Private Offerings: Practical Implications of the SEC's New and Proposed Rules

On July 10, 2013, the Securities and Exchange Commission (the "Commission") adopted rule changes that permit general solicitation and general advertising in private securities offerings made in reliance on Rule 506 or Rule 144A under the Securities Act of 1933, as amended (the "Securities Act").[1] The new rules implement Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"), enacted in April 2012, and are intended to facilitate capital formation.

The consequences of the liberalization beyond the facilitation of capital formation have been the subject of extensive debate, including arguments that it could lead to an increase in sales of unregistered securities to unqualified investors and in fraudulent activity. In light of these concerns and acknowledging that allowing general solicitation in private offerings represents a major change in how those offerings can be conducted, the Commission directed its staff to monitor market practices in offerings conducted with general solicitation and proposed a series of additional rule changes that would, if adopted, impose significant new requirements on Rule 506 offerings, particularly those that are conducted with general solicitation.[2] We expect the proposed rules to draw extensive comments, including concerns about their potential chilling effect on issuers' use of general solicitation in private offerings and resulting frustration of the JOBS Act's intended facilitation of capital formation.

The new rules go into effect on September 23, 2013 and comments on the rule proposals are due the same day.

In this memorandum, we address a number of issues that arise from the practical implementation of the new rules, as well as some potential implications of the proposed rules.

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[1] The rule changes permitting general solicitation and general advertising are set forth in Release No. 33-9415 (July 10, 2013), available at http://www.sec.gov/rules/final/2013/33-9415.pdf (the "Adopting Release"). We generally refer to general solicitation and general advertising in this memorandum as "general solicitation."

[2] The proposed rule changes are set forth in Release No. 33-9416 (July 10, 2013), available at http://www.sec.gov/rules/proposed/2013/33-9416.pdf (the "Proposing Release").

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I. The New Rules: Overview and Threshold Questions

Rule 144A

Section 201(a) of the JOBS Act required the Commission to amend Rule 144A to permit offers to persons other than qualified institutional buyers, or QIBs (as defined in Rule 144A), provided the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Rule 144A is a safe harbor that permits a person other than the issuer to resell securities without registration if the transaction meets specified conditions. Prior to the revision, one of the conditions was that the securities be *offered* or *sold* only to persons the seller and any person acting on the seller's behalf reasonably believe are QIBs. As a result, Rule 144A effectively prohibited general solicitation.

Revised Rule 144A will no longer refer to "offers" and "offerees" in the conditions to be met under paragraph (d)(1) of the rule. Consequently, after the revised rule becomes effective, a seller will be permitted to rely on Rule 144A even if the securities are offered to non-QIBs, including by means of general solicitation.

Rule 506(c)

Rule 506 is a safe harbor for private offerings by issuers. It has provided that offers and sales by an issuer to an unlimited number of "accredited investors" and up to 35 other investors are exempt from registration under Section 4(a)(2) of the Securities Act so long as certain conditions are met. One of the conditions is that neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of "general solicitation" or "general advertising."

Section 201(a) of the JOBS Act directed the Commission to revise Rule 506 to permit general solicitation and general advertising in offerings under the rule, provided all purchasers of the securities are accredited investors and issuers are required "to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."[3]

The new rule leaves the existing safe harbor under Rule 506 unchanged and redesignates it as Rule 506(b). It adds a new paragraph 506(c), under which general solicitation and general advertising may be used in a private offering. All purchasers in a Rule 506(c) offering must be accredited investors (although the definition of accredited investor includes both persons that actually fall in certain specified categories *and* persons the issuer *reasonably believes* fall in those categories).

