SEC Amends Rule 506 to Permit General Solicitation in Securities Offerings

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Amendments to Rule 506 become effective September 23, 2013 and include "bad boy" provisions

The SEC has adopted amendments to Rule 506 under the Securities Act of 1933 that permit general solicitation and general advertising in securities offerings under this exemption from securities registration provided all purchasers are accredited investors. (The SEC adopted a parallel amendment to Rule 144A that permits general solicitation under that rule so long as all purchasers are limited to Qualified Institutional Buyers ("QIBs")). The SEC also amended Rule 506 to make that exemption from registration unavailable if "bad actors" are participants in the offering. All of these amendments will become effective September 23, 2013. The general solicitation amendments were required by the JOBS Act and the "bad boy" amendments were required by the Dodd-Frank Act. The exemptions from registration under Rules 506 and 144A are available to both publicly traded and private companies, both domestic and foreign.

General Solicitation Amendments to Rule 506

To implement the change mandated by the JOBS Act, the SEC has divided Rule 506 into two alternative exemptions. Rule 506(b) continues the current exemption, which permits purchases by up to 35 non-accredited investors and prohibits general solicitation. New Rule 506(c) permits the use of general solicitation, subject to the following additional conditions:

- All terms and conditions of Rules 501 (definitions), 502(a) (integration with other offerings), and 502(d) (securities are "restricted securities" for purposes of Rule 144) must be satisfied.

- All purchasers of the securities (regardless of the status of the offerees) must be "accredited investors" as defined in Rule 501. (This definition includes persons the issuer reasonably believes qualify as accredited.)

- The issuer must take "reasonable steps" to verify that all purchasers are accredited investors.

The SEC adopting release clarifies that, as required by the JOBS Act, Rule 506(c) will be treated as a "private placement" exemption even though general solicitation is permitted under the Rule; however, the statutory "private placement" exemption otherwise provided by Section 4(a)(2) of the Securities Act (commonly referred to as "Section 4(2)" before the re-codification of the Securities Act necessitated by the JOBS Act) continues to be conditioned on the absence of general solicitation. Because offerings conducted under Rule 506(c) are deemed by the JOBS Act to not involve a public offering, hedge funds, private equity funds, and similar "private" funds may sell their securities using general solicitation under Rule 506(c) without losing the ability to satisfy the exemptions from registration under the Investment Company Act that are conditioned on the fund not making a public offering of its securities.

Except for a limited transition provision discussed below, the SEC staff has clarified that an issuer cannot rely on both Rule 506(b) and Rule 506(c) in the same offering. The current integration rules will remain in effect for determining what constitutes a separate offering.

Reasonable Steps to Verify Accredited Investor Status. Rule 506(c) as adopted contains both a general requirement that issuers take "reasonable steps" to verify that purchasers are accredited investors, as well as a non-exclusive list of methods that can be used to satisfy this requirement.

As originally proposed, Rule 506(c) did not mandate a particular verification process or even identify a set of "safe harbor" procedures that would be deemed to be "reasonable." Instead, the proposing release identified certain factors that issuers would need to consider in determining whether their verification process is "reasonable." In the release adopting the final rules, the SEC retained the "principles-based" method of determining whether the verification steps taken by an issuer were reasonable, but supplemented it with four specific verification methods that will be deemed to constitute "reasonable steps" to verify a purchaser's status unless the issuer or its agent has knowledge that the particular purchaser is not an accredited investor.

Under the "principles-based" method, the extent to which an issuer needs to verify the accredited investor status of a proposed purchaser is to be determined based on the facts and circumstances of the particular purchaser and transaction. The adopting release identifies the following as among the factors that an issuer should consider in determining whether the verification steps taken in any particular case were "reasonable."

- **Nature of the Purchaser.** Reasonable verification steps would differ depending on the category of accredited investor in which the purchaser falls. For example, relatively little verification would be required where the purchaser is an accredited investor by virtue of its being a registered broker-dealer. By contrast, more extensive verification would be required for natural persons, whose accredited investor status is based on either income or net worth.

- **Information about the Purchaser.** Issuers could review or rely on the following types of information, which depending on the circumstances may or may not be sufficient verification in and of themselves:

  — Publicly available information in regulatory filings, such as an executive's compensation as reported in his/her employer's proxy statement filed with the SEC, or a tax-exempt organization's assets as reported in its Form 990 filed with the IRS.

