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The SEC Adopts Rules Permitting Public Advertising For "Private" Offerings Under Rule 506 Of Regulation D, Bad Actor Disqualification For Rule 506 Offerings, and Proposes Enhanced Disclosure and Amendments to Form D For Rule 506 Offerings

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On July 10, 2013, the Securities and Exchange Commission adopted final rules on two very significant proposals that are likely to cause fundamental changes in the private placement market.

For the first time, public advertising for private placements that are conducted under Rule 506 of Regulation D will be permitted, so long as the purchasers qualify as accredited investors and the issuer takes certain steps to verify the accredited status of the purchasers. In addition, for the first time, the Rule 506 exemption will be unavailable if certain persons associated with an issuer or a placement agent or investment manager participating in the offering have committed certain specified "bad acts", generally relating to securities regulatory concerns and fraudulent practices. Both rules go into effect in 60 days from the publication of these rules in the Federal Register. In addition, the SEC has proposed enhancements to Form D and certain mandatory disclosures for specified Rule 506 offerings.

I. The New General Solicitation Provisions

As we reported in our April 2012 Client Alert, the Jumpstart Our Business Start Ups Act (the "JOBS Act"), signed into law by President Obama on April 5, 2012, required the SEC to adopt rules, within 90 days of the JOBS Act becoming law, to permit general solicitation (public advertising) in Rule 506 offerings sold solely to accredited investors. The SEC proposed rules on August 29, 2012 to implement this law and it has taken nearly a year for the adoption of the final rules.

The reason for this lengthy comment period is tied to the immense popularity of Rule 506 as the exemption of choice for securities offerings. Rule 506 preempts state "blue sky" regulation due to the status of securities issued in a Rule 506 offering as "covered securities" under Section 18(b)(4)(E) of the Securities Act of 1933, as amended. Moreover, until the adoption of the "bad actor" disqualification rules (discussed in Section II below), there were no restrictions on the type of issuer that could use the exemption, no mandated disclosure requirements as long as the purchasers were solely accredited investors, no limit on the amount of money that can be raised, and no limit on the number of accredited investors who can purchase securities in a Rule 506 offering. Between 90% and 95% of Regulation D Offerings are conducted under Rule 506.

The proposed rule changes caused an outcry from state regulators which were concerned that combining public advertising with an exemption that preempts state regulation would lead to fraudulent practices that would be outside the regulatory purview of the state securities authorities. In fact, there had been a "trial run" for this new regulation in the 1980's and 1990's, when the SEC allowed offerings under $1 million under Rule 504 to be conducted with public advertising. After a great deal of fraudulent activity was reported, the SEC, in 1999, eliminated the ability of issuers to use public advertising for Rule 504 except in states that had a merit review procedure in place or other exemptions for sales solely to accredited investors. The adoption of the "bad actor" disqualification rules in tandem with the new rules permitting general solicitation will provide some comfort that policing of participants in the Regulation D world is beginning to take shape. The SEC has also proposed new disclosures and Form D amendments for Rule 506 offerings (discussed in section III below); however, the effectiveness of the rules permitting general solicitation will not await the adoption of these proposals.

Under the new rules, an issuer will be permitted to publicly advertise an offering under new Rule 506(c) in any manner, so long as only accredited investors purchase the securities in the offering. This will permit advertising of offerings on television, radio, newspapers, internet, social media, etc. The degree to which new capital sources will be reached by advertising remains to be seen, but the new rules clearly carry the potential for a far reaching change in how capital can be accessed without requiring a registration statement reviewed by the SEC.

The principal difference between new Rule 506(c), and the current version of Rule 506 in which public advertising is not permitted (renumbered Rule 506(b), which will continue in effect) is that under new Rule 506(c), the issuer will be required to verify the accredited status of investors. While it is customary to let investors "self represent" their accredited status[1] in offerings conducted under the current version of Rule 506, issuers under new Rule 506 (c) will be required to take reasonable steps to verify the investor's accredited status. The new rules do not dictate any particular method of doing so, adopting a so-called "principles based approach" that allows an issuer to consider the type of accredited investor the purchaser claims to be, the nature of the offering, and the types of information the issuer has about the purchaser. The adopting release suggests a variety of methods of verifying information about a purchaser such as tax returns, financial statements, bank records, brokerage statements, available public filings, third party verifications, consumer credit reporting agencies and others. The new rule allows a variety of circumstances, such as the size of the investment being made and the way the issuer located the investor (such as through a pre-screened database) to support the issuer's determination of the purchaser's accredited status.

