on April 15, 2012, the SEC was tasked with adopting rules governing the general solicitation or general advertisement in offering and selling securities pursuant to Rule 506 of Regulation D of the Securities Act of 1933 (the "1933 Act"), provided that all the purchasers are accredited investors and the issuer (company) takes reasonable steps to verify that such purchasers are accredited investors. The SEC has revised Rule 506 to add subsection 506(c), which provides that issuers, including hedge funds, private equity funds, venture capital funds and start-up issuers may offer securities through means of general solicitation, provided the following conditions are satisfied:

- All terms and conditions of Rule 501 and Rules 502(a) and 502(d);
- All purchasers of the securities are accredited investors; and
- The issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors.

In addition, securities issued under new Rule 506(c) will be considered "covered securities" for purposes of Section 18(b)(4)(E) of the 1933 Act, thereby pre-empting any state blue sky requirements to file a registration statement. Individual notice filings and fees in each state may still apply.

Verifying Accredited Investor Status

While new Rule 506(c) does not specify what "reasonable steps" are, the SEC set forth a list of factors that issuers should consider:

- 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;
- 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 has stated that an issuer will not have taken "reasonable steps" to verify a purchaser's status as an accredited investor if the issuer only requires the purchaser to check a box indicating accredited investor status or signing a form. However, the SEC has provided a non-exclusive list of methods that issuers may use to satisfy the verification requirements that a purchaser is an accredited investor:

- Meeting the individual income standard:
    - Review of IRS forms reporting income such as a W-2;
    - Copies of income tax returns for the two most recent years; and
    - Written representation that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.
- Meeting the individual net worth standard:
    - Review of documentation dated within the prior three months regarding assets and liabilities, examples including:
        - Bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports, credit reports.
- Third-party 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 purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor.
- Written certification by existing accredited investors of the issuer that that he or she qualifies as an accredited investor.

If an issuer takes these reasonable steps and has a reasonable belief that a purchaser was an accredited investor at the time of sale, the issuer will not lose the ability to rely on Rule 506(c) for that offering if the purchaser in fact is not an accredited investor.

Note that these standards for confirming accredited investor status of a purchaser do not specifically apply to the exemptions relied upon under Rules 504, 505, and 506(b). Perhaps it would be good practice now that the SEC has provided guidance on how to verify accredited investor status to follow these rules under 506(c).

Form D Amendment
The SEC also revised Form D by including a check box in Item 6 of the form to indicate whether the issuer is relying on the Rule 506(c).

Private Funds
Private funds, such as hedge funds, private equity funds, and venture capital funds rely on Sections 3(c)(1) or 3(c)(7) under the Investment Company Act of 1940 (the "Investment Company Act") to exclude themselves from the regulatory provisions of the this Act. Private funds will lose these exemptions if they make a public offering of their securities. In its release, the SEC specifically stated that private funds that rely on Rule 506(c) will not lose their exemptions under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

Amendment to Rule 144A
The SEC revised Rule 144A(d)(1) of the 1933 Act to require only that the securities be sold to a Qualified Institutional Buyer ("QIB") or to a purchaser that the seller and any person acting on behalf of the seller reasonably believes is a QIB. Resales of securities under Rule 144A may be conducted using general solicitation, as long as the purchasers are QIBs. The SEC did not discuss what constitutes a reasonable belief, however based upon the discussion of accredited investor status regarding new Rule 506(c) one could surmise that many of the steps suggested in Rule 506(c) would suffice in determining whether a purchaser was a QIB.

Integration with Regulation S
Many issuers offer their securities in unregistered offerings inside the U.S. by relying on Rule 144A or Rule 506 and simultaneously outside the United States by relying on Regulation S of the 1933 Act. As there is a prohibition under Regulation S against using "directed selling efforts," the SEC has clarified that concurrent offshore offerings conducted in accordance with Regulation S will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as amended.

Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings
In a separate release, the SEC handed down final rules disqualifying securities offerings involving "felons and other 'bad actors'" from reliance on Rule 506 of Regulation D through the addition of Rule 506(d) as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC provided a list of "covered persons" to whom the disqualifying events would apply:

- The issuer and any predecessor of the issuer or affiliated issuer;
- Any director, executive officer or any officer that participates in the offering, general partner or managing member of the issuer;
- Beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- Any investment manager to an issuer that is a pooled investment fund, and any director, executive officer, other officer participating in the offering, general partner

or managing member of such investment manager; as well as any director, executive officer, or officer participating in the offering of any such general partner or managing member;
- Any promoter connected with the issuer in any capacity at the time of the sale;
- Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- Any director, executive officer or any officer that participates in the offering, general partner, or managing member of any such compensated solicitor.

Disqualifying Events
The following events as applied to "covered persons" at the effective date of the final rules will preclude the issuer from relying on Rule 506:

- Criminal convictions (felony or misdemeanor), entered within the last five years in the case of issuers and ten years in the case of other covered persons, in connection with the purchase or sale of any security; involving the making of a false filing with the SEC; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Court injunctions and restraining orders, including any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security; involving the making of a false filing with the SEC; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- Final orders issued by state banking, credit union, and insurance regulators, federal banking regulators, and the National Credit Union Administration that either create a bar from association with any entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking or from savings association or credit union activities; or are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the last ten years;
- Certain orders of the Commodity Futures Trading Commission and for SEC cease-and-desist orders arising out of scienter-based anti-fraud violations and violations of Section 5 of the 1933 Act;
- SEC disciplinary orders entered pursuant to Section 15(b) or 15(B)(c) of the Securities Exchange Act of 1934 or Section 203(e) or (f) of the Investment Advisers Act of 1940 that, at time of the sale, suspend or revoke a person's registration as a broker, dealer, municipal securities dealer or investment adviser; place limitations on the activities, functions or operations of such person; or bar such person from being associated with any entity or from participating in the offering of any penny stock;
- Suspension or expulsion from membership in, or suspension or a bar from association with a member of, a self-regulatory organization, i.e., a registered

national securities exchange or a registered national or affiliated securities association;

- Stop orders applicable to a registration statement and orders suspending the Regulation A exemption for an offering statement that an issuer filed or in which the person was named as an underwriter within the last five years and being the subject at the time of sale of a proceeding to determine whether such a stop or suspension order should be issued; and
- U.S. Postal Service false representation orders including temporary or preliminary orders entered within the last five years.

Disqualification will apply only for triggering events that occur after the effective date of the amendments to Rule 506; however, pre-existing matters will be subject to mandatory disclosure. Disqualification will not apply if the authority issuing the relevant judgment or order determines and advises the SEC that disqualification from reliance on Rule 506 should not arise as a result.

"Reasonable Care" Exception

The SEC included an exception from disqualification for offerings where the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of another covered person. Again, the SEC did not provide examples of what constitutes "reasonable care" on the part of the issuer, however, it did state that an issuer that made a factual inquiry at the time of the relevant transaction by means of questionnaires or certifications could be sufficient if there was no other indication suggesting bad actor involvement. For continuous offerings, reasonable care includes updating the factual inquiry through bring-downs of representations, questionnaires and certifications and re-checking public databases.

Amendment to Form D

The signature block on Form D will include a certification that issuers claiming a Rule 506 exemption will confirm that the offering is not disqualified from reliance on Rule 506 for one of the reasons stated in Rule 506(d).

Coordination with Blue Sky Law

As securities issued under Rule 506 are considered "covered securities," state-level bad actor disqualifications will not apply.

Effectiveness

The final rules will be effective 60 days after publication in the Federal Register, which is scheduled for July 24, 2013. Look for effectiveness on or about September 23, 2013.