Rule 506(c) requires an issuer to take "reasonable steps to verify" that each purchaser is an accredited investor. This is an independent procedural requirement, and it must be met even if all the purchasers are in fact accredited investors. This requirement of "reasonable steps to verify" was the subject of extensive comment and is discussed at length in the Adopting Release. The release explains that this is a "principles-based" requirement, resting on "an

[3] JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (Apr. 5, 2012), Section 201(a).

objective determination, based on the particular facts and circumstances of each transaction."[4] Among the factors that issuers should consider are the nature of the purchaser, the information the issuer has about the purchaser and the nature and terms of the offering.

Rule 506(c) also includes a non-exclusive safe harbor setting out four methods to verify accredited investor status for natural persons that will be deemed to satisfy the verification requirement: (a) review of specified documentation showing that a person meets the income test in the definition of accredited investor;[5] (b) review of specified documentation showing that a person meets the net worth test;[6] (c) reliance on written confirmation from specified categories of third parties verifying the person's accredited investor status;[7] and (d) reliance on certification from an existing investor who previously invested in a Rule 506(b) offering by the issuer prior to the effective date of the new rules. The issuer may not rely on the safe harbor if it or its agent has knowledge that the purchaser is not an accredited investor.

The new rules also amended Form D to provide separate check boxes for Rule 506(b) and Rule 506(c). Form D is a notice required to be filed by an issuer that offers or sells securities in reliance on any of the Regulation D exemptions, including Rule 506, and it requires disclosure of the specific exemption being used. The Adopting Release specifies that for any particular offering, the issuer must check only one exemption box, eliminating the possibility that an issuer could check the boxes for both Rule 506(b) and Rule 506(c) to protect against losing the exemption as a result of inadvertent general solicitation, as had been suggested in some of the comments on the proposed rules. It appears, however, that an issuer could amend a Form D for an offering to select Rule 506(c) after having initially selected Rule 506(b) or vice versa (assuming the requirements for the other exemption have been met). We discuss how this might work in practice below.

In practice, what can issuers do now that they couldn't do before?

Technically, the new rules permit issuers and their agents to communicate with prospective investors in Rule 144A and Rule 506(c) offerings with no limit on the method of communication or the number or type of investors reached. Issuers may use, among other methods, cold calls, blast emails, advertisements, articles and other communications published in newspapers, magazines, on the Internet or in television or radio broadcasts. The liberalization also allows communications about these kinds of offerings at conferences, promotional seminars or other meetings. Regardless of the prospective investors reached by these communications, the ultimate sales must be made to investors reasonably believed to be QIBs (in Rule 144A offerings) or accredited investors (in Rule 506(c) offerings).

[4] Adopting Release, at 27-28.

[5] The required documentation includes specified IRS forms showing the requisite income level for the two most recent years and a written representation from the potential investor that he or she has a reasonable expectation of reaching the requisite income level during the current year.

[6] The required documentation includes specified documentation regarding assets, a credit report and a written representation from the potential investor that all liabilities necessary to make a determination of net worth have been disclosed.

[7] The third party may be a broker-dealer, an investment adviser, an attorney or a certified public accountant.

Issuers and their agents should be aware that any communications made to prospective investors are, of course, still subject to the antifraud provisions of the securities laws and, in particular, Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 thereunder. In addition to liability concerns related to the purchasers in the offering itself, use of general solicitation may also expand the scope of potential liability for these communications to secondary market participants, either with respect to the security being sold or other securities of the issuer. Furthermore, many foreign jurisdictions have their own rules and restrictions regarding publicity in connection with offerings[8] that will require careful analysis and consultation with local counsel. As a result, issuers and their agents should carefully consider the content, form and distribution of general solicitation communications, and it remains to be seen the extent to which offering participants will proactively take advantage of the new flexibility.

