Corporate and Securities Alert: SEC Clears Way for General Solicitation in Private Securities Offerings

Adopts Final Rules and Proposes Additional Rules

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New regulations approved by the Securities and Exchange Commission (SEC) in July 2013 give companies greater freedom to communicate with potential investors in certain private securities offerings, creating both new opportunities and additional risks. The regulations affect private and public companies, as well as pooled investment funds (such as venture capital, private equity, and hedge funds) seeking to raise money through offerings under Rule 506 or Rule 144A of the Securities Act.

Specifically, on July 10, 2013, the SEC **approved two new final rules**[1] that:

- Permit companies to engage in general solicitation and advertising in connection with certain private securities offerings made under Rule 506 or Rule 144A under specific conditions.
- Prohibit companies from relying on Rule 506 if the company or certain participants in the offering (including directors, executive officers and 20%+ stockholders) have been the subject of a "bad actor" disqualifying event, such as a securities fraud conviction.

The final rules were published in the Federal Register on July 24, 2013 and will become effective 60 days thereafter. The rules pertaining to general solicitation implemented Section 201(a)(1) of the JOBS Act, and are substantially similar to the draft rules proposed by the SEC in August 2012, with one significant variation: the final rules also include a non-exclusive safe harbor setting forth procedures that constitute "reasonable steps to verify" that a purchaser is in fact an accredited investor. The rules pertaining to "bad actor" disqualification implemented Section 926 of the Dodd-Frank Act, and establish procedures similar to those that currently apply to offerings under Rule 505 and Regulation A of the Securities Act.

The new rules allowing general solicitation represent a significant change in how private securities offerings can be conducted, and open up new opportunities for companies seeking to raise capital. The new rules are intended to make it easier and less costly for companies to identify potential investors and raise funds, and could be particularly useful for capital-efficient businesses that can be sustainably funded with angel investment, or for companies operating in sectors where traditional sources of venture capital and other investment have become scarce. On the other hand, the new rules also impose additional requirements, and companies seeking to rely on the new rules will need to use care to ensure compliance.

In addition, the SEC also **proposed additional rules**[2] that, if adopted, would significantly increase the filing and disclosure requirements for Rule 506 offerings, and would disqualify issuers that fail to make Form D filings from relying on Rule 506 for future offerings. The proposed rules are intended to enable to SEC to better assess market practices for Rule 506 offerings, and evaluate the impact of lifting the ban on general solicitation and advertising. The proposed rules were published in the Federal Register on July 24, 2013, and are currently open for public comment.

This remainder of this client memorandum reviews the new and proposed rules in detail, and discusses the following topics:

- Background of Rule 506 and Rule 144A
- Amendments to Rule 506 – General Solicitation Permitted; Bad Actor Disqualification
- Amendments to Rule 144A

1 *The final rules pertaining to general solicitation and advertising are set forth in SEC Release No. 33-9415 (July 10, 2013), available at* http://www.sec.gov/rules/final/2013/33-9415.pdf*; and the final rules pertaining to "bad actor" disqualification are set forth in SEC Release No. 33-9414 (July 10, 2013), available at* http://www.sec.gov/rules/final/2013/33-9414.pdf.

2 *The proposed rules pertaining to Form D and disclosure matters are set forth in SEC Release No. 33-9416 (July 10, 2013), available at* http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

- Proposed New Filing and Disclosure Requirements for Rule 506 Offerings
- Implications for Private and Public Companies

I. Background of Rule 506 and Rule 144A

Under current federal securities laws, companies seeking to raise capital through the sale of securities must either register the securities offering with the SEC or rely on an exemption from registration. Two of the most widely-used exemptions from registration are Rule 506 and Rule 144A.

Old Rule 506, now redesignated as Rule 506(b), is a non-exclusive safe harbor for private offerings under Section 4(a)(2) of the Securities Act, and provides an exemption for sales of securities to an unlimited number of accredited investors and up to 35 non-accredited investors. Rule 506 is the typical exemption that startup and high-growth companies use when raising capital from angel investors, venture capitalists and private equity investors. The rule is also used for fundraising by investment funds, and in some cases by publicly held companies (e.g., in PIPE transactions).

