Arnall Golden Gregory LLP

Legal Insights

Contact Attorneys Regarding This Matter:

Joseph Alley, Jr.
404.873.8688 - direct
joe.alley@agg.com

Tanner D. Ivie
404.873.8788 - direct
tanner.ivie@agg.com

Arnall Golden Gregory LLP
Attorneys at Law

171 17th Street NW
Suite 2100
Atlanta, GA 30363-1031

Two South Biscayne Boulevard
One Biscayne Tower 2690
Miami, FL 33131

1775 Pennsylvania Avenue NW
Suite 1000
Washington DC 20006

www.agg.com

SEC Lifts General Solicitation Ban and Imposes Bad Actor Disqualifiers

After much anticipation, on July 10, 2013, the SEC finally adopted amendments to permit general solicitation and general advertising in offerings conducted pursuant to Rule 506 of Regulation D and Rule 144A. In addition, the SEC adopted amendments to disqualify securities offerings involving certain felons and other bad actors from reliance on Rule 506. In conjunction, the SEC also proposed amendments to Regulation D, Form D, and Rule 156 in an effort to add investor safeguards, enhance the information available from the private placement market, and monitor how general solicitation impacts that market. Below we provide a summary of the significant aspects of the adopted and proposed amendments.

General Solicitation

In accordance with Section 201(a) of the Jumpstart Our Business Startups Act, on August 29, 2012, the SEC proposed amendments to lift the ban on general solicitation and general advertising in Rule 506 and Rule 144A offerings. For a summary of the proposals, please see our client alert[1] dated August 31, 2012. For the most part, the SEC adopted the amendments as proposed. Accordingly, the adopted amendments:

- Create a new Rule 506(c) that permits general solicitation and advertising in Rule 506(c) offerings, provided that
    - all terms and conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied,
    - all purchasers are reasonably believed to be "accredited investors," as defined in Rule 501 of Regulation D, and
    - the issuer takes *reasonable steps* (as discussed below) to verify that all purchasers are accredited investors;
- Allow securities to be offered pursuant to Rule 144A to persons other than "Qualified Institutional Buyers" as defined in Rule 144A ("QIBs"), including by means of general solicitation, provided that the securities are only sold to persons that the seller, and any person acting on behalf of the seller, reasonably believes to be QIBs; and

1 http://www.agg.com/SEC-Issues-Proposed-Rules-Allowing-General-Solicitation-in-Private-Offerings-Pursuant-to-Section-201a-of-the-JOBS-Act-08-31-2012/

- Revise Form D to require the issuer to check a box if it is relying on Rule 506(c). Because they will engage in public advertising, issuers relying on Rule 506(c) will not be able to fall back on the Section 4(a)(2) exemption under the Securities Act. Securities sold pursuant to Rule 506(c), however, will be "covered securities," exempt from state registration requirements. Moreover, Rule 506(b) remains as a separate exemption, and issuers may choose to rely on Rule 506(b), without any general solicitation, if the issuer wants to sell to non-accredited investors and/or avoid the Rule 506(c) verification requirements.

Reasonable Steps. Whether the steps taken to verify accredited investor status are "reasonable" will require an objective determination by the issuer, in the context of the particular facts and circumstances of each purchaser and transaction. If, however, an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer will not have to take any steps at all. Regardless, because the issuer has the burden of demonstrating entitlement to the Rule 506(c) exemption from registration, the issuer should thoroughly document the steps the issuer took to verify the accredited investor status of purchasers.

In determining the verification steps to take, and the reasonableness of its methods, issuers should consider the following:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as the minimum or maximum investment amount.

Issuers may rely on a third party that has verified a person's status, provided that the issuer has a reasonable basis to rely on such third-party verification. But, the issuer will not have taken the reasonable steps to verify accredited investor status if (absent other indications of such status) the issuer only requires a purchaser to check a box in a questionnaire or sign a form.

Verification Methods. For purposes of Rule 506(c), as adopted, the SEC has provided issuers with a non-exclusive list of methods that issuers may use to satisfy the verification requirement as it applies to natural persons (unless the issuer knows the person is not an accredited investor).[2] The issuer will have satisfied the Rule 506(c) verification requirement if it uses any of the following (as applicable) methods.