Nevertheless, some changes in practice with respect to press releases and other publicity about or at the time of an offering pursuant to Rule 144A or Rule 506(c) seem likely.[9] These press releases and other communications no longer need to comply with the strict requirements of Rule 135c under the Securities Act or other similar safe harbors,[10] although in light of the liability concerns, it would still be prudent to limit the content and ensure it is consistent with the offering memorandum. The timing of offering press releases is unlikely to change—they are unlikely to be published prior to launch both to avoid liability concerns associated with making statements prior to finalizing the content of the offering memorandum and also to preserve flexibility for the offering participants about whether and when to launch the offering.[11]

Currently, issuers limit posting materials related to private offerings on their websites to Rule 135c-compliant press releases, if anything, unless access is restricted or blocked. Under the new rules, issuers could post more information related to Rule 144A and Rule 506(c) offerings, although we do not expect this to become a common practice and in light of liability concerns, again recommend limiting posted material to press releases that are consistent with the offering memorandum. Form 8-K and Form 6-K filings designed to ensure public dissemination of material non-public information included in the offering memorandum could

[8] As discussed below, for non-SEC-reporting issuers in Rule 144A offerings, U.S. state Blue Sky laws also may inhibit the full use of the flexibility provided under the new rules.

[9] Another change in practice that has been proposed relates to aftermarket trading in Rule 144A debt securities. Currently, those trades are reported to the Financial Industry Regulatory Authority, Inc. ("FINRA") through the Trade Reporting and Compliance Engine (TRACE) but are not publicly disseminated in part due to concerns about general solicitation. With the liberalization, FINRA has proposed a rule change to disseminate information about these transactions under FINRA Rule 6750, to provide greater transparency. See Proposed Rule Change Relating to the Dissemination of Transactions in TRACE-Eligible Securities that are Effected Pursuant to Securities Act Rule 144A, filed with the Commission on July 17, 2013, available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p297240.pdf.

[10] Rule 135c deems a press release that satisfies its requirements not to be an offer for Section 5 purposes, as does Rule 135e under the Securities Act for certain non-U.S. communications and press releases by foreign private issuers.

[11] The Commission's proposal to require a Form D filing in advance of the first use of general solicitation, if adopted, could affect the timing of these press releases in Rule 506(c) offerings. See Section IV for a discussion of the proposed rules.

now attach the offering memorandum as an exhibit in Rule 144A and Rule 506(c) offerings, rather than including a summary of the specific material information as is now the practice, although liability concerns about the expansion of the scope of potential liability to secondary market participants for the entire contents of the offering memorandum may again favor existing practice.

In light of the liability concerns, we also generally recommend limiting discussion of Rule 144A and Rule 506(c) offerings at conferences or other public speaking engagements to completed transactions and, after an offering has launched, information consistent with the offering memorandum.

Issuers with Exchange Act-registered securities will also have to consider, in addition to liability concerns, the implications under Regulation FD[12] of any communications or disclosures of material non-public information that they make as part of general solicitation materials. Regulation FD prohibits communication of material nonpublic information to market professionals and to security holders if it is reasonably foreseeable that holders will trade on the basis of the information, subject to certain exceptions, unless the information is simultaneously (or in the case of inadvertent disclosure, within 24 hours) widely disseminated to the public. General solicitation that does not constitute a sufficiently broad disclosure to satisfy Regulation FD's dissemination requirements could raise concerns depending on the information communicated. Confidentiality provisions and agreements, which are often used in private offerings, are not practicable with at least certain forms of general solicitation. The exceptions in Regulation FD for certain kinds of registered public offerings, which represented a recognition that the Regulation was not designed to interfere with legitimate capital raising, are not available for unregistered offerings. As a result, issuers will have to consider any Regulation FD consequences of the information communicated in general solicitation and the manner of that solicitation.

Finally, the ability to use general solicitation will permit issuers and their agents to expand the pool of potential investors and contact investors with whom they had no pre-existing relationship.[13] Over time, paid referral agencies and other similar services may develop to facilitate this process.[14]

What are "general solicitation" and "general advertising"?

"General solicitation" and "general advertising" are not new concepts—an issuer and its intermediaries have long had to determine whether they had engaged in general solicitation to be able to rely on the various private placement exemptions. Now, however, the existence of

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[12] Selective Disclosure and Insider Trading, SEC Release Nos. 33-7881, 34-43154, IC-24599 (Aug. 15, 2000).

