July 15, 2013

SEC Makes Fundamental Changes to Private Capital-Raising Rules

On July 10, the Securities and Exchange Commission ("SEC" or the "Commission") approved final rules eliminating the decades-old prohibition against general solicitation and general advertising in all Rule 144A offerings and certain Regulation D transactions, as required by Title II of the JOBS Act. The new rules (the "General Solicitation Rules") permit issuers, including start-ups, hedge funds, venture capital funds and private equity funds, to promote their offerings to the general public over the Internet, in traditional print and broadcast media, at public seminars, and through other means. For many issuers, the General Solicitation Rules will significantly impact the way that they raise capital. In related developments, the SEC approved a final rule prohibiting certain "bad actors" from making private securities offerings (the "Bad Actor Rule"). The SEC also approved proposed rules for public comment that would require issuers availing themselves of the General Solicitation Rules to provide additional information about such offerings to the SEC (the "Regulation D Proposals"). The Regulation D Proposals are designed to aid the Commission in monitoring market practices as they evolve in connection with the General Solicitation Rules. The General Solicitation Rules are substantially similar to those proposed in August 2012, and these rules, along with the Bad Actor Rule, will be effective 60 days after their publication in the Federal Register. Public comments on the Regulation D Proposals may be submitted?within 60 days after their publication in the Federal Register. The SEC's fact sheet with respect to Rule 506(c), as well as the release accompanying its adoption (the "Adopting Release"), is available on the SEC's website at http://www.sec.gov/news/press/2013/2013-124.htm. **New Rule 506(c)** The General Solicitation Rules eliminate the prohibition against general solicitation with respect to offers and sales of securities conducted in reliance on new Rule 506(c) of Regulation D. Offerings made pursuant to Rule 506(c) must comply with the following conditions:

- All purchasers of the securities must be "accredited investors,"[1] or the issuer must reasonably believe that all purchasers are accredited investors at the time of the sale of securities; and
- The issuer must take reasonable steps to verify that all purchasers of the offered securities are accredited investors.

The SEC has adopted a flexible, principles-based approach toward accredited investor verification. The issuer must make an objective determination that the steps taken to verify the accredited investor status of a purchaser are "reasonable" in the context of the particular facts and circumstances. The requirement that issuers take "reasonable" steps to verify that purchasers are accredited investors is an independent requirement, and it must be satisfied even if all purchasers happen to be accredited investors. For example, if the purchaser was solicited to participate in the offering through a website accessible to the general public, it may be reasonable for the issuer to take more steps to verify accredited investor status than it would had the purchaser been solicited by a broker-dealer that had a pre-existing relationship with the purchaser. The General Solicitation Rules include a non-exclusive list of methods that issuers may use to verify a purchaser's accredited investor status, including:

- Verifying accredited investor status on the basis of income through the review of IRS forms along with a written representation from the individual.
- Verifying accredited investor status on the basis of net worth through the review of certain bank, brokerage and other documents along with a written representation from the individual.

- Obtaining 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 that the purchaser is an accredited investor.
- Obtaining a certification from the purchaser at the time of sale, for any natural person who invested in an issuer's 506(b) offering as an accredited investor prior to the effective date of Rule 506(c) and remains an investor.

