Advisory

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SEC Adopts Final Rules Allowing General Solicitation in Private Placements but Takes Other Significant Actions that May Impact Fundraising

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On July 10, 2013, the Securities and Exchange Commission adopted final rules that allow the use of general solicitation to solicit investors in private placements under Rule 506 ("Rule 506") of Regulation D ("Regulation D") of the Securities Act of 1933 (the "Securities Act") or Rule 144A ("Rule 144A") of the Securities Act.

In addition to adopting final rules regarding general solicitation, the SEC also:

- adopted final rules that prohibit a company from issuing securities in reliance on Rule 506 if the company or any of its controlling persons or shareholders or any promoter or solicitor of the issuance has been subject to a conviction or order with respect to certain unlawful securities activities; and
- proposed new rules that would require companies to meet certain additional requirements in order to use general solicitation in connection with Rule 506 offerings and that would prohibit a company from relying on Rule 506 if the company has failed to file timely the Form D required by Regulation D.

The final rules described above will become effective 60 days after they are published in the federal register.

GENERAL SOLICITATION

The Jumpstart Our Business Startups Act or "JOBS Act" was enacted on April 5, 2012. The JOBS Act includes several provisions with the potential to stimulate investments by both reducing restrictions on the manner in which companies may seek funding and by easing regulatory burdens both during and following the fundraising process.

Rule 506 was originally adopted by the SEC as a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act, which exempts transactions by a company not involving any public offering from the registration requirements of Section 5 of the Securities Act. The availability of Rule 506 is subject to a number of requirements, including the current requirement that a company not offer or sell securities through any form of general solicitation. Rule 144A is a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for offerings of securities to "qualified institutional buyers" (typically, large institutional investors).

The JOBS Act requires the SEC to amend its rules to allow the use of general solicitations to solicit investors in private placements under Rule 506 as long as companies take reasonable steps to verify that purchasers of the securities are "accredited investors" using methods as determined by the SEC. The SEC is also required to amend its rules to allow the use of general solicitations in connection with offerings under Rule 144A to qualified institutional buyers. By eliminating the prohibition against general solicitation in these offerings, the rule amendments are designed to open the Internet and other media to fundraising efforts.

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An investor qualifies as an "accredited investor" if the investor:

- is one of several enumerated entities listed in Rule 501 under the Securities Act; or
- is an individual who has individual net worth, or joint net worth with a spouse, that exceeds $1 million at the time of the investment, excluding the value of the investor's primary residence, or who has income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.

If a company uses general solicitation in seeking investment by accredited investors under Rule 506, the new rules require the company to take "reasonable steps" to verify that an investor is an accredited investor. In its release adopting the new rules, the SEC explains that, in determining whether a company has taken reasonable steps to verify an investor's accredited status, companies are to consider the facts and circumstances of each offering, which includes among other things the following factors:

- the type of investor and the type of accredited investor that the investor claims to be;
- the amount and type of information that the company has about the investor; and
- the nature of the offering, meaning the manner in which the investor was solicited to participate in the offering and the terms of the offering, such as a minimum investment amount.

In its proposing release, the SEC declined to propose specific verification methods or safe harbors that would constitute reasonable steps under the new rules, citing concern that designating a list, even a non-exclusive list, could lead to companies disregarding information indicating that an investor is not accredited and the public considering the list as the exclusive methods of verifying accredited status. The new rules, however, include a non-exclusive list of methods that a company may use to verify the accredited investor status of individuals, provided that the company does not have knowledge that the individual is not an accredited investor. These methods include the following:

- in regard to whether the individual is an accredited investor on the basis of income, reviewing any Internal Revenue Service form that reports the individual's income for the two most recent years and obtaining a written representation from the individual that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;
- in regard to whether the individual is an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation with respect to the individual's assets and liabilities dated within the prior three months and obtaining a written representation from the individual that all liabilities necessary to make a determination of net worth have been disclosed:
  - with respect to 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
  - with respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies;
- obtaining a written confirmation from one of the following persons or entities that the person or entity has taken reasonable steps to verify that the individual is an accredited investor within the prior three months and has determined that the individual is an accredited investor:
  - a registered broker-dealer;
  - an investment adviser registered with the SEC;
  - a licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or
  - a certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office; or
- in regard to any individual who purchased securities in a company's Rule 506 offering prior to the effective date of the new rules and continues to hold those securities, that company obtaining a certification by that individual at the time of sale of new securities by that company that he or she qualifies as an accredited investor.

Regardless of the particular steps taken, the SEC warns that it will be important for companies to retain adequate records that document the steps taken to verify

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accredited investor status because a company claiming an exemption from the registration requirements of the Securities Act has the burden of showing that it is entitled to that exemption.

The new rules preserve the existing portions of Rule 506 as a separate exemption so that companies conducting traditional Rule 506 offerings, without the use of general solicitation, will not be subject to the new verification requirements.

The new rules also amend Form D, which companies must file with the SEC when they sell securities under Regulation D. The revised form would add a separate box for companies to check if they are claiming the new Rule 506 exemption that would permit general solicitation.

Because SEC guidance and market practices in respect of the use of general solicitations are likely to continue to evolve, companies should consult with counsel prior to initiating an offering in reliance on Rule 506 that will include general solicitations.