[13] As discussed below, the Commission has long recognized the existence of a substantive pre-existing relationship by the issuer or its agent with a prospective investor as conclusive evidence that the investor was not attracted to an offering through general solicitation.

[14] These kinds of services will need to consider a variety of issues, including whether they will be required to register as a broker-dealer under the Exchange Act.

general solicitation may necessitate use of the Rule 506(c) exemption rather than Rule 506(b) (and the resulting selection of the appropriate check box on Form D). In addition, the proposed rules discussed below would require the filing of Form D 15 days in advance of using general solicitation and the submission of general solicitation materials to the Commission, among other things. FINRA has also updated its private placement form to require disclosure by broker-dealers of whether an issuer has engaged in or anticipates engaging in general solicitation (though broker-dealers may respond "unknown").[15] Accordingly, there is likely to be increased focus on exactly what constitutes "general solicitation" and "general advertising."

"General solicitation" and "general advertising" are not defined in the Adopting Release, although it refers to the examples given in Rule 502(c).[16] It is clear that the use of uncontrolled, unilateral modes of communication (*e.g.*, TV, radio broadcasts, billboards), where the universe of recipients cannot be limited, constitutes general solicitation. The use of controlled, bi- or multi-lateral modes of communication (*e.g.*, telephone calls, emails, meetings) should generally not be general solicitation, even to an unlimited number of prospective investors, so long as the issuer or its agent has a "substantive pre-existing relationship" with the recipients. The Commission has long recognized the existence of a substantive pre-existing relationship by the issuer or its agent with a prospective investor as conclusive evidence that the investor was not attracted to an offering through general solicitation.[17]

Communications with up to 35 prospective investors, even without a substantive pre-existing relationship, should also be permissible without constituting general solicitation. This is consistent with the ability to include up to 35 non-accredited investors in a Rule 506(b) offering. In eliminating the qualification requirements that originally applied not just to purchasers but also to offerees in the predecessor to Rule 506, the Commission acknowledged commenter concerns that it was impossible to evaluate an offeree's qualifications without communicating basic information about the offering[18] (which generally would not have been relevant if the only

[15] See FINRA Regulatory Notice 13-26 (Aug. 19, 2013), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p325359.pdf

[16] General solicitation includes "advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars where attendees have been invited by general solicitation or general advertising. By interpretation, the Commission has confirmed that other uses of publicly available media, such as unrestricted websites, also constitute general solicitation and general advertising." Adopting Release, at 6-7.

[17] See, *e.g.*, Adopting Release, at 18 ("Retaining the safe harbor under existing Rule 506(b) may also be beneficial to investors with whom an issuer has a pre-existing substantive relationship."), citing Release No. 33-7856 (Apr. 28, 2000), available at http://www.sec.gov/rules/interp/34-42728.htm, at [52] (noting that "one method of ensuring that general solicitation is not involved is to establish the existence of a 'pre-existing, substantive relationship'" and that "there may be facts and circumstances in which a third party, other than a registered broker-dealer, could establish a 'pre-existing, substantive relationship' sufficient to avoid a 'general solicitation'").

[18] See Release No. 33-6339 (Aug. 7, 1981), at 15 ("Proposed Rule 506 would modify present Rule 146 in several respects. The most significant modification to Rule 146 is a proposal to eliminate the qualification requirements with respect to offerees. Many commentators have expressed the view that it is impossible to evaluate an offeree's qualifications without providing the offeree basic information concerning the offering. Moreover, participants in the Small Business Hearings believed that the test for offerees was complicated and difficult for a small business to observe, particularly in light of the danger of inadvertently making an offer while trying to elicit facts about an offeree's qualification and thereby losing the protection of Rule 146. It was maintained by these participants that eliminating the provisions for offeree qualifications would not result in a loss of protection to investors since an investor would still have to be qualified before purchasing the securities. In light of the comments received, the Commission is

investors that could be approached were those with whom the issuer or its agents had a substantive pre-existing relationship).