The Adopting Release makes clear that the issuer's verification obligation is not satisfied by relying on a potential purchaser's self-verification (such as filling out a questionnaire or checking a box on a subscription agreement). Issuers who choose not to engage in general solicitation may continue to rely on the existing rule, Rule 506(b), which remains unchanged. Rule 506(b) is likely to be used by issuers who do not wish to undertake the verification requirements or who want to be able to sell securities to certain non-accredited investors. A revised Form D will require issuers to check a box indicating whether they are relying on the General Solicitation Rules. **Rule 144A** Under revised Rule 144A(d)(1), general solicitation will be permitted in all Rule 144A transactions. The revised rule requires only that securities be sold (not offered and sold, as currently is the case) to qualified institutional buyers ("QIBs") or persons that the seller reasonably believes are QIBs. As a result, the current ban on general solicitation no longer exists for Rule 144A transactions. **Special Impact on Private Funds** The Adopting Release confirms that a private fund may engage in general solicitation in compliance with the General Solicitation Rules without being regarded as making a public offering of its securities that would preclude the private fund from relying on the exclusions from the definition of "investment company" under the Investment Company Act. However, private funds that invest in commodity interests and rely on the "de minimis exemption" from registration as commodity pool operators may find that engaging in general solicitation jeopardizes their ability to rely on that exemption. The relevant exemption, CFTC Rule 4.13(a)(3), includes a restriction against "marketing to the public." Also, "registration lite" under CFTC Rule 4.7, which relieves private funds that are registered as commodity pool operators from certain disclosure, reporting and recordkeeping requirements, may not be available to private funds making general solicitations. The General Solicitation Rules in no way mitigate the requirement that investors in a private fund managed by an SEC-registered investment adviser that charges such investors a performance fee or incentive allocation must still be "qualified clients" as defined under Rule 205-3 of the Investment Advisers Act of 1940. **"Bad Actor" Rule** The Bad Actor Rule disqualifies issuers from making private offerings in reliance on Rule 506 of Regulation D if the issuer or any other person covered by the Bad Actor Rule (including officers and directors of the issuer who participate in the offering) had a "disqualifying event." Disqualifying events include, among others, certain criminal convictions, certain court injunctions and restraining orders, and a variety of disciplinary actions and orders. The disqualification is limited to events that occur after the Bad Actor Rule becomes effective, although pre-existing events are subject to mandatory disclosure. There is an exception that allows an issuer to rely on Rule 506 to the extent that the issuer had no knowledge of the disqualifying event and through the exercise of reasonable care could not have known of such event. **The Regulation D Proposals** In conjunction with the General Solicitation Rules, the SEC proposed rules regarding Regulation D offerings. These include:

- Amending Form D to require disclosure of additional information about Rule 506(c) offerings, and requiring issuers to file a Form D in Rule 506(c) offerings both prior to engaging in general solicitation and after the offering is completed.
- Disqualifying issuers who fail to comply with Form D filing requirements from making an offering pursuant to Regulation D for one year, subject to a cure period.
- Requiring issuers to include certain legends and disclosures in all written general solicitation materials, and to file general solicitation materials with the SEC for a period of two years after a final rule incorporating the Regulation D Proposals becomes effective.

In addition, the Regulation D Proposals solicited public comment on possible amendments to the definition of "accredited investor." **Impact of the New Rules** Although the impact of these rules is difficult to predict, we believe that many issuers will choose not to rely on Rule 506(c). This will be particularly true if the Regulation D Proposals are adopted and issuers relying on Rule 506(c) are required to file general solicitation materials with the SEC and place legends on such documents. Two of the SEC commissioners expressed concern that the Regulation D Proposals, if adopted, would subject private offerings to considerable burdens and undermine the goals of the JOBS Act. Although certain issuers with limited access to capital will undoubtedly be willing to accept these requirements, those issuers that are experienced in accessing the private capital markets may choose to rely on the traditional Rule 506(b) offering and forgo general solicitation. The General Solicitation

Rules will likely result in substantially more Form D filings, as many issuers today do not file the form in the absence of any real consequences for failing to do so. We also expect the market for third-party service providers willing to verify accredited investors to expand exponentially. The new General Solicitation Rules are expected to have a significant impact on capital-raising efforts of private funds, growth companies and investment crowd-funding platforms. We will continue to monitor the progress of this and other proposed legislation and will provide updates accordingly. Please feel free to contact any of the members of our firm listed on the right-hand side of this alert to discuss aspects of how the new General Solicitation Rules may apply to you. [1] Rule 501(a)(1)-(8) sets forth the qualifications for accredited investors. Natural persons may be accredited investors based on either their net worth, individually or collectively with a spouse (exceeding $1 million, excluding the value of the person's primary residence), or their annual income (individually in excess of $200,000 or jointly with spouse in excess of $300,000 in each of the two most recent years, with a reasonable expectation of such income levels continuing in the current year).

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