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## Capital Markets

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# The SEC Adopts Final Rules Eliminating the Prohibition Against General Solicitations in Certain Private Offerings

On July 10, 2013, the SEC adopted final rules removing the ban on general solicitation and general advertising in connection with certain private placements under Rule 506 of Regulation D and Rule 144A under the Securities Act.[1] The rules adopted are substantially the same as those proposed last August, except that the SEC has added a non-exclusive list of methods an issuer may use to verify the accredited investor status of purchasers. These new rules satisfy the requirement contained in Section 201(a) of the Jumpstart Our Business Startups Act, or the "JOBS Act," that the SEC remove these prohibitions. On the same date, the SEC also adopted final rules that disqualify felons and other "bad actors" from participating in certain Rule 506 securities offerings as required by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the "Dodd-Frank Act."[2] We summarize some of the highlights of the new rules below.

### Removing the Ban on General Solicitation

- The SEC created a new clause (c) in Rule 506 of Regulation D. Offers and sales conducted pursuant to Rule 506(c) will not have to comply with the ban on general solicitation and general advertising under Rule 502(c), provided that all the purchasers of the offered securities are Accredited Investors[3] and the issuer takes "reasonable steps" to verify that purchasers are Accredited Investors.
- The adopting release retains the proposal that what constitutes "reasonable steps" to verify Accredited Investor status 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 provides the following factors that issuers should consider under this principles-based method of analysis.
  - The type of Accredited Investor the investor claims to be, with some types (such as broker/dealers) naturally lending themselves to easier verification than others (such as individuals).
  - The type of information the issuer has about an investor, including publicly available information and information provided by third parties.
  - The nature and terms of the offering itself, such as how it is marketed and the minimum investment amount. The release states that highly public offerings, such as through

1 The final rules are contained in SEC Release No. 33-9415, which can be found at this link: http://www.sec.gov/rules/final/2013/33-9415.pdf.

2 The final rules are contained in SEC Release No. 33-9414, which can be found at this link: http://www.sec.gov/rules/final/2013/33-9414.pdf.

3 "Accredited Investor" is defined in Rule 501(a) under the Securities Act.


Ian Clark
Partner, London
+ 44 20 7532 1398
iclark@whitecase.com

Colin Diamond
Partner, New York
+ 1 212 819 8754
cdiamond@whitecase.com

Holt Goddard
Partner, New York
+ 1 212 819 8685
hgoddard@whitecase.com

David Johansen
Partner, New York
Capital Markets
+ 1 212 819 8509
djohansen@whitecase.com

Laura Sizemore
Partner, Istanbul and New York
Capital Markets
+ 90 212 355 1346
+ 1 212 819 8373
lsizemore@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom
+ 44 20 7532 1000

websites or widely disseminated email or social media, would require more stringent verification, making explicit that issuers in such offerings could not merely rely on representations from the investor in a questionnaire or form. On the other hand, a high minimum investment amount that only an Accredited Investor could reasonably be expected to meet could be used as evidence of the investors' status.

The release makes clear that the foregoing factors would be both non-exclusive and interconnected, with factors indicating a higher level of verification able to offset those indicating a lower level and vice versa.

- To supplement the principles-based framework discussed above (which was part of the proposing release), the final Rule 506(c) also provides a non-exclusive and non-mandatory list of methods for verifying the Accredited Investor status of a natural person. The list includes the following.
  - Use of any Internal Revenue Service form (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) showing that the purchaser meets the Accredited Investor annual income threshold for the prior two years (currently set at US$200,000 per year for individuals, or US$300,000 per year for spousal joint income), accompanied by a written representation from the purchaser that he or she reasonably expects to reach the income threshold in the current year.
  - Obtaining documentation dated within the prior three months showing that the purchaser meets the Accredited Investor net worth threshold (currently set at US$1 million). For such net worth determinations, documentation of assets may include: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties. Documentation of liabilities can be shown with a consumer report from at least one of the nationwide consumer reporting agencies, accompanied by a written representation from the purchaser that he or she has disclosed all liabilities needed to make a net worth determination.
  - Obtaining written confirmation from a registered broker-dealer, an investment advisor registered with the SEC, a licensed attorney or a certified public accountant, stating that the entity or individual has, within the prior three months, taken reasonable steps to confirm that the purchaser is an Accredited Investor and thereby determined that the purchaser is an Accredited Investor.
  - With regard to any person who purchased securities in an offering by the issuer under Rule 506(b) prior to the effective date of Rule 506(c) and continues to hold those securities, a certification from that person that it qualifies as an Accredited Investor.

It is important to note that none of these verification methods will be sufficient if the issuer or its agent has actual knowledge that the purchaser is not an Accredited Investor.