  — Third-party information that is reasonably reliable, such as an individual's pay stubs or publicly available information about the average compensation earned at the purchaser's workplace by persons at his or her position.

  — Verification of the person's status as an accredited investor by a third party if the issuer has a reasonable basis for relying on this source. The release anticipates that in the future vendors may emerge to fulfill this function.

- **Nature of the Offering.** An issuer that solicits purchasers through media accessible by the general public or by widely disseminated email or social media solicitations would need to take greater measures to verify accredited investor status than an issuer that limits its solicitations to pre-screened investors. Where the solicitation is made available to the general public, purchaser questionnaires and self-certifications would be insufficient verification.

- **Terms of the Offering.** If the minimum investment is sufficiently high that only accredited investors could reasonably be expected to invest that amount, the additional verification required would be limited. The release indicates that in this situation it may be sufficient for the issuer to verify that the investment is not being financed by the issuer or a third party.

The four verification methods that are deemed "reasonable" (absent knowledge to the contrary) all relate

to the status of individuals, and are as follows:

- **Income.** An issuer may verify an individual's status as an accredited investor on the basis of income by reviewing copies of any IRS form that reports net income, such as Forms W-2 or 1099 (which are typically filed by an employer or other third party payor), or Forms 1040 filed by the prospective purchaser (with non-relevant information permitted to be redacted). Under this method, the issuer must review IRS forms for the two most recent years and obtain a written representation from the prospective purchaser that he or she has a reasonable expectation of attaining the necessary income level for the current year. Where accredited investor status is based on joint income with the person's spouse, the IRS forms and representation must be provided with respect to both the purchaser and the spouse.

- **Net Worth.** Under this method, an issuer would need to review bank or brokerage statements or third-party appraisal reports to verify the purchaser's assets and a credit report to verify liabilities, in each case dated within the prior three months, and would need to obtain a written representation from the prospective purchaser that all liabilities have been disclosed. Where accredited investor status is based on joint net worth with the person's spouse, the asset and liability documentation and representation must be provided with respect to both the purchaser and the spouse.

- **Reliance on Determination by Specified Third Parties.** An issuer is deemed to satisfy the verification requirement if the issuer obtains a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that within the prior three months such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor and has determined that the purchaser is an accredited investor. While these are the only categories of third parties that the issuer is entitled to rely on without further steps, the SEC release notes that in appropriate circumstances an issuer may be entitled to rely on a similar confirmation by a third party that is not in one of these categories if the issuer has a reasonable basis to rely on such verification.

- **Existing Accredited Investors.** If a person purchased securities as an accredited investor in a previous Rule 506(b) offering by the issuer (*i.e.*, made without general solicitation) and continues to hold such securities, the issuer may continue to treat such person as an accredited investor if it obtains a certification by the person at the time of the Rule 506(c) sale that he or she qualifies as an accredited investor. However, this method is only available if the previous Rule 506(b) offering was made before the effective date of Rule 506(c).

Transition Matters. An issuer that commenced a Rule 506 offering before the effective date of new Rule 506(c) may choose to use either Rule 506(b) or Rule 506(c) for the portion of the offering conducted after the effective date of the new rule. Use of Rule 506(c) will not affect the availability of Rule 506(b) for sales in the same offering that were made to non-accredited investors before the effective date of Rule 506(c). However, except for these limited transition provisions, an issuer cannot use both Rule 506(b) and Rule 506(c) in the same offering.

Bad Actor Amendments to Rule 506

The "bad boy" provisions have been added as a new paragraph (d) to Rule 506. These provisions disqualify an offering from utilizing the Rule 506 exemption from registration if certain persons related to the issuer or the offering have engaged in specified "bad acts." The disqualification provisions apply to offerings under Rule 506(b) and Rule 506(c).

Covered Persons. The disqualification provisions apply to the following categories of persons ("covered persons"):

• The issuer, any predecessor of the issuer, and any affiliated issuer.

• Directors of the issuer.

• Executive officers of the issuer, as well as other officers of the issuer who participate in the offering. The release indicates that "participation" in the offering refers to more than incidental involvement, and could include involvement in due diligence, preparation of disclosure documents, and communications with prospective investors or other participants in the offering process.

• General partners and managing members of the issuer.

• Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power.