- In verifying whether a natural person (whether individually or jointly with his or her spouse) is an accredited investor on the basis of income, the issuer

    - reviews copies of any IRS form that reports income for the two most recent years (such as a Form W-2, Form 1099, Schedule K-1 of Form 1065, and Form 1040); and
    - obtains a written representation from the investor (and the spouse) that he, she, or they have

2 Issuers, however, are not required to use any of the four verification methods, and instead may undertake the reasonableness approach described above.

a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

- In verifying whether a natural person (whether individually or jointly with their spouse) is an accredited investor on the basis of net worth, the issuer

    - reviews one or more of the following documents, dated within the prior three months:

        - For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and independent appraisal reports; and
        - For liabilities: consumer or credit report; and

    - obtains a written representation from the investor (and the spouse) that they have disclosed all liabilities necessary to make a net worth determination;

- 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 such person or entity has taken reasonable steps to verify within the prior three months, and has determined, that the purchaser is an accredited investor; or

- With respect to any natural person who invested in the issuer's Rule 506(b) offering as an accredited investor prior to Rule 506(c)'s effective date and remains an investor of the issuer,

    - the same issuer, in a subsequent Rule 506(c) offering, obtains a certification by the person that he or she qualifies as an accredited investor.

Effective Date/Ongoing Offerings. Rule 506(c) will be effective sixty (60) days after its publication in the Federal Register. For Rule 506 offerings that commenced before the effective date of Rule 506(c), the issuer may choose to continue the offering in accordance with either Rule 506(b) or Rule 506(c). Any general solicitation that occurs after the effective date will not affect the exempt status of offers and sales of securities that occurred prior to the effective date in reliance on Rule 506(b).

Bad Actor Disqualification

Pursuant to Section 926 of the Dodd-Frank Act, on May 25, 2011, the SEC proposed rule amendments to disqualify securities offerings involving certain bad actors from reliance on the registration exemption provided by Rule 506. For a discussion and analysis of the proposed bad actor rules, please see our client

alert[3] in the January/February 2013 edition of our Private Equity and Capital Transactions Newsletter. In conjunction with its lifting of the ban on general solicitation in Rule 506 offerings, the SEC adopted new Rule 506(d), which disqualifies securities offerings involving certain bad actors from reliance on Rule 506.

Covered Persons. As adopted, the bad actor disqualification provisions of Rule 506(d) apply to the following individuals and entities ("covered persons"):

- the issuer (or any predecessor) or affiliated issuer;[4]
- any director, executive officer, other officer participating[5] in the offering, general partner or managing member of the issuer;
- any beneficial owner of twenty percent (20%)[6] or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- any investment manager of an issuer that is a pooled investment fund and various principals of the investment manager;
- any promoter connected with the issuer in any capacity at the time of the sale; and
- any compensated solicitor and various principals of such compensated solicitor.

Disqualifying Events. Rule 506(d) provides an expansive list of disqualifying events. Pursuant to Rule 506(d), an offering would be disqualified if any of the covered persons:

- has been convicted of any felony or misdemeanor (if the judgment was entered within the last five years in the case of issuers and ten years in the case of other covered persons)
    - in connection with the purchase or sale of any security;
    - involving the making of a false filing with the SEC; or
    - 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;

- is subject to court injunctions and restraining orders (entered within five years before such sale) preventing such person from engaging in any conduct or practice
    - in connection with the purchase or sale of any security;
    - involving the making of a false filing with the SEC; or
    - 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;

3 http://www.agg.com/Bad-Boy-Disqualifiers-Are-Coming-Soon-Time-to-Upgrade-Diligence-Procedures-Now-02-07-2013/
4 Events relating to certain affiliated issuers are not disqualifying if they pre-date the affiliate relationship.
5 The proposed amendments would have extended the rule to all "officers," not just officers participating in the offering. To be covered, the officer's participation has to be more than transitory or incidental involvement.
6 The proposed amendments would have set a lower threshold of ten percent (10%).

- is subject to a final order of a state securities commission; state and federal banking regulators; state saving association, credit union, and insurance regulators; the U.S. Commodities Futures Trading Commission; or the National Credit Union Administration that at the time of such sale, bars the person from:

    - Association with any entity regulated by the authority issuing the order;
    - Engaging in the business of securities, insurance or banking; or savings association or credit union activities; or
    - Constitutes a final order (entered within the last ten years before the sale) based on a violation of anti-fraud laws or regulations.

- is (at the time of the sale) subject to SEC disciplinary orders that

    - Suspend or revoke a person's registration as a broker-dealer, municipal securities dealer or investment adviser; limit the person's activities, functions or operations; or bars the person from associating with or participating in penny stock offerings.