- The adopting release discusses the treatment of Regulation D offerings that commence prior to the effectiveness of Rule 506(c). It allows issuers to later choose to conduct the offering under Rule 506(c) and states that any general solicitation under Rule 506(c) would not taint any of the investments that closed (in reliance on Rule 506(b)) prior to the switch to Rule 506(c). There is a similar provision for Rule 144A offerings.
- The SEC has maintained the prohibition on general solicitation or general advertising in connection with sales to up to 35 non-Accredited Investors (and an unlimited number of Accredited Investors) in offerings pursuant to the existing exemption in Rule 506(b)(2). The new Rule 506(c) does not provide an equivalent carve-out for 35 non-Accredited Investors. Therefore, issuers that want to sell securities to non-Accredited Investors can do so by conducting an offering under the rules in effect prior to this release.
- Current rules require an issuer to report any sales it makes under Regulation D on Form D. The new rules revise the check boxes in Form D so as to require an issuer to state whether it is relying on Rule 506(b) or 506(c) in conducting its offering.
- The adopting release notes that certain privately offered funds (such as hedge funds, venture capital funds and private equity funds) rely on exclusions under the Investment Company Act that would not be available to them if they make a public offering of their securities. According to the release, it is the SEC's position that the effect of Section 201(b) of the JOBS Act is to permit these privately offered funds to make a general solicitation as part of an offering in compliance with Rule 506(c) without losing these exclusions under the Investment Company Act.
- The new rules also permit general solicitations in connection with offerings under Rule 144A, so long as sales ultimately are made only to purchasers the issuer reasonably believes are Qualified Institutional Buyers, or "QIBs." Rule 144A(d)(1) currently requires that the securities be "offered or sold" only to QIBs, or persons the issuer reasonably believes to be QIBs, in order for an offering to qualify for the exemption under Rule 144A. The new rules remove the references to "offer" and "offeree," so the amended Rule 144A only requires that sales be made to QIBs, while offers could be made to anyone, including by general solicitation.
- With respect to offshore offerings under Regulation S, the adopting release reiterates the SEC's position that offerings under Regulation S will not be integrated with domestic offerings conducted in compliance with Rule 506 or Rule 144A. This means that any general solicitation or general advertising under a Regulation D or Rule 144A offering would not constitute "directed selling efforts" that would taint a simultaneous Regulation S offering.

## Implications of Removing the Ban on General Solicitations

The new rules affect in important ways how private offerings will be conducted. Below are a few implications we anticipate.

- We often receive questions from clients regarding whether company executives can speak at industry conferences or other events near the time of a private offering of the company's securities or during the roadshow. The new rules enable executives to make such appearances without limiting their ability to mention that the company is engaged in a private offering or raising concerns about the status of attendees. It will still be important to make sure the information provided in these forums does not contradict or go beyond what is disclosed in the offering document.

- A private offering document will no longer have to be confidential (although many issuers may still want to treat it as confidential for competitive or other reasons). This means that issuers should be able to send private offering documents to investors without first verifying their status as an Accredited Investor (because verification is only required at the time of sale). Issuers should also be able to distribute the offering document more widely, including by email, without concern about whether a potential investor forwards the email to others.

- Issuers often inquire about whether they may send a private offering document to customers or publish it on their website. The adopting release confirms that an issuer may take these types of actions. Further, a US reporting company engaged in a private offering would likely have the freedom to publicly share information about that offering, including publishing the entire offering document and roadshow on its website or filing them on a Form 8-K or 6-K, rather than filing only those portions that contain previously undisclosed information.

- The list of verification methods includes one that would allow the issuer to rely on written confirmation from a broker-dealer, law firm or auditor that it has verified a purchaser's status as an Accredited Investor. It is unclear whether any of these parties will begin to provide these third-party verifications given the potential legal liability, something the SEC noted in the adopting release.

- Two other stand-alone verification methods, which relate to an investor's annual income or net worth, are aimed at establishing the Accredited Investor status of individuals, and it seems likely that these will become standard for verifying such status, except where unusual circumstances dictate a different approach. It is notable that outside the third-party verification method, there is no method that could be applied generally to institutions, which means that a facts-and-circumstances approach may become standard in offerings that include institutional investors.

- Agreements that issuers customarily enter into in connection with Rule 144A or Regulation D offerings may no longer have to include the standard representations about the absence of general solicitation or general advertising, but may need more robust provisions regarding the vetting of investors.