• Promoters connected with the issuer in any capacity at the time of the sale. (The term "promoter" is defined in Rule 405 to mean anyone who, alone or together with others, directly or indirectly takes initiative in founding the business, or who in connection with the founding of the business receives 10% or more of a class of issuer securities or 10% or more of the proceeds from the sale of a class of issuer securities.)

• Any person being paid (directly or indirectly) for soliciting purchasers in the offering (as well as such person's general partners and managing members, and the directors, executive officers, other officers participating in the offering, general partners, and managing members of the solicitor or its general partner or managing member).

• Investment managers of issuers that are pooled investment funds (as well as such investment manager's general partners and managing members, and the directors, executive officers, other officers participating in the offering, general partners, and managing members of such investment manager or its general partner or managing member).

Disqualifying Events. Rule 506 is unavailable if any covered person has engaged in any of the following disqualifying events, unless either the SEC or the court or regulatory body that issued the relevant order determines that disqualification is not necessary in the particular circumstances and grants a waiver of disqualification. In addition, even if there is a disqualifying event, an offering will not lose the Rule 506 exemption if the issuer can establish that it did not know, and in the exercise of reasonable care based on factual inquiry could not have known, that a disqualification existed.

• **Criminal Convictions.** An offering is disqualified if any covered person was convicted of a misdemeanor or felony (i) in connection with the purchase or sale of a security, (ii) involving the making of a 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. A conviction is disqualifying only if it occurred within five years before the Rule 506 sale in the case of the issuer, its predecessor, or an affiliated issuer, and ten years before the Rule 506 sale in the case of all other covered persons.

• **Court Injunctions and Restraining Orders.** An offering is disqualified if any covered person is subject to a court order entered into within five years before the Rule 506 sale that restrains such person from engaging in any conduct or practice (i) in connection with the purchase or sale of a security, (ii) involving the making of a 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. A court order is **not** a disqualifying event if either it was entered into more than five years before the offering (even if it remains in effect at the time of the

offering) or if the court order is no longer in effect at the time of the offering (even if entered into within the five-year period).

• **Final Orders of Regulators.** An offering is disqualified if any covered person is subject to a final order (including a settlement order) of a state securities regulator, federal or state banking regulator, state insurance regulator, or the CFTC that (i) at the time of the Rule 506 sale bars the person from associating 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 (ii) is based on a violation of a law or regulation that prohibits fraudulent, manipulative or deceptive conduct and was entered into within ten years before the Rule 506 sale. Bars are disqualifying for as long as they are in effect, regardless of how long ago they were ordered. By contrast, final orders covered in clause (ii) cease to be disqualifying ten years after their entry.

• **SEC Disciplinary Orders.** An offering is disqualified if any covered person is subject to an SEC order under specified provisions of the securities laws that, at the time of the Rule 506 sale, (i) suspends or revokes such person's registration as a broker, dealer, municipal securities dealer, or investment adviser; (ii) places limitations on the activities, functions, or operations of such person; or (iii) bars such person from being associated with any entity or from participating in an offering of penny stock. Disqualification continues for as long as some act is prohibited or required to be performed pursuant to the order. As a result, there is no cut-off date if the order involves a permanent prohibition. However, if the order calls for performing a specific act (such as paying a penalty), the order is no longer disqualifying once the required act has been fully performed.

• **SEC Cease-and-Desist Orders.** An offering is disqualified if any covered person is subject to an SEC order entered into within five years before the Rule 506 sale that orders the person to cease and desist from committing or causing violations or future violations of (i) any scienter-based anti-fraud provision of the federal securities laws, or (ii) Section 5 of the Securities Act.

• **Suspension or Expulsion from SRO Membership or Association with an SRO Member.** An offering is disqualified if any covered person is suspended or expelled from membership in, or suspended or barred from association with, a stock exchange or other self-regulatory organization for conduct inconsistent with just and equitable principles of trade.

• **SEC Stop Orders.** An offering is disqualified if any covered person was an issuer or underwriter of an offering which, within five years of the Rule 506 sale, was subject to an SEC stop order or order suspending Regulation A exemption, or is, at the time of the sale, the subject of an investigation or proceeding to determine whether such an order should be issued.

• **US Postal Service False Representation Orders.** An offering is disqualified if any covered person is subject to a US Postal Service false representation order entered into within five years before the Rule 506 sale, or is, at the time of the sale, subject to an injunction or temporary restraining order with respect to conduct alleged to constitute a scheme for obtaining money or property through the mail by means of false representation.

