Corporate Finance Alert

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Changing the Private Placement Playbook: General Solicitation and General Advertising Now Permitted for Certain Offerings

On September 23, 2013, new Securities and Exchange Commission rules took effect that:

- Eliminate the prohibition against general solicitation and general advertising in private offerings made in reliance on Rule 506 of Regulation D or Rule 144A under the Securities Act of 1933 (Securities Act);[1] and
- Disqualify certain securities offerings involving "bad actors" from reliance on Rule 506 whether or not general solicitation and advertising are used.[2]

The new rules have the potential to transform the private placement market. We expect that market practices and procedures with respect to the new rules will continue to develop over time.[3]

Ban Lifted on General Solicitation and General Advertising for Certain Private Placements

The new rules eliminate the prohibition against general solicitation and general advertising in private offerings made in reliance on Rule 506 or Rule 144A and make a corresponding change to Form D. The amendments only address the rule-based safe harbors under Rule 506 and Rule 144A and do not affect offerings conducted solely under the statutory exemption under Section 4(a)(2) (formerly Section 4(2)). Section 4(a)(2) offerings remain subject to the prohibition against general solicitation and general advertising. Additionally, the SEC did not address the private resale exemption under so-called Section 4(1½).

Rule 506

The safe harbor from Securities Act registration provided by amended Rule 506 permits an issuer to use general solicitation and general advertising to offer and sell securities, provided that:

- The issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;
- All purchasers of securities are accredited investors, or the issuer reasonably believes that they are accredited investors at the time the securities are sold; and
- The sales otherwise satisfy the definitional, integration and resale provisions of the Regulation D safe harbor.

1 The final rule release, Securities Act Release No. 33-9415 (July 10, 2013), is available here.

2 The final rule release, Securities Act Release No. 33-9414 (July 10, 2013), is available here.

3 This article briefly outlines the new rules. For a more comprehensive discussion and analysis of the new rules, as well as a discussion of certain related proposed rules, please see our previous *Corporate Finance Alert*, which can be found here.

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The new safe harbor provisions are designated as Rule 506(c)(General Solicitation Exemption).

In the adopting release, the SEC noted that "reasonable steps" to verify investor status will be an objective determination by the issuer based on the SEC's principles-based guidance. Issuers should consider the facts and circumstances of the transaction, including, among other things, the following factors:

- The type of 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; and
- The nature of the offering, including:
  - 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.

These factors will help form an issuer's reasonable belief that a potential purchaser is an accredited investor and will assist the issuer in determining which steps are reasonable to verify a purchaser's status as an accredited investor. The SEC also provided a non-exclusive list of methods in the General Solicitation Exemption that issuers may use to satisfy the verification requirement for investors who are natural persons.

An issuer will not lose the ability to rely on the General Solicitation Exemption for an offering where an investor purchased securities after providing false information or documentation relating to its accredited investor status, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and the issuer had a reasonable belief that such person was an accredited investor at the time the securities were sold.

Issuers may continue to conduct offerings without the use of general solicitation and general advertising under the old safe harbor, which is now redesignated as Rule 506(b) (No General Solicitation Exemption). Because the No General Solicitation Exemption remains unchanged from the old safe harbor, issuers may continue to sell securities to up to 35 non-accredited investors.

Form D

Form D, which issuers conducting a Rule 506 offering are required to file with the SEC no later than 15 calendar days after the first sale of securities in the offering, has been revised to include a separate box for issuers to check if they are claiming the General Solicitation Exemption.

Specific Issues for Private Funds

Privately offered funds (such as private equity funds, hedge funds and venture capital funds) are precluded from relying on two critical statutory exclusions from the definition of "investment company" under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 if they make a public offer of securities. The adopting release makes clear that private funds may offer and sell securities under the General Solicitation Exemption without losing either of the exclusions under the Investment Company Act. It should be noted, however, that neither the new rules nor the adopting release addresses whether the offer and sale of securities under the General Solicitation Exemption would satisfy existing Commodity Futures Trading Commission private marketing restrictions.

Rule 144A

Under the new rules, securities sold pursuant to Rule 144A may be offered to persons other than qualified institutional buyers (QIBs), including by means of general solicitation and general advertising, provided that the securities actually are sold only to persons that the seller and any person acting on behalf of the seller reasonably believes are QIBs. Accordingly, issuers conducting a Rule 144A offering are no longer subject to the limitations in Rule 135c under the Securities Act when publicly disseminating written communications related to the offering.

