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The SEC Adopts Rules to Allow General Solicitation in Rule 506 and Rule 144A Offerings, Adopts Rules Prohibiting “bad actors” From Relying on Rule 506, and Proposes Amendments to Regulation D, Form D and Rule 156

On July 10, 2013, the Securities and Exchange Commission (the “SEC”) adopted amendments to important rules used to offer securities in private placements:

- The SEC adopted new Rule 506(c) of Regulation D to permit general solicitation and general advertising in Rule 506 securities offerings, provided that all purchasers of the securities are accredited investors and the issuer reasonably believes, and takes reasonable steps to verify, that such purchasers are accredited investors, as required by Section 201(a) of the Jumpstart Our Business Act.
- The SEC adopted new rules that disqualify certain “bad actors” from relying on Rule 506.
- The SEC adopted new Rule 144A(d)(1) under the Securities Act of 1933, as amended (the “Securities Act”), to permit the offering of securities to persons other than qualified institutional buyers (“QIBs”) in Rule 144A offerings, including by means of general solicitation, provided that the securities are sold only to persons that the seller reasonably believes are QIBs.

The new rules will become effective 60 days after publication in the *Federal Register* (estimated to be in mid-September).

The SEC also proposed amendments to Regulation D, Form D and Rule 156 intended to collect more data about the private market and monitor for fraud.

The new rules will fundamentally change the way issuers raise capital in private markets and should be of interest to those involved in non-public capital formation activities, such as issuers, venture capital, private equity and hedge funds, and intermediaries, such as sales agents, who offer securities on their behalf. Mutual funds should also take notice, as the new rules will increase competition with private funds that will be better positioned to target investors.

Permitting General Solicitation and General Advertising

The SEC originally proposed new Rule 506(c) on August 29, 2012.¹ The SEC adopted the amendments as proposed, by a vote of 4-1,² with one modification. In addition to a specific set of principles that issuers may use to objectively verify that purchasers are accredited investors, Rule 506(c) includes, as

¹ For a more detailed description of the now adopted rules, see our client alert from August 30, 2013, entitled THE SEC PROPOSES RULES ALLOWING GENERAL SOLICITATION IN RULE 506 AND RULE 144A OFFERINGS, available at <http://www.bhfs.com/News/Publications?find=183020>.

² Commissioner Luis Aguilar opposed lifting the solicitation ban. He said that general solicitation will allow fraudsters to cast a wider net and called the adoption reckless without any accompanying investor safeguards.

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urged in many comment letters, a non-exclusive list of specific methods that issuers may use to satisfy the verification requirement as it applies to natural persons. The methods include verification (1) of a purchaser's income by reviewing copies of Internal Revenue Service forms and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year; (2) of a purchaser's net worth by reviewing copies of documents containing information about the purchaser's 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; (3) obtaining a written confirmation from a broker-dealer, investment adviser, attorney or accountant that such third party has taken reasonable steps to verify that the purchaser is an accredited investor and has determined that such purchaser is an accredited investor; and (4) self-certification with respect to investors who previously purchased securities in the same issuer's Rule 506(b) offering as an accredited investor before effectiveness of Rule 506(c) and who still holds such securities.

It is important to note that the adopted rules do not eliminate the issuers' ability to conduct Rule 506 offerings without general solicitation under current Rule 506. Further, the proposal only applies to Rule 506 and is not intended to alter the body of law governing offerings under Securities Act Section 4(a)(2) in general. Also, as the SEC noted, because an offering under new Rule 506(c) will be regarded as a non-public offering, hedge funds, venture capital funds, private equity funds and other private funds will be able to rely on new Rule 506(c) in offering their securities without losing their ability to rely on the exemptions from registration as an investment company in Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act of 1940, which exemptions are unavailable to issuers that conduct public offerings.

Bad Actor Disqualification

The SEC also adopted amendments to Rules 501 and 506 of Regulation D disqualifying securities offerings involving certain "bad actors" from relying on Rule 506 to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Under the amendments, issuers cannot rely on Rule 506 if the issuer or any "covered person" is subject to a "disqualifying event." Covered persons include, among others, directors, certain officers, 20 percent beneficial owners, investment managers and principals of pooled investment funds and persons compensated for soliciting investors. Disqualifying events include, among others, security-related criminal convictions, court injunctions and administrative orders, and suspension or expulsion from membership in a self-regulatory organization ("SRO") or from association with an SRO member. Only disqualifying events that occur after the effective date of the amendments triggers disqualification. However, pre-existing events must be disclosed to investors. Despite the foregoing, a Rule 506 offering subject to an undisclosed disqualifying

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event may still be exempt from Securities Act registration requirements if the issuer can prove that it did not know and could not have known of the existence of the undisclosed disqualifying event.

Proposed Amendments to Regulation D, Form D and Rule 156

The SEC also voted 3-2³ to propose amendments to Regulation D, Form D and Rule 156. The proposed amendments aim to improve the SEC's ability to monitor developments in the Rule 506 market and to address concerns about fraud. The proposed amendments will be open to public comment for 60 days after they are published in the *Federal Register*. The rule changes would:

- Require issuers to file a Form D at least 15 calendar days before engaging in general solicitation in a Rule 506(c) offering and to file a final amendment to that Form D not later than 30 calendar days after completion of the offering;
- Prohibit an issuer from using the Rule 506 exemption for one year if the issuer, or any predecessor or affiliate of the issuer, failed to comply, within the last five years, with Form D filing requirements;
- For a temporary two-year period, require issuers engaging in general solicitation under Rule 506(c) to submit confidentially their solicitation materials to the SEC;
- Require additional information in Form D filings regarding the issuer and its website, the type of securities offered, the purchasers involved in the offering, the use of proceeds from the offering, the types of solicitation methods used, and the accredited investor verification methods used;
- Require issuers to provide legends on solicitation materials that explain that the offering is limited to accredited investors and disclose the risks involved; and
- Expand Rule 156 of the Securities Act to provide guidance for private funds about when information in sales literature could be fraudulent or misleading. Rule 156 currently provides investment companies with such guidance.

Should you require further analysis or explanation of the SEC's new rules, please contact Rikard Lundberg, Jeff Knetsch or the Brownstein Hyatt Farber Schreck attorney with whom you typically consult.⁴

This document is intended to provide you with general information on recent amendments adopted by the SEC. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorney listed or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

³ Republican commissioners Parades and Gallagher opposed the proposal, citing the increased burden the amendments would have on issuers and the capital formation process.

⁴ Brownstein wishes to acknowledge Daniel L. Nordstrom for his contributions to this article.

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