The new rule does not abandon the current standard of satisfying the exemption by the issuer having a "reasonable belief" that investors are accredited. Rather it raises the bar on steps that must be taken to establish reasonable belief. If those steps are taken, the SEC's position is that the exemption can be satisfied even if an investor who is not in fact accredited purchases in the offering.

An issuer relying on Rule 506(c) for its exemption must check a new box on Form D to indicate such reliance. As discussed further below in section III, the SEC is proposing a variety of enhancements to Form D, particularly in connection with Rule 506 (c) offerings.

Private funds will also be permitted to use the new Rule 506(c) without losing their ability to use the typical exemptions (Section 3(c) (1) and 3 (c)(7)) from being treated as an "investment company" under the Investment Company Act of 1940. These exemptions are dependent on the fund not conducting a public offering. An offering conducted under the new Rule 506 (c) will not be deemed a public offering for these purposes. Finally, for purposes of conducting an offering under Rule 144A, which previously required that offerees under this exemption be QIB's (Qualified Institutional Buyers), an amendment is being provided so that a 144A offering that is made through general solicitation will still be compliant (even though non QIB offerees may be solicited as a result of advertising) so long as the purchasers in the 144A offering are QIBs.

II. The Bad Actor Disqualification Provisions

Another requirement of the Dodd-Frank Act, the SEC proposed the "bad actor" disqualification rules in May, 2011 (see our June 2011 Client Alert discussing the proposal). The final rules, meant to go into effect simultaneously with the Rule 506(c) general solicitation provisions, provide that an issuer will be disqualified from using Rule 506 (and not just new Rule 506 (c)) if a defined set of "covered persons" involved with that issuer or, for placement agents, that private offering, have been the subject of certain disqualifying events.

The regulation defines the following as "covered persons"

- *the issuer and any predecessor of the issuer or affiliated issuer;*

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[1] The definition of the term "accredited investor" that is applicable to Rule 506 is set forth in Rule 501(a) of Regulation D and includes any person who comes within one of the definition's enumerated categories of persons, or whom the issuer "reasonably believes" comes within any of the enumerated categories, at the time of the sale of the securities to that person. For natural persons, Rule 502(a) defines an accredited investor as a person (1) whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence; or (2) who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.

- *any director, executive officer, other officer participating in the offering, general partner or managing member 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;*
- *any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of any such investment manager , as well as any director, executive officer or officer participating in the offering of any such general partner or managing member*
- *any promoter connected with the issuer in any capacity at the time of the sale*
- *any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering (a "compensated solicitor"); and*
- *any director, executive officer, other officer participating in the offering, general partner, or managing member of any such compensated solicitor*

The disqualification provisions would apply to a covered person:

(i) Who has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the SEC; or

(C) 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;

(ii) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the SEC; or

(C) 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;

(iii) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:

(A) At the time of such sale, bars the person from:

(1) Association with an entity regulated by such commission, authority, agency, or officer;

(2) Engaging in the business of securities, insurance or banking; or

(3) 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;

(iv) Is subject to an order of the SEC 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;

(v) Is subject to any order of the SEC entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of:

(A) Any scienter-based anti-fraud provision of the federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 , section 10(b) of the Securities Exchange Act of 1934, section 15(c)(1) of the Securities Exchange Act of 1934 and section 206(1) of the Investment Advisers Act of 1940, or any other rule or regulation thereunder; or

(B) Section 5 of the Securities Act of 1933.

(vi) Is suspended or expelled from membership in, or suspended or barred from association 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;

(vii) Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the SEC that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

(viii) Is subject to a United States Postal Service false representation order entered within five years before such sale, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction 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.

Effective Date and Transition Requirements

The “bad actor” disqualification provisions go into effect 60 days after publication in the Federal Register. Disqualifying acts involving covered persons occurring before the effective date of these regulations will not cause disqualification of the offering from the Rule 506 exemption. However, the new regulations will require disclosure in any offering occurring after the effective date of the regulations (or an offering continuing after the effective date), of all such events with respect to covered persons that, but for the fact they occurred prior to the effective date of the regulations, would have disqualified the offering from utilizing the Rule 506 exemption. **Thus, an issuer currently involved in an offering which is expected to continue after the effective date of the regulations will need to make the necessary inquiries into the covered persons and disqualifying events so that any required disclosure is made for the period the offering will be in ongoing after the effective date of the regulations.**

The adopting release states the SEC’s view that the failure to comply with the disclosure requirements will result in a loss of the Rule 506 exemption if the reasonable care exception (discussed below) is not available. In this regard, the SEC believes the issuer will not be able to rely on the “insignificant deviation” exception for failure to comply with an element of Regulation D.