Will use of general solicitation require registration under state Blue Sky laws?

For offerings under Rule 506(c), no. For Rule 144A offerings, non-reporting issuers that use broad-ranging general solicitation may still be subject to registration requirements in most states.

Section 18 of the Securities Act preempts state "Blue Sky" laws with respect to offerings of "covered securities." All securities offered and sold in Rule 506 offerings are covered securities and therefore exempt from state registration requirements.[19] There is, however, no parallel exemption applicable to Rule 144A transactions—Section 18 includes as covered securities only securities of *reporting issuers* offered and sold in Rule 144A transactions.[20] The states themselves exempt offers and sales to sophisticated institutional investors by all issuers. But broad-reaching general solicitation could also constitute offers to non-institutional investors—and only three states effectively exempt offers to those investors in a Rule 144A context.[21] Accordingly, use of broad-reaching general solicitation in Rule 144A offerings by non-reporting issuers[22] could require registration under most state Blue Sky laws. It remains to be seen whether any of those states would pursue an enforcement action in such a case.

We expect that practitioners will ask the Commission to use its authority under Section 18 of the Securities Act to preempt Blue Sky laws for all offers and sales made pursuant to Rule 144A, which would align them with the existing preemption for all offers and sales made pursuant to Rule 506, but this request has been made before and the Commission has yet to address it.[23] Our analysis in this memorandum with respect to general solicitation in Rule 144A

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proposing to eliminate the requirement to determine the qualifications of each offeree. The Commission believes that the limitation as to the manner of the offering and the limitations as to disposition set forth in proposed Rule 502(c) and (d) are sufficient to assure that the offering is private in nature.")

In a number of no-action letters, the Commission staff concluded that solicitation of prospective offerees with whom the issuer and/or its agent have no substantive pre-existing relationship is only permissible if the solicitation is generic in nature and does not reference any specific investment, and a waiting period is imposed before the offer is made. See, *e.g.*, *Bateman Eichler* (Dec. 3, 1985), *E.F. Hutton* (Dec. 3, 1985), *H.B. Shaine* (May 1, 1987), *IPONET* (July 26, 1996) and *Lamp Technologies* (May 29, 1997). However, these cases all involve a broad solicitation of a large number of prospective investors, rather than fewer than 35 prospective investors.

[19] Section 18 exempts (as covered securities) all securities with respect to transactions conducted pursuant to an exemption under Section 4(a)(2) of the Securities Act, which includes the exemptions under Regulation D.

[20] Section 18 includes as exempted covered securities all securities with respect to *reporting company* transactions exempt under Sections 4(a)(1) and 4(a)(3) of the Securities Act—that includes transactions under Rule 144A, which was created under Sections 4(a)(1) and 4(a)(3) of the Securities Act.

[21] California, Louisiana and Vermont exempt from their registration requirements offers and sales made in compliance with Rule 144A as in effect from time to time.

[22] This could also include Rule 144A offerings by reporting issuers with non-reporting guarantors.

[23] See, *e.g.*, Securities Industry and Financial Markets Association, comments on the JOBS Act (Apr. 27, 2012), at 7, available at http://www.sec.gov/comments/jobs-title-i/general/general-18.pdf.

offerings therefore applies, for the time being, to reporting issuers only, at least until the Commission clarifies the Blue Sky situation by using its exemptive authority as described above.

II. Implications for Offering Structure, Other Exemptions and Concurrent or Proximate Offerings

Do the new rules affect the prohibition on directed selling efforts in Regulation S offerings?