Impact on Regulation S – Integration With Offshore Offerings

Consistent with historical practices, concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with domestic offerings that are conducted in compliance with Rule 506 or Rule 144A, and the use of general solicitation or general advertising will not constitute directed selling efforts that would threaten the validity of a concurrent Regulation S offering. However, Regulation S-only offerings remain unchanged, and thus any general solicitation or general advertising in the U.S. could constitute prohibited directed selling efforts in the United States.

Blue Sky Issues

The lifting of the ban on general solicitation and general advertising raises a number of potential state blue sky issues, as discussed in our previous *Corporate Finance Alert*.

Offerings Involving Bad Actors Disqualified From Reliance on Rule 506

Securities offerings are disqualified from reliance on the Rule 506 exemption if any of the issuer or other specified persons (such as underwriters, placement agents and the directors, executive officers, and certain other officers and certain large beneficial owners of the issuer) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. The new rules are set forth in new paragraph (d) of Rule 506 and apply regardless of whether general solicitation is used.

The new rules apply only with respect to disqualifying events that occur after effectiveness of the new rules on September 23, 2013. However, events that occurred before September 23, 2013 that would have been disqualifying events under the new rules must be disclosed in writing to each purchaser a reasonable time prior to the sale of securities. If an issuer fails to furnish disclosure to investors, it is disqualified from using the Rule 506 exemption unless 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."

Covered Persons

The disqualification rules apply to the following "covered persons":

- The issuer and any predecessor of the issuer or affiliated issuer;
- Any director, general partner or managing member of the issuer;
- Any executive officer or other officer of the issuer participating in the proposed offering;
- 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 the sale;
- Any investment manager of an issuer that is a pooled investment fund (Investment Manager);
- Any person that has been or will be paid (directly or indirectly) for solicitation of purchasers in connection with sales of securities (*i.e.*, a placement agent) (Compensated Solicitor);
- Any general partner or managing member of any such Investment Manager or Compensated Solicitor; and
- Any director or executive officer or other officer participating in the offering of any such Investment Manager or Compensated Solicitor or general partner or managing member of such Investment Manager or Compensated Solicitor.

Events relating to any affiliated issuer that occurred before the affiliation arose will not be considered disqualifying as long as the affiliated entity is not (i) in control of the issuer or (ii) under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

Disqualifying Events

The rules set forth types of disqualifying events applicable to "covered persons," including the following:

- **Criminal convictions** (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC or (iii) 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 (collectively, certain financial intermediaries). The criminal conviction must have occurred within 10 years before the proposed sale of securities (or five years, in the case of issuers, their predecessors and affiliated issuers).
- **Court injunctions and restraining orders** that restrain or enjoin a person from engaging or continuing to engage in any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of any false filing with the SEC or (iii) arising out of the conduct of the business of certain financial intermediaries. The injunction or restraining order must have been entered within five years before the proposed sale of securities.
- **Final orders of certain state regulators (such as state securities, banking and insurance regulators), federal regulators and the U.S. Commodity Futures Trading Commission** that, (i) at the time of the proposed sale of securities, bar the person from (a) associating with a regulated entity, (b) engaging in the business of securities, insurance or banking, or (c) engaging in savings association or credit union activities; or (ii) are entered within 10 years before the proposed sale of securities and are based on violations of law that prohibit fraudulent, manipulative or deceptive conduct.
- **SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons** that, at the time of the proposed sale of securities, (i) suspend or revoke such person's registration, (ii) place limitations on the activities, functions or operations of such person or (iii) bar such person from being associated with any entity or from participating in the offering of any penny stock. Such orders will be disqualifying for so long as they are in effect.
- **SEC cease-and-desist orders**, entered within five years before the proposed sale of securities, related to violations of certain anti-fraud provisions and registration requirements of the federal securities laws.
- **Suspension or expulsion from membership in, or suspension or bar from associating 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. The period of disqualification will equal the period of the suspension, expulsion or bar.

Reasonable Care Exception and Waivers

The new rules include a "reasonable care" exception. An issuer will still be able to take advantage of the Rule 506 safe harbor even though a disqualifying event exists if the issuer can establish that it did not know and, in the exercise of reasonable care, could not have known, of the disqualification. To establish reasonable care, the issuer will need to make a factual inquiry, the nature and scope of which will depend, at least in part, on the facts and circumstances of the issuer and the other offering participants.