- The removal of the prohibition on general solicitation raises a question of whether it will be easier for a company conducting an IPO to sell securities to investors in a private placement concurrent with the IPO. This practice has been conducted under a policy-based exception pursuant to the SEC's "Black Box" no-action letter that permits such sales to QIBs and two or three large institutional Accredited Investors at the same time as an IPO. However, while the new rules remove the prohibition on general solicitation, the SEC has not expressly addressed the question of whether a private placement conducted outside the "Black Box" parameters (i.e., to a large number of Accredited Investors) would still run afoul of the SEC's rules regarding "integration" of public and private offerings. We therefore believe that absent further clarification from the SEC, issuers and underwriters should continue to follow existing guidelines and practices with respect to the conduct of private placements concurrently with IPOs.

## Disqualification of "Bad Actors" From Rule 506 Offerings

The final rules disqualifying felons and other "bad actors" from participating in certain securities offerings are contained in new clause (d) in Rule 506 of Regulation D and will apply to triggering events occurring after the effective date of the rule amendments. New Rule 506(d) disallows reliance on the registration exemptions in Rule 506 of Regulation D in connection with securities offerings if the issuer or other "Covered Persons" (described below) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws (a "Triggering Event"). The bad actor provisions promulgated in new Rule 506(d) apply only to Rule 506 offerings; however, the adopting release makes clear that the SEC anticipates further rulemaking that would apply similar disqualification rules to offerings under Regulation A, Regulation E and Rules 504 and 505 of Regulation D.

- "Covered Persons" include:
  - The issuer
  - Any predecessor of the issuer
  - Any affiliated issuer
  - Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer
  - Any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities (calculated on the basis of voting power)
  - Any promoter connected with the issuer in any capacity at the time of such sale
  - Any investment manager of an issuer that is a pooled investment fund
  - Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities
  - Any general partner or managing member of any such investment manager or solicitor or any director, executive officer or other officer participating in the offering of any such investment manager, solicitor, general partner or managing member of such investment manager or solicitor
- "Triggering Events" include any of the following that occur after the effective date of Rule 506(d):
  - *Criminal convictions* (within the past five years for issuers and ten years for other Covered Persons) for any felony or misdemeanor in connection with the purchase or sale of any security, false filings 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
  - *Injunctions or court orders* (within the past five years) restraining or enjoining conduct connected to the sale or purchase of securities, the making of false filings 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 by relevant state or federal regulators* that: (A) at the time of such sale, bars the person from association with an entity regulated by such regulator; engaging in the business of securities, insurance or banking; or engaging in savings association or credit union activities; or (B) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale
  - *SEC disciplinary orders* entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act or of the Investment Advisers Act of 1940 that, at the time of such sale: (A) suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser; (B) places limitations on the activities, functions or operations of such person; or (C) bars such person from being associated with any entity or from participating in the offering of any penny stock
  - *SEC cease-and-desist orders* entered within five years relating to (A) any scienter-based anti-fraud provision of the federal securities laws or (B) Section 5 of the Securities Act
  - *Self-Regulatory Organization suspension or expulsion* for any act or omission to act that constitutes conduct inconsistent with just and equitable principles of trade
  - *Regulation A registration* occurring within five years before such sale, in which the Covered Person was a registrant, issuer or underwriter and that became subject to a stop order or suspension order relating thereto, or that at the time of such sale is the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued and
  - *Postal Service false representation orders* entered within five years before such sale or, at the time of such sale, temporary restraining orders or preliminary injunctions 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
- New Rule 506(d) contains a "reasonable care" carve-out pursuant to which an issuer will not lose the benefit of the Rule 506 safe harbor, despite the existence of a Triggering Event, if it can establish that at the time of the sale it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. The steps that an issuer will need to take (including the scope and timing of factual checks that may need to be undertaken) to establish such reasonable care will vary according to the facts and circumstances of a particular securities offering.
- The rule amendments also add a new Rule 506(e) that mandates disclosure of Triggering Events that pre-date the effectiveness of Rule 506(d). Rather than imposing disqualification for pre-existing triggering events, new Rule 506(e) requires written disclosure to investors in the relevant securities offering of matters that would have triggered disqualification, except that they occurred before the effective date of the new disqualification provisions. The disclosure requirement in new Rule 506(e) will apply to all offerings under Rule 506, regardless of whether purchasers are accredited investors, and issuers will be required to provide disclosure "a reasonable time prior to sale."
- Form D will be revised to require an issuer to certify that it is not disqualified from relying on Regulation D for one of the reasons stated in the new Rule 506(d).

## When Will the New Rules Become Effective?

The final rules removing the ban on general solicitation and general advertising in connection with certain private placements under Rule 506 of Regulation D and Rule 144A, and the final rules providing for the disqualification of "bad actors" in Rule 506 offerings, will each become effective 60 days after the date that the relevant final rules are published in the Federal Register. It is important to note that these amendments are not yet in effect, and in particular that the ban on general solicitation and general advertising under Regulation D and Rule 144A remains in force until the expiry of the 60-day period.






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