Transition Matters. Disqualifying events that occurred before the effective date of the Rule 506 amendments will not make Rule 506 unavailable. However, a description of any such events must be provided to each purchaser a reasonable time before the Rule 506 sale. In addition, disqualifying events relating to an affiliated issuer will not disqualify the offering if they occurred before the affiliate relationship existed.

Proposed Amendments to Reg D and Form D

Anticipating that Rule 506 offerings are likely to undergo significant changes when such offerings are

made using general solicitation, the SEC has proposed a number of additional amendments to Regulation D and Form D to help it monitor the changes, as well as certain additional disclosure requirements intended to address concerns that general solicitation could increase the potential for abuse.

Timing of Form D.

- For offerings under Rule 506 using general solicitation, a Form D containing specified information called for by the Form would be required to be filed no later than 15 calendar days before the first use of general solicitation. The remaining Items called for by Form D (and the entire Form in the case of Reg D offerings that are not conducted under Rule 506(c)) would be due 15 days after the first sale in the offering.

- A final amendment to Form D would be required to be filed within 30 calendar days after termination of any Rule 506 offering. This is in addition to the amendments currently required to correct material mistakes or reflect changes in specified information, or to update the information if the offering is ongoing for more than a year.

Content of Form D. Existing Items of Form D would be expanded to include information such as the issuer's website address and controlling persons, as well as the trading symbol and CUSIP number of the securities being offered. Information about the size of the issuer, which is currently optional, would be required unless the issuer does not otherwise make this information publicly available. Additional information would be required about the number of accredited and non-accredited investors and the amount invested by each category, with each of these categories further broken down into natural persons and legal entities. The Item dealing with use of offering proceeds would be expanded to call for information about the percentage of offering proceeds expected to be used for each of six specified purposes.

Six new Items would be added to the Form, calling for the following information:

- The number of purchasers who qualified as accredited investors on the basis of each of income; net worth; status as officer, director or general partner; or some other basis.

- Information about the stock exchange or other trading venue on which the issuer's securities are traded.

- Whether any general solicitation materials were filed with FINRA.

- For offerings by pooled investment funds, identification of any investment adviser registered with or reporting to the SEC who functions as a promoter of the issuer.

- Check-the-box identification of the types of general solicitation to be used in the offering (*e.g.*, mass mailing, email, public website, social media, print media, broadcast media).

- Check-the-box identification of the methods used to verify accredited investor status, supplemented by more specific descriptions of the materials used in connection with the principles-based methods.

Conditions on the Availability of Rule 506. Under the SEC proposal, an issuer would be disqualified from using Rule 506 for an offering if it failed to comply with the Form D filing requirements within the past five years in connection with an earlier offering under Rule 506. The disqualification would end one year after the required filings were made, or if the offering had already terminated, one year after a final Form D was filed for the offering. The disqualification would not apply to the offering with respect to which the failure to file occurred, but only to subsequent offerings. Failures to file that occurred before the effective date of the rule amendment would not trigger disqualification. The SEC would have the ability to waive

this disqualification in appropriate circumstances. Rule 506 would also be unavailable if the issuer or any of its predecessors or affiliates has been subject to any court order enjoining it for failure to comply with the disclosure or SEC submission requirements discussed below.

Additional Disclosures in General Solicitation Materials. Offerings under Rule 506(c) would be required to include five specified legends in any written general solicitation materials. In addition to typical private placement legends (*e.g.*, that the offering is not registered under the Securities Act, that there are restrictions on transfer of the securities, and that investing in securities involves risk), the materials would be required to contain a legend that the securities may be sold only to accredited investors, which for natural persons are investors who meet certain minimum annual income or net worth thresholds.

Private funds, such as hedge funds, venture capital funds and private equity funds, would be required to include a legend to the effect that the fund is not subject to the Investment Company Act, and if the general solicitation materials include performance data would be required to include additional legends and disclosures related to such data.

Submission of General Solicitation Materials to SEC. In order to help it assess market developments, the SEC has proposed that all written general solicitation materials used in connection with a Rule 506(c) offering be submitted to the SEC no later than the date of their first use. These materials would not be deemed "filed" or "furnished" and would not be publicly available. This rule would be a temporary rule and would expire two years after it became effective.

For more information about the final and proposed amendments to Rule 506 and other SEC rulemaking, or about Hughes Hubbard's Securities and Capital Markets Practice Group, please contact any of the following attorneys:

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