- is subject to any SEC cease-and-desist order (entered within five years before such sale) that bars the person from committing or causing violations of:

    - Any scienter-based anti-fraud provisions or the registration requirements of the federal securities laws;

- is suspended or expelled from membership in, or association with a member of, a national securities exchange or securities association, for conduct inconsistent with just and equitable principles of trade;

- was subject (within five years prior to the sale) to SEC orders suspending the Regulation A exemption or is currently subject to pending investigations and proceedings to consider issuing such orders; or

- is subject to certain U.S. Postal Service orders relating to conduct alleged to violate anti-fraud laws.

Reasonable care exception. The issuer can avoid disqualification if it establishes that it did not know, and in the exercise of reasonable care, could not have known that a disqualification event existed. To rely on this reasonable care exception, the issuer must have conducted a factual inquiry, based on the facts and circumstances, into whether any disqualifications existed.

Waivers. Rule 506(d) allows the Director of the Division of Corporate Finance to grant a waiver from disqualification if the issuer shows "good cause" (such as change of control or change of supervisory personnel) and that no other SEC action will be prejudiced, and otherwise demonstrates that it is not necessary under the circumstances that the Rule 506 registration exemption be denied.

Furthermore, the issuer can avoid disqualification if, before the relevant sale, the court or regulatory authority that entered the relevant order, judgment or decree against the issuer advises in writing that the bad actor disqualification should not arise as a consequence of the order, judgment or decree.

Implementation and Disclosure. Notably, notwithstanding the applicable look-back periods, Rule 506(d) only applies to bad acts or disqualifying events that occur after the amendment's effective date.[7] Nevertheless, new Rule 506(e), which applies to all Rule 506 offerings, requires issuers to provide each investor, a reasonable time prior to sale, with written disclosure of events that would have triggered disqualification but occurred before the effective date of Rule 506(d). The failure to furnish the Rule 506(e) disclosure on a timely basis will not prevent an issuer from relying on Rule 506 if the issuer establishes the reasonable care defense, as discussed above.

Effective Date. Rule 506(d) and (e) will take effect sixty (60) days after publication in the Federal Register. Only sales made after the effective date will be subject to the disqualification and mandatory disclosure provisions.

Proposed Amendments

In conjunction with its adoption of Rule 506(c), the SEC proposed rule and form amendments that are (in the words of Chairman Mary Jo White) "designed to provide more information to the [SEC] to track the Rule 506 market after the general solicitation ban is lifted and to provide additional investor protection safeguards . . . in light of the ban being lifted." Among others, the proposed amendments would:

- Require an issuer relying on Rule 506(c) to file an initial Form D no later than fifteen (15) days in advance of the first use of general solicitation;
- Require the filing of a closing Form D amendment within thirty (30) days after the termination of a Rule 506(b) or (c) offering;
- Revise Form D to expand the information provided by issuers;
- Amend Rule 507 to generally disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, any predecessor or affiliate, did not comply, within the last five years, with all of the Form D filing requirements. In addition, Rule 506 would be unavailable for an issuer if an issuer,

7 Under the proposed amendments, Rule 506 disqualification would have been triggered by events that occurred before the effective date of the rule amendments.

any predecessor or affiliate, has been subject to any order, judgment or court decree enjoining such person for failure to comply with new Rule 509 or new Rule 510T;

- Create Rule 509, which would require issuers to include prescriptive legends in any written general solicitation materials, and require additional disclosures for private funds if such materials include performance data;

- Amend Rule 156 to apply that rule's guidance to the sales literature used by private funds generally soliciting under Rule 506(c); and

- Add Rule 510T, which would require issuers to submit any written general solicitation materials used in their Rule 506(c) offerings to the SEC no later than the date of the first use of the materials. Rule 510T would expire two years after its effective date.

In addition, the SEC is also seeking comments regarding Rule 501's definition of "accredited investor" as it relates to natural persons.

Conclusion

The lifting of the general solicitation ban provides new capital raising opportunities for issuers engaging in Rule 506 offerings, but the new verification requirements and bad actor disqualifications may trap the unprepared and unwary. Please feel free to contact any of the Securities and Corporate Governance attorneys at Arnall Golden Gregory LLP with any questions regarding the SEC's adopted and proposed amendments.

Arnall Golden Gregory LLP serves the business needs of growing public and private companies, helping clients turn legal challenges into business opportunities. We don't just tell you if something is possible, we show you how to make it happen. Please visit our website for more information, www.agg.com.

This alert provides a general summary of recent legal developments. It is not intended to be, and should not be relied upon as, legal advice.