Generally, no. The new rules do not amend Regulation S and its prohibition on the use of "directed selling efforts" in the United States. However, the Adopting Release reaffirms the guidance in the proposing release that offers made outside the United States under Regulation S will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 144A or Rule 506.[24] Accordingly, as for other permissible activities in connection with a private (or registered) U.S. offering, the use of general solicitation in a Rule 144A or Rule 506(c) offering should not be understood to be directed selling efforts in connection with a concurrent Regulation S offering.

Does the use of general solicitation in a Rule 144A offering affect the issuer's initial placement of securities with an initial purchaser under Section 4(a)(2)?

No. Although Rule 144A is not available for offerings by issuers, the rule is frequently used to permit investment banks to resell securities purchased from an issuer for immediate resale. The issuer's sale to the "initial purchasers" generally relies on the exemption provided by Section 4(a)(2) of the Securities Act, while the resale relies on Rule 144A. The Adopting Release confirms that the use of general solicitation in the second step will not affect the availability of the Section 4(a)(2) exemption for the initial sale.[25]

Is general solicitation permitted in Section 4(a)(2) and "4(1½)" offerings?

Generally, no. The exemption from registration in Section 4(a)(2) of the Securities Act applies to a transaction by an issuer "not involving any public offering." The Commission has long expressed the view that for there not to be a public offering, the issuer and those acting on its behalf may not contact investors for the offering by means of a public solicitation.[26] The JOBS Act and the new rule do not change this: the Adopting Release states that "[a]n issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering because public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)."[27] It should

[24] See Adopting Release, at 57. The integration doctrine was developed to prevent a public offering from being divided into multiple private offerings to avoid registration. The doctrine has since been extended to apply to various types of multiple offerings and may result in the combined offering not meeting the requirements either of a registered public offering or any exemption from registration for a private offering.

[25] See id., at 8.

[26] See Release No. 33-4552 (Nov. 6, 1962).

[27] See Adopting Release, at 12.

generally be assumed that broad-reaching general solicitation activities[28] conducted in the context of Rule 506(c) offerings will constitute communications that preclude reliance on Section 4(a)(2).

Similarly, although some practitioners have suggested that general solicitation should be permitted in a private resale under the interpretive doctrine referred to as the "Section 4(1½) exemption"—resales from one purchaser in a private offering to another—we believe the Commission's affirmative statement prohibiting public solicitation in a Section 4(a)(2) offering extends to Section 4(1½) because that interpretive doctrine is based principally on the need for a private transaction as embodied in Section 4(a)(2).

Can general solicitation be used in "144A direct" offerings?

In some non-U.S. jurisdictions, the settlement of the ultimate sale in an otherwise Rule 144A-compliant offering has for some time been structured as a direct sale of the security from the issuer to the purchaser under Section 4(a)(2) (in most cases to avoid the additional stamp tax that would result from a two-step transfer of a security from the issuer to an intermediary and the intermediary to the purchaser, as is customary in a Rule 144A offering). In all other respects, these offerings mirror traditional Rule 144A offerings. Most importantly, as in a typical Rule 144A offering, the investment banks serve as intermediaries that bear the ultimate economic risk of the offering not being fully subscribed through a standby arrangement with the issuer. The "direct" offering structure thus has no impact on economics, which are identical to the traditional Rule 144A offering. By contrast, in a classic Section 4(a)(2) offering, the issuer bears the economic risk if the placement agent (if any) does not find investors.

Because the investment banks soliciting prospective investors bear the economic risk rather than the issuer in these offerings and are functionally indistinguishable from the intermediaries in a traditional Rule 144A offering, we interpret the applicable Section 5 exemption for their activities to be Rule 144A. Accordingly, they should be able to use general solicitation to procure those investors. The solicitation and offers by the investment banks as permitted under Rule 144A do not affect the issuer's Section 5 exemption for its sale to investors that are all reasonably believed to be QIBs. Rule 144A(e) provides that offers and sales of securities pursuant to the Rule shall be deemed not to affect the availability of any exemption or safe harbor relating to any previous or subsequent offer or sale of those securities by the issuer or any prior or subsequent holder thereof. In effect, where prospective investors are solicited in a permissible manner, that solicitation will not affect the availability of the Section 4(a)(2) exemption for the sale.[29]

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[28] For a discussion of communications that may constitute general solicitation, see Section I.

