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General Solicitation and Bad Actor Guidance from the SEC[1]

The Securities and Exchange Commission (the "SEC") has released a series of Compliance and Disclosure Interpretations (the "Interpretations") recently addressing the general solicitation exemption under new Rule 506(c) of Regulation D (the "General Solicitation Exemption")[2] and rules under new Rule 506(d) and (e) of Regulation D to disqualify certain securities offerings involving "bad actors" from reliance on Rule 506 of Regulation D (collectively, "Bad Actor Rules").[3]

I. General Solicitation Exemption Interpretations

Switching between exemptions. An issuer who commences a Rule 506 offering prior to September 23, 2013, the effective date of the new Rule 506(c) exemption allowing issuers to conduct a general solicitation subject to certain requirements (the "Effective Date"), must file an amendment to its previously-filed Form D if it wishes to continue that offering after the Effective Date in accordance with Rule 506(c). Converting the offering to a Rule 506(c) offering would constitute a change in the information provided in the previously-filed Form D, requiring the issuer to check the Rule 506(c) box on the recently updated Form D.[4, 5]

The Interpretations include guidance on switching an offering relying on Rule 506(b) (requiring no general solicitation) to an offering relying on Rule 506(c) (allowing general solicitation) and vice-versa. Whether an issuer may switch to one exemption after initially relying on the other is based on whether the issuer's offering still meets the conditions required by the exemption ultimately to be used. If an issuer begins an offering intending to rely on Rule 506(c), it would be permitted to rely on Rule 506(b) instead so long as it has not engaged in any form of general solicitation and met the other requirements imposed by Rule 506(b).[6] Conversely, an issuer initially intending to rely on Rule 506(b) for an offering may subsequently decide to rely on Rule 506(c) for that offering, so long as the offering meets all the conditions imposed by Rule 506(c).[7]

An issuer who commenced an offering under Rule 506 prior to the Effective Date and then opted to continue that offering under Rule 506(c) after the Effective Date would need to take reasonable steps to verify the accredited investor status only of those investors who purchased securities after the issuer started offering or selling securities under Rule 506(c), even if the issuer already had sold securities to non-accredited investors

1 For background, please see our previous mailings Shout It From the Rooftops! SEC Removes Ban on General Solicitation and Advertising for Certain Private Placements (August 2013) and Changing the Private Placement Playbook: General Solicitation and General Advertising Now Permitted for Certain Offerings (Oct. 14, 2013).

2 *See* SEC, Securities Act Rules, Compliance & Disclosure Interpretations, Questions 260.05 to 260.13 (Nov. 13, 2013).

3 *See* SEC, *supra* note 2, at Questions 260.14 to 260.27 (Dec. 4, 2013), Questions 260.28 to 260.32 (Jan. 3, 2014), Questions 260.33 to 260.34 (Jan. 23, 2014).

4 *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415 (July 10, 2013).

5 SEC, *supra* note 2, at Question 260.05 (Nov. 13, 2013).

6 SEC, *supra* note 2, at Question 260.11 (Nov. 13, 2013).

7 SEC, *supra* note 2, at Question 260.12 (Nov. 13, 2013).

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while conducting offers and sales pursuant to Rule 506 (before the Effective Date) or Rule 506(b) (after the Effective Date).[8]

Issuers who rely on Rule 506(c) for an offering should note carefully that, if the conditions of Rule 506(c) are not met, the issuer will not be able to rely on the Section 4(a)(2) private offering exemption of the Securities Act of 1933 (the "Securities Act") if it already has engaged in general solicitation.[9]

Verification of accredited investors generally. As long as an issuer takes reasonable steps to verify that an investor is an accredited investor and has a reasonable belief that such investor is an accredited investor at the time of the sale of its securities, the issuer will not lose the ability to rely on Rule 506(c) for a particular offering if a person who does not qualify as an accredited investor actually buys securities in that offering.[10] However, the issuer must satisfy the requirement to take reasonable steps to verify the accredited investor status of investors in an offering under Rule 506(c), even if all of its investors turn out to be accredited investors.[11] Under the principles-based method of verification, whether such verification requirement is adequately satisfied is an objective determination based on the particular facts and circumstances of each investor and transaction.[12]