Rule 506 offers several key advantages that make it particularly useful, most notably:

- Securities issued under Rule 506 are exempt from state "blue sky" securities regulations. This relieves the issuer from needing to comply with multiple, often more burdensome, sets of state securities regulations, making it easier and less expensive to raise capital.
- As long as the offering is made entirely to accredited investors, the issuer is not required to prepare an offering memorandum, or to follow any particular mandatory disclosure requirements when providing information to investors.
- Under current law, no public filings or disclosures are required in order to use Rule 506.[3]

Rule 144A is a safe harbor for resales of restricted securities to qualified institutional buyers, known as QIBs. In a typical Rule 144A transaction, a bank or other financial intermediary purchases securities from the issuer (in a private placement or an offshore Regulation S offering) and immediately resells the securities to QIBs in reliance on Rule 144A.

A central feature of Rule 506 and Rule 144A is the requirement that companies refrain from engaging in general solicitation or general advertising, such as advertising on the radio or in a newspaper, or posting information about an offering on a publicly-accessible Internet website.[4] As a result, under current law, it can be difficult for companies relying on Rule 506 or Rule 144A to identify and communicate with potential new investors. Typically, in order to avoid the possibility of a general solicitation, companies contact only those potential investors who have a pre-existing relationship with the company, or with a bank or placement agent working on behalf of the company. The new rules approved by the SEC remove the prohibition on general solicitation under Rule 506 and Rule 144A, and thus represent a significant change in how private offerings can be conducted.

II. Amendments to Rule 506 – General Solicitation Permitted; Bad Actor Disqualification

New Rule 506(c) Permits General Solicitation in Rule 506 Offerings

The new rules adopted by the SEC amend Rule 506 to allow offers and sales of securities by means of a general solicitation, provided certain conditions are met. Specifically, under new Rule 506(c), use of general solicitation is permitted if:

3 Rule 503(a) does state that an issuer is to file a Form D, containing certain basic information about the issuer and the offering, within 15 days after the first sale of securities in reliance on Rule 506. However, the SEC has stated that it is not necessary to file a Form D in order to rely on Rule 506 or to treat securities issued under Rule 506 as "covered securities." See Compliance and Disclosure Interpretations 257.07 and 257.08. *As a result, many issuers do not file a Form D on time or at all. See SEC Release No. 33-9416, fn. 85 (noting that many commentators have asserted that non-compliance with Form D filing obligations is widespread). As discussed further below, however, the new rules being proposed by the SEC would penalize issuers that fail to file a Form D by rendering Rule 506 unavailable for future offerings.*

4 The terms "general solicitation" and "general advertising" are not given a precise definition in Regulation D. However, Rule 502(c) and SEC guidance (e.g., Release 34-42728, Use of Electronic Media (April 28, 2000), available at http://www.sec.gov/rules/interp/34-42728.htm*) give as examples of general solicitations: newspaper and magazine ads, TV and radio broadcasts, publicly advertised seminars, and notices and information posted on unrestricted portions of Internet websites.*

- All purchasers are accredited investors, either because they fall into one of the categories in the existing rule (Rule 501) or because the issuer reasonably believes they do.[5]
- The issuer takes "reasonable steps to verify" that all purchasers are accredited investors.
- The requirements of Rule 501 (definitions), Rule 502(a) (integration) and Rule 502(d) (restricted securities) are satisfied.

Use of new Rule 506(c) is optional, and issuers that do not wish to make general solicitations may instead continue to rely on the existing provisions of Rule 506, which are reflected in new Rule 506(b). Under Rule 506(b) — but not under Rule 506(c) — an issuer may sell securities to up to 35 unaccredited investors (provided the information disclosure requirements of Rule 502(b) are satisfied) and is not required to take reasonable steps to verify the accredited investor status of purchasers.

Issuers Must Take Reasonable Steps to Verify That All Purchasers Are Accredited

A key aspect of new Rule 506(c), which was the subject of extensive and conflicting public comments, is the requirement that the issuer take reasonable steps to verify that all purchasers are accredited investors.

This verification requirement is separate and independent from the requirement that all purchasers be accredited investors. In other words, an issuer that engages in a general solicitation must be able to demonstrate that it took reasonable steps to verify accreditation status, even if, in point of fact, all purchasers are accredited investors.

The SEC has emphasized that "reasonably steps to verify" is intended to be a flexible standard that will vary with the particular facts and circumstances of each transaction, and suggests that relevant factors include:

- The nature of the purchaser and the type of accredited investor the purchaser claims to be.
- The amount and type of information that the issuer has about the purchaser.
- The nature of the offering, including the manner in which the purchaser was solicited to participate and the minimum investment amount, if any.