BAD ACTOR DISQUALIFICATION

The Dodd-Frank Wall Street Reform and Consumer Protection Act or "Dodd-Frank Act" was enacted on July 21, 2010. The Dodd-Frank Act instructs the SEC to issue disqualification rules for Rule 506 offerings that prohibit a company from issuing securities in reliance on Rule 506 if any "covered person" has been subject to any one of a list of certain "disqualifying events."

With respect to any offering of securities by a company, a "covered person" includes the company itself as well as any predecessor or affiliated issuer of the company, any of the company's directors, executive officers, general partners or managing members, or any other officer of the company participating in the offering, any beneficial owner of 20% or more of the company's outstanding voting equity securities, any promoter connected with the company in any capacity at the time of the sale of securities, any person that has been or will be paid for solicitation of purchasers in connection with the sale of the securities or any general partner, managing member, director or executive officer of that person or other officer of that person participating in the offering of the securities.

A "covered person" has been subject to a "disqualifying event" if that person:

- has been convicted, within the prior ten years (or five years, in the case the company or its predecessors or affiliated issuers), of any felony or misdemeanor: in connection with the purchase or sale of any security; involving the making of any false filing with the SEC; or arising out of the conduct of the business of an underwriter, broker, dealer, investment adviser or paid solicitor of purchasers of securities;

- is subject to any order, judgment or decree of any court of competent jurisdiction entered within the prior five years that continues to restrain or enjoin that 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 any false filing with the SEC; or arising out of the conduct of the business of an underwriter, broker, dealer, investment adviser or paid solicitor of purchasers of securities;

- is subject to a final order of a state securities or insurance commission (or like agency or officer), federal or state banking agency, the U.S. Commodity Futures Trading Commission or the National Credit Union Administration that:

  - continues to bar the person from association with an entity regulated by any of those authorities or engaging in the business of securities, insurance or banking; or

  - constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct entered within the prior ten years;

- is subject to an order of the SEC that continues to: suspend or revoke that person's registration as a broker, dealer or investment adviser; place limitations on the activities, functions or operations of that person; or bar that person from being associated with any entity or from participating in the offering of any penny stock;

- is subject to any order of the SEC entered within the prior five years that continues to order that person to cease and desist from committing or causing a violation or future violation of the Securities Act or any fraud provision of the federal securities laws;

- is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

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- has filed (as a registrant), or was or was named as an underwriter in, any registration statement that, within the prior five years, was the subject of a refusal order, stop order or order suspending that registration statement, or is the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

- is subject to a United States Postal Service false representation order entered within the prior five years, or is subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

No conviction, order, judgment, decree, suspension, expulsion or bar event will constitute a "disqualifying event" if that event occurred or was issued before the effective date of the new disqualifying rules or if the relevant court or authority advises in writing that disqualification should not arise. A company, however, must provide purchasers of its securities, a reasonable time prior to sale, a written description of any event that would have been a "disqualifying event" but for the fact that it occurred prior to the effective date of the new disqualifying rules.

In addition, a company is not prohibited from relying on Rule 506 as a result of a "disqualifying event" if the company establishes that it did not know and, in the exercise of reasonable care, could not have known that the disqualification existed. A company will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist. A company will need to make that factual inquiry by obtaining representations from its "covered persons" through written questionnaires or other documents and, in cases where there is information suggesting the possible existence of a "disqualifying event," by checking public databases and taking any other appropriate steps.

PROPOSED NEW RULE 506 REQUIREMENTS

The SEC has proposed new rules to amend Regulation D. According to the SEC, these proposed new rules are intended to enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting companies to engage in general solicitation.

Under current rules, a company that sells securities under Regulation D must, no later than 15 days after the first sale of the offering, file a Form D with the SEC setting forth various information regarding the offering. Under the proposed new rules, in addition to this obligation, a company that intends to offer securities in reliance on Rule 506 and through the use of general solicitation would be required to file with the SEC, no later than 15 calendar days prior to the first use of general solicitation for that offering, a notice containing the information required by Form D. In addition, the company would be required to file a closing amendment to its Form D within 30 days after the termination of the offering conducted in reliance on Rule 506.

Subject to a 30-day cure period (which may not be relied upon more than once for filing deadlines in connection with the same offering), a company's failure to comply with the filing requirements described above in connection with any Rule 506 offering after the proposed new rules became effective would result in that company not being permitted to rely on Rule 506 in connection with new offerings for a period of either five years or one year after the company makes the required filings, whichever period is shorter.

The proposed new rules would also require companies to include, in a prominent manner, a legend in any written general solicitation in any offering conducted in reliance on Rule 506 that, among other things, advises investors as to the private nature of the offering, the transfer restrictions on the securities being offered and the existence of risks in investing in the offered securities.

Finally, the proposed new rules would, for a temporary period of two years from the date the proposed new rules become effective, require companies to submit to the SEC any written general solicitation in any offering conducted in reliance on Rule 506 no later than the date of first use.

The proposed new rules are now subject to a 60-day comment period after which the SEC may adopt final rules.

We will continue to monitor developments with respect to the proposed new rules.