Verification of accredited investors – non-exclusive list of methods. The SEC release adopting Rule 506(c)[13] included two means by which an issuer may satisfy the requirement to verify the accredited investor status of investors in a Rule 506(c) offering: (1) a holistic, principles-based approach or (2) a non-exclusive list of methods that issuers may use to satisfy the verification requirement for investors that are natural persons. In the Interpretations, the SEC provided further guidance on using some of the methods from the non-exclusive list. The issuer is free to use either the principles-based method of verification or one of the methods from the non-exclusive list, but an issuer who chooses one of the non-exclusive methods of verification must satisfy the specific requirements of that method.[14]

For example, the SEC confirmed that relevant documentation provided to verify an investor's net worth must not be older than three months at the time the investor decides to purchase securities in the offering.[15] The SEC also confirmed that self-certification from investors is only available to existing investors who previously purchased securities of the same issuer in a Rule 506 offering prior to the effective date of Rule 506(c) and not for an offering of any other issuer, even if both issuers share the same sponsor (for example, a new limited partnership organized by a general partner where the investor purchased securities of a prior limited partnership sponsored by the same general partner).[16] The SEC also stated that written confirmations from an attorney or certified public accountant who is licensed or duly registered in good standing in a non-U.S. jurisdiction are acceptable.[17]

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8 SEC, *supra* note 2, at Question 260.33, 260.34 (Jan. 23, 2014).

9 SEC, *supra* note 2, at Question 260.13 (Nov. 13, 2013).

10 SEC, *supra* note 2, at Question 260.06 (Nov. 13, 2013).

11 SEC, *supra* note 2, at Question 260.07 (Nov. 13, 2013).

12 SEC, *supra* note 2, at Question 260.07 (Nov. 13, 2013).

13 Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 33-9414 (July 10, 2013) (the "Bad Actor Adopting Release").

14 SEC, *supra* note 2, at Question 260.08 (Nov. 13, 2013).

15 SEC, *supra* note 2, at Question 260.08 (Nov. 13, 2013).

16 SEC, *supra* note 2, at Question 260.10 (Nov. 13, 2013).

17 SEC, *supra* note 2, at Question 260.09 (Nov. 13, 2013).

II. Bad Actor Rules Interpretations

Covered persons

Covered persons generally. The SEC clarified that issuers must determine if they are subject to bad actor disqualification any time that they rely on Rule 506 to offer or sell securities.[18] Issuers that are not offering securities (such as funds that are winding down or are closed to investment) will not need to determine if they are subject to bad actor disqualification unless and until they engage in an offering in reliance on Rule 506.[19] An issuer may reasonably rely on a covenant of a covered person to provide notice of a bad act, provided that issuers engaged in continuous, delayed or long-lived offerings must update their factual inquiry periodically using various methods depending on the circumstances, such as bring-down of representations, questionnaires and certifications, negative consent letters and periodic re-checking of publicly available databases.[20]

Placement agents and other compensated solicitors. An issuer may continue to rely on Rule 506 for an ongoing offering even if a placement agent or one of its covered control persons becomes subject to a disqualifying event during that offering, so long as the engagement with that placement agent is terminated and the placement agent is not compensated for subsequent sales or, if the disqualifying event affected only covered control persons of that placement agent, such covered control persons were terminated or removed from performing roles for the placement agent that rendered them covered persons under Rule 506(d).[21]

The SEC clarified that the term "compensated solicitors," as used in the Bad Actor Adopting Release, includes all persons who have been or will be paid, directly or indirectly, compensation for the solicitation of purchases whether or not they are, or are required to be, registered under the Securities Exchange Act of 1934 (the "Exchange Act") or are associated persons of registered broker-dealers.[22] Additionally, "participation" in an offering covers a broad range of activities not limited to soliciting investors. Activities such as preparation of offering materials (including analyst reports), provision of structuring or other advice, and communication with the issuer, prospective investors or other offering participants would constitute participation, but transitory, incidental or administrative activities (such as opening accounts, wiring funds or bookkeeping) would not constitute participation.[23]

Affiliated issuers. The SEC also clarified that "affiliated issuer" only refers to an affiliate[24] of an issuer that participates in the same offering as such issuer, including an offering subject to integration under Rule 502(a) of Regulation D.[25] The term does not include every affiliate of the issuer that has ever offered securities and, for example, does not include fund portfolio companies.[26]

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18 SEC, *supra* note 2, at Question 260.14 (Dec. 4, 2013).