In the adopting release, the SEC also underscores the potential importance of third-party investor screening and verification services in enabling issuers to verify accredited investor status. For example, the SEC indicates that information issuers could rely on, and "which might, depending on the circumstances, in and of themselves constitute reasonable steps to verify a purchaser's accredited investor status," include verification by a third party, such as a web-based Rule 506 offering portal, that the issuer has a reasonable basis to consider reliable. Similarly, the SEC notes that an issuer that solicits investors from a database of pre-screened accredited investors maintained by a reliable third party would be required to take fewer measures to verify accredited investor status than an issuer who solicits purchasers through broadly-disseminated communications such as a public website, or email or social media solicitations.

New Rule 506(c) also includes a non-exclusive safe harbor for verifying the accredited investor status of natural persons. This safe harbor provides issuers with a way to obtain greater certainty that they have satisfied the verification requirements necessary to rely on Rule 506(c).[6] Specifically, the final rule provides that the following constitute reasonable methods for verifying a natural person's accredited investor status:

- Reviewing IRS tax forms (such as a W-2 or Form 1040) that report the person's income for the two

5 The term "accredited investor" is defined in Rule 501(a) as an investor who meets certain enumerated criteria set forth in the rule (such as a natural person who meets certain minimum income or net worth standards) or who the issuer reasonably believes does. In the release adopting Rule 506(c), the SEC expressly stated that in its view the JOBS Act, and therefore new Rule 506(c), was not intended to modify the "reasonably believes" standard currently embedded in the definition.

6 The rules initially proposed by the SEC in August 2012 did not contain any specific verification methods that would automatically be considered to be reasonable, and the SEC voiced a concern that, by doing so, it would undermine issuers' flexibility and imply that other methods would not be sufficiently reasonable. However, given the serious consequences of failure to use reasonable methods – i.e., that the issuer would be unable to rely on Rule 506(c), and by virtue of having conducted a general solicitation could be left without an exemption from the Section 5 registration requirements, giving purchasers a rescission right – the existence of a safe harbor is likely to be important to issuers.

most recent years, and obtaining a representation regarding anticipated current year income.

- Reviewing specified third-party documentation (such as bank statements and credit reports) describing the person's assets and liabilities, and obtaining a representation that there are no undisclosed liabilities.
- Relying on a written confirmation from a broker-dealer, investment advisor, attorney or accountant that has taken reasonable steps to verify that the purchaser is an accredited investor.

Use of Rule 506(c) by Private Investment Funds

In the release adopting Rule 506(c), the SEC confirmed that investment funds, such as venture capital, private equity or hedge funds, may use the new rule to raise funds through a general solicitation without undermining their ability to rely on commonly-used exceptions to Investment Company Act regulation. Specifically, private investment funds often rely on exemptions provided under Section 3(c)(1) (100 holder) or Section 3(c)(7) (qualified purchaser) of the Investment Company Act, which require that the fund not make or propose to make a public offering of its securities. In the adopting release, the SEC confirmed its view that securities sold in compliance with new Rule 506(c) will be considered to have been sold in a non-public offering for purposes of Section 3(c)(1) and Section 3(c)(7).

Non-integration of Rule 506(c) and Regulation S Offerings

The SEC also confirmed that offshore offerings made in reliance on Regulation S will not be integrated with domestic offerings made in compliance with Rule 506 or Rule 144A, as amended. Therefore, any general solicitations or other offering activities by an issuer in connection with a Rule 506 or Rule 144A offering should not constitute "directed selling efforts" that would undermine the issuer's ability to undertake a concurrent Regulation S offering.

New Checkbox Added to Form D

The new rules also make minor changes to the content of Form D filings, such that issuers relying on Rule 506 will be required to check a box to indicate whether they are relying on Rule 506(b) or Rule 506(c). The SEC indicates that issuers must check one box or the other.

New Rule 506(d) Prohibits Use of Rule 506 if "Bad Actors" Are Involved

Under the new rules adopted by the SEC, the exemptions provided by Rule 506 will not be available if the issuer or other specified participants in the offering (including directors, executive officers, 20%+ stockholders and placement agents or promoters) have been the subject of certain "bad actor" disqualifying events. The new rules are implemented by adding a new paragraph (d) to Rule 506, and making various conforming changes to other rules.

Disqualifying events include a variety of securities-related criminal convictions, regulatory determinations and disciplinary actions, which are described with detailed and highly specific wording in the new rule. Notably, however, in order to constitute a disqualifying event, the event must have occurred after effectiveness of the new rule. So, for example, a voluntary consent decree entered into prior the effectiveness of the new rule would not provide a basis for a disqualifying event.