[29] The Commission made a similar point in an analogous context: "it is our view that the determination as to whether the filing of the registration statement should be considered to be a general solicitation or general advertising that would affect the availability of the Section 4(2) exemption for such a concurrent unregistered offering should be based on a consideration of whether the investors in the private placement were solicited by the registration statement or through some other means that would otherwise not foreclose the availability of the Section 4(2) exemption." Release No. 33-8828 (Aug. 3, 2007), at 55, available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

What if an issuer does not use general solicitation in a Rule 506 offering?

Private placements conducted without the use of general solicitation may proceed exactly as before, now under Rule 506(b). Rule 506(b) offerings may still include up to 35 non-accredited investors plus an unlimited number of accredited investors and, if they include any purchasers that are not accredited investors, must meet certain information and other requirements. The new requirement in Rule 506(c) of taking "reasonable steps to verify" the status of participating accredited investors is not required in a Rule 506(b) offering, but an issuer should, as before, take steps to support the reasonable belief requirement under the definition of accredited investor.

Will the use of general solicitation in a Rule 506(c) offering be considered prohibited general solicitation for a concurrent or proximate Rule 506(b) offering?

The ability to use general solicitation in some private offerings raises new integration questions in the context of proximate private offerings, as illustrated by the scenarios below. If a Rule 506(c) offering that uses general solicitation is integrated with a Rule 506(b) offering, the general solicitation will result in the loss of the Rule 506(b) exemption and any sales to non-accredited investors will be a violation of Section 5. Currently, Rule 502(a) provides a safe harbor for Regulation D private offerings spaced six months or more apart, and a five-factor test[30] for integration of offerings conducted within six months of each other, but we believe this may not be the most appropriate framework for analyzing these integration issues.

- *A Rule 506(b) offering, followed by a Rule 506(c) offering*: Where a Rule 506(b) offering is completed and then followed by a Rule 506(c) offering, we believe integration should not be a concern because it is clear the investors in the Rule 506(b) offering were not attracted to the offering by the general solicitation in the subsequent Rule 506(c) offering. However, application of the five-factor test may not produce this result.

- *A Rule 506(c) offering, followed by a Rule 506(b) offering*: In certain cases, a Rule 506(b) offering should clearly not be permitted to follow a Rule 506(c) offering with general solicitation—for example, where the general solicitation targets non-accredited investors who then invest in the Rule 506(b) offering. Nevertheless, we believe there are other cases fitting this scenario that should be permitted, although application of the five-factor test is likely to result in integration.

In both scenarios, we believe the analysis should turn on whether the investors in the Rule 506(b) offering were attracted to the offering by general solicitation used in the Rule 506(c) offering. This approach is consistent with Commission guidance in the area of Section 4(a)(2) private placements, where the Commission has recognized that although the filing of a registration statement could be considered general solicitation, it should not *per se* eliminate an

[30] These factors are whether the offerings (1) are part of a single plan of financing, (2) involve the issuance of the same class of securities, (3) are made at or about the same time, (4) involve the receipt of the same type of consideration and (5) are made for the same general purpose. This is the same test for integration more generally articulated in Release No. 33-4552 (Nov. 6, 1962).

issuer's ability to conduct a concurrent private placement.[31] Instead, the issuer should determine "whether the investors in the private placement were solicited by the registration statement or through some other means that would otherwise not foreclose the availability of the Section 4(2) exemption."[32]