19 SEC, *supra* note 2, at Question 260.14 (Dec. 4, 2013).

20 SEC, *supra* note 2, at Question 260.14 (Dec. 4, 2013).

21 SEC, *supra* note 2, at Question 260.15 (Dec. 4, 2013).

22 SEC, *supra* note 2, at Question 260.17 (Dec. 4, 2013).

23 SEC, *supra* note 2, at Question 260.19 (Dec. 4, 2013).

24 As such term is defined in Rule 501(b) of Regulation D, "An *affiliate* of, or person *affiliated* with, a specified person shall mean a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified." 17 C.F.R. 230.501(b) (2013).

25 SEC, *supra* note 2, at Question 260.16 (Dec. 4, 2013).

26 SEC, *supra* note 2, at Question 260.16 (Dec. 4, 2013).

Rule 502(a) provides factors to be considered in determining whether separate offers and sales should be integrated into one offering, such as whether the sales are part of a single plan of financing; whether the sales involve issuance of the same class of securities; whether the sales have been made at or about the same time; whether the same type of consideration is being received; and whether the sales are made for the same general purpose.[27] Offerings by feeder funds created for the sole purpose of investing in a master fund may, for example, be integrated as one offering under Rule 502(a).[28]

When is a 20% beneficial owner a covered person? The SEC clarified that an investor who becomes a beneficial owner of 20% or more of an issuer's securities upon completion of a sale of such securities is not a covered person for purposes of that offering and would only be a covered person for purposes of subsequent offerings.[29]

Beneficial owner concept borrowed from Exchange Act rules. The SEC affirmed that the definition of "beneficial owner" for purposes of Rule 506(d) is the same as the definition in Exchange Act Rule 13d-3 ("Rule 13d-3").[30] A "beneficial owner" of a security under Rule 506(d) refers to any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares, or is deemed to have or share (1) voting power, which includes the power to vote, or to direct the voting of, such security and/or (2) investment power, which includes the power to dispose, or to direct the disposition of, such security.[31] Beneficial ownership for these purposes includes both direct and indirect interests. As a result, issuers will need to "look through" investing entities to their controlling persons for purposes of determining 20% beneficial ownership.[32] Group and group member concepts from Rule 13d-3 also will apply to beneficial ownership in the Rule 506(d) context. If investors in an issuer have formed a group through a voting agreement, for example, then that group becomes a person that beneficially owns the issuer's securities that are owned by the group's members, and such "group" itself may also be a covered person.[33] Additionally, any parties to such a voting agreement who have or share the power to vote or control the vote of securities owned by any of the other parties to such agreement also will be deemed beneficial owners of the securities subject to that agreement.[34] In a recent question in the Interpretations related to Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G, the SEC provided new guidance that a party's mere membership in a group would not confer beneficial ownership of the securities of other members of that group.[35] Power over the voting or investment of the securities, such as may be evidenced by an agreement that provides a party with the power to direct the vote or disposition of securities owned by other members in the group, would be required in order for that party to be considered a beneficial owner of all the securities owned by other members in the group.[36]

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27 SEC, *supra* note 2, at Question 260.16 (Dec. 4, 2013) (citing Rule 502(a) of Regulation D (17. C.F.R. 230.502(a))).

28 *See* SEC, *supra* note 2, at Question 260.16 (Dec. 4, 2013) (citing SEC, Securities Act Forms, Compliance & Disclosure Interpretations, Question 130.02 (Feb. 27, 2009)).

29 SEC, *supra* note 2, at Question 260.28 (Jan. 3, 2014).

30 SEC, *supra* note 2, at Question 260.29 (Jan. 3, 2014).

31 SEC, *supra* note 2, at Question 260.29 (Jan. 3, 2014).

32 SEC, *supra* note 2, at Question 260.30 (Jan. 3, 2014).

33 SEC, *supra* note 2, at Question 260.31 (Jan. 3, 2014).

34 SEC, *supra* note 2, at Question 260.31 (Jan. 3, 2014).

35 SEC, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Compliance & Disclosure Interpretations, Question 105.06 (Jan. 3, 2014).