An issuer also may seek a waiver of disqualification if the issuer shows "good cause" and the SEC determines "that it is not necessary under the circumstances that an exemption be denied." Additionally, a court or regulatory authority that entered a disqualifying order, judgment or decree may advise in such document or separately in a writing to the SEC that disqualification under Rule 506 should not arise as a consequence of such order, judgment or decree.

Form D

The new rules amend Form D to require an issuer, in connection with a securities offering conducted in reliance on Rule 506, to certify that the offering is not disqualified from relying on Rule 506.

Summary of Adopted Amendments to Rule 506, Rule 144A and Form D		
	Prior to Amendments	**As Amended**
Rule 506	• An issuer is not permitted to offer or sell securities through any form of general solicitation or general advertising.* • Safe harbor does not disqualify securities offerings in which certain felons and other "bad actors" are involved. • Issuers may sell securities to up to 35 non-accredited investors who meet certain sophistication requirements.	• An issuer (including a privately offered fund) is permitted to use general solicitation and general advertising to offer and sell securities under new Rule 506(c) (General Solicitation Exemption) as long as: – The issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors; – All purchasers of securities are accredited investors because they fall within one of the categories of persons that qualify as an accredited investor (under Rule 501) or the issuer reasonably believes that they fall within one of the categories at the time the securities are sold; and – The sales otherwise satisfy the definitional, integration and resale provisions of the Regulation D safe harbor. • Existing safe harbor under Rule 506 is not otherwise affected and is redesignated as Rule 506(b) (No General Solicitation Exemption). • Issuers that use the General Solicitation Exemption may not sell securities to any non-accredited investors; however, under the No General Solicitation Exemption, issuers may sell securities to up to 35 non-accredited investors who meet certain sophistication requirements. • Safe harbor (either the General Solicitation Exemption or No General Solicitation Exemption) unavailable for securities offerings in which certain felons and other "bad actors" are involved.
Form D**	• Form D due no later than 15 calendar days after first sale of securities; Form D filing is required by rule but not a condition to exemption under Rule 506. • Form includes a single box to check indicating reliance on Rule 506. • Form does not require certification that a Rule 506 offering does not involve certain felons and other "bad actors."	• Form D due no later than 15 calendar days after first sale of securities; Form D filing required by rule, but not a condition to exemptions under Rule 506 (either the General Solicitation Exemption or No General Solicitation Exemption). • Form includes separate boxes for issuers to check to indicate whether they are claiming the General Solicitation Exemption or, alternatively, the No General Solicitation Exemption. • Form requires certification that a Rule 506 offering is not disqualified from relying on Rule 506 (as a result of the new "bad actor" provisions).

(continued)

Summary of Adopted Amendments to Rule 506, Rule 144A and Form D		
	Prior to Amendments	**As Amended**
Rule 144A	• Although no express limitation against general solicitation and general advertising, offers of securities under Rule 144A limited to QIBs. • Form D not applicable to Rule 144A offerings. • Offerings not subject to "bad actor" disqualification.	• Securities may be offered for resale to persons other than QIBs, including by means of general solicitation and general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believes are QIBs. • General solicitation and general advertising solely in connection with resales by financial intermediaries (initial purchasers) will not affect the validity of an otherwise proper and exempt initial sale by the issuer to the financial intermediaries. • Form D not applicable to Rule 144A offerings. • Offerings not subject to "bad actor" disqualification.
Section 4(a)(2) (formerly Section 4(2))	• Offerings subject to the prohibition against general solicitation and general advertising. • Offerings not subject to "bad actor" disqualification.	• No changes. – Offerings remain subject to the prohibition against general solicitation and general advertising. – Offerings not subject to "bad actor" disqualification.

* General solicitation and general advertising are not defined under Regulation D or elsewhere. Rule 502(c) does set forth examples of general solicitation and general advertising, including "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio" and "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising," subject to limited exceptions, such as publication of a notice pursuant to Rule 135c. The adopting release related to new Rule 506(c) notes the SEC interpretations confirming that other uses of publicly available media, such as unrestricted websites, are also deemed to constitute general solicitation and general advertising.

** Additional changes to Form D and Regulation D and changes to Rule 156 were proposed. The comment period on the proposed rule amendments was scheduled to close on September 23, 2013 but recently was extended until November 4, 2013.

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