The final rule contains a "reasonable care" exception from disqualification, which applies if the issuer can show that it did not know and in the exercise of reasonable care could not have known, that a covered person with a disqualifying event participated in the offering. The SEC has indicated that the steps that constitute "reasonable care" will vary with the facts and circumstances of a transaction and the nature of the parties involved. For example, the adopting release notes that issuers will typically have in-depth knowledge of their own officers and directors, and for such individuals no further inquiry may be necessary. The SEC also notes that, in cases where there are no indicators of bad actor involvement, it may be sufficient to rely on questionnaires and certifications.

III. Amendments to Rule 144A

Under the new rules adopted by the SEC, securities sold pursuant to Rule 144A can be offered to persons other than qualified institutional buyers (QIBs), including by means of a general solicitation, as long

as the actual purchasers are QIBs or persons that the seller or persons acting on behalf of the seller reasonably believe are QIBs.

Prior to the revisions implemented by the new rules, Rule 144A was unavailable if securities were sold *or offered for sale* to buyers who were not QIBs or reasonably believed to be QIBs. Under this framework, a general solicitation – which could be interpreted as constituting an offer to sell securities to any person who received the solicitation – rendered Rule 144A unavailable. By eliminating the references to "offers," Rule 144A will now be available even where a general solicitation has occurred.

IV. Proposed New Filing and Disclosure Requirements for Rule 506 Offerings

Concurrently with adopting the final rules described above, the SEC also proposed an additional set of rules that, if implemented, would significantly modify the filing and disclosure requirements associated with Rule 506 offerings. The proposed rules are intended to increase the amount of information available to the SEC regarding use of Rule 506, and thereby make it easier for the SEC to evaluate market practices in Rule 506 offerings and address concerns relating to the use of general solicitations.

The proposed modifications to Rule 506 filing and disclosure requirements include the following:

- **Additional Form D filings would be required.** Specifically, in addition to the current requirement to file a Form D within 15 days of the first sale of securities in reliance on Regulation D, issuers would also be required to (i) file an "Advance Form D" at least 15 days before engaging in a general solicitation under Rule 506(c), and (ii) file an amended Form D ("closing amendment") within 30 days after terminating any Rule 506 offering (i.e., whether under Rule 506(b) or Rule 506(c)).[7]
- **Form D filings would be required to contain additional information.** The proposed rules would require issuers to include additional information in Form D filings. Some of the additional information requirements would apply to all Regulation D offerings, and other requirements would apply only to issuers relying on Rule 506(c) (general solicitation). The additional information that would be required for Rule 506(c) offerings would include: information regarding the issuer's "control persons," including 10%+ shareholders; methods of general solicitation used; and methods used to verify accredited investor status.
- **Issuers that fail to file Form D would be disqualified from using Rule 506 in future offerings.** Specifically, under the proposed rule, an issuer that fails to make any required Form D filing, including the additional filings and amendments described in the proposed rules, would be disqualified from relying on Rule 506 for future offerings. It is important to note that this disqualification would be prospective (i.e., applying to future offerings) only, and an issuer that failed to file a Form D in an offering could continue to rely on Rule 506 for that particular offering. The rule would also permit an issuer to remedy any disqualification by making the filings it missed and then waiting for a one-year period to elapse.
- **General solicitation materials would be submitted to the SEC.** The proposed rules would require that written general solicitation materials include certain legends and disclosures, and for a period of two years after the proposed rules are adopted, also be submitted to the SEC. Materials submitted to the SEC would not be made available to the public (although presumably would still be subject to Freedom of Information Act (FOIA) requests), and the requirement for materials to be submitted to the SEC would expire two years after its effective date.

The most significant change contained in the proposed rules is the provision disqualifying issuers that fail to file Form D from using Rule 506 in future offerings. Under current law, the consequences to an issuer

7 Note that, depending on how the proposed rule ultimately gets implemented, it is possible that the advance filing requirement could eliminate the ability to use the Rule 506(c) safe harbor for inadvertent publicity that could be deemed to be a "general solicitation."

for failing to file a Form D are limited.[8] As a result, issuers concerned about the publicity associated with filing a Form D (which is made publicly available on the SEC's website) will often delay, or even decline to make, a Form D filing. The proposed rule would create significant consequences for issuers that fail to file a Form D, and would likely result in significant changes to current Form D filing practices.