36 SEC, *supra* note 35, at Question 105.06 (Jan. 3, 2014).

Disqualifications

Effect of foreign judicial and regulatory actions. According to the Interpretations, actions taken in non-U.S. jurisdictions, such as convictions, court orders or injunctions in a foreign court or regulatory orders issued by foreign regulatory authorities, will not give rise to a disqualification under Rule 506(d).[37]

Commission cease-and-desist orders. The SEC clarified that disqualification would be triggered only by orders to cease and desist from violations of scienter-based provisions of the federal securities laws, including scienter-based rules.[38]

Court or regulatory carve outs from disqualification. The SEC affirmed that the provisions of Rule 506(d)(2)(iii) allowing for courts and regulatory authorities to determine no disqualification should apply in connection with orders and judgments are self-executing. If an order issued by a court or regulator provides that disqualification from Rule 506 should not arise as a result of the order, it is not necessary to seek a further waiver from the SEC or to take any other action to confirm that bad actor disqualification will not apply as a result of the order.[39]

Additionally, the SEC noted that an order of a court or regulator of the type contemplated by Rule 506(d)(2)(iii) could not be used to waive an issuer's disclosure obligation under Rule 506(e) for events occurring before the Effective Date and only applies to whether a 506(d) disqualification applies to an event occurring after the Effective Date.[40] The SEC stated that a regulatory authority could, however, find that an order entered before the Effective Date would not have triggered disqualification under Rule 506(d)(1) because the violation was not in fact a disqualifying event.[41]

Reasonable care exception. The SEC elaborated on the applicability of the reasonable care exception by explaining that it applies whenever an issuer can establish that it did not know and could not have known, despite exercising reasonable care, that a disqualification existed under Rule 506(d)(1).[42]

The SEC provided the following examples where such a situation could occur: an issuer is unable to determine the existence of a disqualifying event; an issuer cannot determine that a particular person was a covered person; or an issuer initially determined that a particular person was not a covered person but subsequently learned that its initial determination was incorrect.[43]

The SEC noted that issuers must determine for themselves what actions must be taken to remedy the discovery of a disqualifying event or a covered person during the course of a Rule 506 offering, which may involve seeking waivers of disqualification, termination of the relationship with a covered person, or providing Rule 506(e) disclosure to investors in the offering.[44]

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37 SEC, *supra* note 2, at Question 260.20 (Dec. 4, 2013).

38 SEC, *supra* note 2, at Question 260.21 (Dec. 4, 2013).

39 SEC, *supra* note 2, at Question 260.22 (Dec. 4, 2013).

40 SEC, *supra* note 2, at Question 260.32 (Jan. 3, 2014).

41 SEC, *supra* note 2, at Question 260.32 (Jan. 3, 2014).

42 SEC, *supra* note 2, at Question 260.23 (Dec. 4, 2013).

43 SEC, *supra* note 2, at Question 260.23 (Dec. 4, 2013).

44 SEC, *supra* note 2, at Question 260.23 (Dec. 4, 2013).

Rule 506(e) disclosure

Issuers cannot seek a waiver of the requirement to disclose past events that would have been disqualifying but for their occurrence before the Effective Date.[45] The SEC emphasized that events that occurred outside the applicable look-back period and orders and bars that do not have continuing effect do not mandate disclosure under Rule 506(e) because they would not trigger disqualification under Rule 506(d).[46]

In offerings that have multiple compensated solicitors, an issuer is required to disclose disqualifying events pursuant to Rule 506(e) about all such compensated solicitors to all investors, not merely about the compensated solicitor(s) who solicited that investor.[47] However, the issuer is only required to provide an investor with Rule 506(e) disclosure regarding a compensated solicitor who is still involved in the offering at the time of such sale.[48] The issuer must provide Rule 506(e) disclosure to a prospective investor a reasonable time prior to the sale of securities to that investor.[49]

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45 SEC, *supra* note 2, at Question 260.24 (Dec. 4, 2013).

46 SEC, *supra* note 2, at Question 260.25 (Dec. 4, 2013).

47 SEC, *supra* note 2, at Question 260.26 (Dec. 4, 2013).

48 SEC, *supra* note 2, at Question 260.27 (Dec. 4, 2013).

49 SEC, *supra* note 2, at Question 260.27 (Dec. 4, 2013).