Reasonable Care Exception

The new regulations allow an issuer to preserve its exemption if it was unable, despite having taken reasonable care, to determine that its covered persons had been the subject of a disqualifying act. What reasonable care is has been left intentionally flexible based on facts and circumstances, similar to the facts and circumstances based inquiry to establish the accredited status of investors under new Rule 506(c). When it comes to the issuer’s own shareholders, promoters, directors and officers, the issuer would presumably have a history with such persons and the ability to make an inquiry sufficient to meet the standard. When it comes to placement agents, FINRA’s online “Broker Check” provides a great deal of the information that would be required to be ascertained.

The degree of inquiry will be a “work in progress” for securities lawyers and their clients for some time. Note that the reasonable care exception applies both to an offering which would otherwise be subject to disqualification, as well as an offering only subject to mandatory disclosure because the bad acts occurred prior to the effective date of the new rules.

Amendment to Form D

A new “check the box” will be added to Form D to have the filer certify that the offering is not subject to disqualification due to the “bad actor’ provisions.

III. The Proposals to Enhance Form D Requirements and Provide Additional Disclosure in Certain Rule 506 Offerings

In a rule proposal issued the same day as the adoption of the final rules on the general solicitation and bad actor provisions, the SEC has given us a glimpse into a future of a more regimented utilization of Form D. Currently, many issuers do not file Form D as it is not a condition of the exemption. While the SEC has the power under Rule 507 to bring an action against the issuer to enjoin it from future use of the Regulation D exemption for failure to file a Form D, it has rarely done so. The SEC recognizes, in the proposed rule release, that many issuers do not file a Form D.

Under one of the new proposals, the failure to file a Form D at any time during the five year period prior to an offering for which the issuer intends to utilize the Regulation D exemption would result in a suspension from utilizing the Regulation D exemption, which would last for one year after the issuer has made a curative filing. In other words, an issuer would not lose the exemption for the offering in which it failed to file the Form D, but would lose its ability to utilize the exemption for a future offering conducted within the next 5 years, until one year after the curative Form D filing is made for the prior offering. The SEC expressly intends this new rule to “strengthen the incentives” for issuers to make a Form D filing. Only offerings for which a Form D is not filed after the effective date of the new regulations would be considered the basis for the future one year disqualification. There would also be a 30 day “cure period” to make a filing of a late Form D without triggering the one year suspension.

Under another new proposal, an issuer would be required, 15 days in advance of a Rule 506(c) offering (an offering in which public advertising is used), to file a Form D with limited information about the issuer and the offering. The intention behind this advanced filing seems to be to permit state regulators to get a jump on dealing with an offering that may have troublesome issues associated with it.

Another new proposal would be that for any Rule 506 offering, a Form D would need to be filed within 30 days of the termination of the offering. The purpose of this proposal is to allow the SEC more visibility into how Regulation D offerings are actually conducted. Currently, a Form D is required within 15 days of first sale. Unless the offering extends for over a year, no amendment is required to show, for example, how much of the securities offered were actually sold.

The SEC has also proposed various enhancements to the content of the Form D, particularly for Rule 506 (c) offerings. It has also proposed that certain legends be added to materials furnished under a Rule 506 (c) offering, and that those materials be filed with the SEC for a two year period (although not through the EDGAR system, so they would not be publicly disclosed). Various enhanced disclosures are also proposed for private funds utilizing Rule 506(c), specifically related to the use of performance data in general solicitation materials.

The Impact of the New Regulations

The law of unintended consequences is alive and well. The amendment to Rule 506 to permit general solicitation has in turn unleashed a variety of additional regulation. While some of these were long overdue, like the “bad actor” provisions, some were clearly a reaction to the Jobs Act provisions and will likely add time and expense to the use of the Rule 506 exemption, even for those issuers not using the new permissive advertising protocols. Nevertheless, the ability of issuers to advertise their need for capital utilizing the Rule 506 exemption carries with it tremendous potential for broadening the pool of investors for these offerings. Hopefully, this will not carry with it the abuses that have concerned so many since these rules were first proposed.

For more information about this alert, please contact Allan Grauberd at agrauberd@mosessinger.com.

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