V. Implications for Private and Public Companies

The new rules described above represent a significant change in how private securities offerings can be conducted, presenting new risks and opening up new opportunities for companies seeking to raise capital. The new rules have yet to become effective, and it will be some time before market practices evolve and the full impact of the rules can be assessed.

However, at this stage we see a number of considerations relevant to public and private companies who are seeking to evaluate the new rules:

- **Companies can continue current fundraising practices, where those practices are effective.** The new rules permitting general solicitation in private offerings operate side-by-side with the existing rules, and companies that are able to raise funding successfully using current practices (i.e., without use of general solicitation) can continue with current practices largely unabated. Companies will need to bear in mind the "bad actor" disqualification requirements, although for offerings that do not involve placement agents or other outside parties, these requirements should impose little additional burden. In addition, if the proposed rules regarding Form D filings become effective, companies will also need to more closely evaluate their options for securities law compliance, and either identify an alternative to relying on Regulation D or plan for the publicity associated with a Form D filing.

- **Companies willing to comply with the new general solicitation rules will have greater latitude to identify and communicate with potential investors.** The current private offering rules (which prohibit general solicitation) make it difficult for companies to contact potential investors who are not already known to the company or reachable through the personal networks of the company's directors, officers and advisors. In some cases, companies can elect to engage a banker or placement agent, but this imposes additional costs on companies and is often difficult or impossible for companies seeking to raise seed or startup capital.[9] The new rules are intended to allow companies to communicate more broadly with potential investors, without the need to rely on personal networks or outside placement agents, thereby increasing the number of potential investors who become aware of investment opportunities and lowering companies' cost of capital. The new rules are likely to be particularly useful for capital-efficient businesses that can be funded through angel investment, or for companies operating in sectors where traditional sources of venture capital and other investment have become scarce.

- **Companies that make general solicitations will need to be careful to ensure full compliance with Rule 506(c), particularly with the "reasonable steps to verify" requirement.** Companies that intend to rely on the Rule 506(c) safe harbor need to be aware that, by making a general solicitation, they are effectively operating "without a net." Any failure to comply with Rule 506(c) – for example failure to take "reasonable steps to verify" that all purchasers are accredited investors – will render Rule 506(c) unavailable and (because the company has engaged in a general solicitation) will most likely leave the company unable to rely on Section 4(a)(2) or another alternative exemption from registration. The consequences of this would

8 As noted above in footnote 3, current Rule 503 requires a Form D to be filed with 15 days after the first issuance of securities in reliance on Regulation D, but the safe harbor remains available (and securities issued under Rule 506 remain "covered securities" for purposes of pre-empting state securities regulations) even if the Form D filing is not made.

9 See, e.g., Report and Recommendations of ABA Task Force on Private Placement Broker-Dealers *(June 20, 2005) (noting "that too few brokerage firms are willing to do offerings, public or private, under $25 million"). On a similar topic, the ABA task force also recently submitted a* position paper *and recommendation to the SEC regarding rule changes intended to address this issue by making it easier for placement agents not registered as broker-dealers to assist with private placements.*

be severe: if a company is unable to rely on Rule 506(c) or another exemption, the issuance would be in violation of Section 5 of the Securities Act, and all purchasers would have a right to rescind the transaction and "put" their shares back to the company.

- **Online platforms will likely play an increasingly important role in private offerings under the new rules.** Under the current rules, online platforms such as AngelList and SecondMarket have come to play important roles in facilitating private placement transactions. The new rules are likely to increase the potential roles and importance of online platforms. For example, companies making a general solicitation will need to take reasonable steps to verify the accreditation status of purchasers, and the SEC has suggested that online platforms could provide verification services (that would meet the "reasonable steps" requirement) and/or could provide a pre-screened database of accredited investors (which, due to the pre-screening, would reduce the level of effort required to meet the "reasonable steps" requirement).
- **Issuers considering an initial public offering (IPO) will need to consider additional factors when evaluating whether to undertake a Rule 506(c) offering.** For example, companies that are considering filing an IPO registration statement need to be concerned about the potential for "gun jumping" communications. A typical private placement involving limited communications with selected investors should pose relatively little risk, but a private offering under Rule 506(c) that included general solicitations could be viewed as problematic.

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*If you have questions about the new and proposed rules discussed in this memorandum, please feel free to contact the author (*Matt Rossiter, mrossiter@fenwick.com*), or any member of your Fenwick* corporate *or* securities *team.*