The six-month safe harbor in Rule 502(a) also seems out of step with other safe harbors created more recently by the Commission, which use a 30-day timeframe. For example, Rule 155 under the Securities Act permits a private offering to proceed 30 days after an abandoned public offering, despite the potential general solicitation created by the registration statement, and Rule 163A under the Securities Act provides that communications made more than 30 days prior to the filing of a registration statement do not constitute "gun jumping" (as described below). The Commission has recognized that "the 30-day timeframe adequately assures that these communications will not condition the market for a securities offering by providing a sufficient time period to cool any interest in the offering that might arise from the communication."[33]

Unless the Commission offers guidance on this topic, however, issuers should continue to rely on the five-factor integration test and the six-month safe harbor in Rule 502(a).[34]

Will the use of general solicitation in a Rule 144A or Rule 506(c) offering trigger the prohibition on gun jumping for a concurrent or proximate public offering?

The use of general solicitation in a Rule 144A or Rule 506(c) offering in advance of the filing of a registration statement for a public offering may result in a violation of Section 5 of the Securities Act. Once a company has made the decision to proceed with a public offering of securities, under Section 5, it may not make any offers that could be viewed as offers of those securities, whether written or oral, until it files the registration statement. Offers made in contravention of this requirement are known as "gun jumping." The new rules do not exempt general solicitation from the definition of "offer,"[35] they simply provide that the use of general solicitation (even if considered an offer) is permitted in a Rule 144A or Rule 506(c) offering. Accordingly, general solicitation may be an offer and prohibited as gun jumping with respect to a public offering, even if made in the context of a valid Rule 144A or Rule 506(c) offering. (Issuers may continue to rely on the safe harbor provided by Rule 163A for communications that

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[31] See Release No. 33-8828 (Aug. 3, 2007), at 55. The Commission staff has also issued interpretive letters permitting companies to conduct private placements concurrently with public offerings. See, *e.g.*, *Black Box Incorporated* (June 26, 1990) and *Squadron Ellenoff, Pleasant & Lehrer* (Feb. 28, 1992).

[32] See Release No. 33-8828 (Aug. 3, 2007), at 55. This approach is equally relevant, and already generally applied, in the context of Rule 144A and Section 4(a)(2) offerings.

[33] Release No. 33-8591 (June 19, 2005), at 30.

[34] In 2007, the Commission proposed to reduce the six-month safe harbor to 90 days, but rejected suggestions of a 30-day safe harbor as too short. See Release No. 33-8828 (Aug. 3, 2007), at 59-60. The change to 90 days was ultimately not adopted. In the same release, while articulating the importance of whether investors were attracted to the offering by the general solicitation, as we discuss above, the Commission declined to change the five-factor test.

[35] Section 2 of the Securities Act defines "offer" as "every attempt or offer to dispose of, or solicitation of offers to buy, a security or interest in a security for value."

meet the safe harbor's requirements and are made more than 30 days prior to the filing of a registration statement.)

After the filing of a registration statement for a public offering and before effectiveness, issuers may make oral offers, but written offers may only be made by means of a prospectus that complies with Section 10 of the Securities Act. Accordingly, in the case of a Rule 144A or Rule 506(c) offering conducted during this period and until completion of the public offering, offering participants should be cautious about the use of written general solicitation materials that could be viewed as offers of the securities in the public offering, particularly in the IPO context where a valid Section 10 prospectus must contain a price range and a non-compliant prospectus cannot be filed as a free writing prospectus.

As a result of these concerns, we expect that, in practice, issuers conducting a Rule 144A or Rule 506(c) offering in close proximity to a public offering where gun jumping concerns are raised will likely either complete any general solicitation in connection with the Rule 144A or Rule 506(c) offering at least 30 days before filing the registration statement for the public offering or wait until the completion of the public offering before engaging in general solicitation for the Rule 144A or Rule 506(c) offering. (Issuers may also continue to rely on Rule 135c to publish limited information about a private offering.)

Will the filing of a registration statement preclude a concurrent or proximate Rule 144A or Rule 506(c) offering?

No. Because offering participants relying on Rule 144A or Rule 506(c) may now engage in general solicitation, the filing of a registration statement should not affect the ability to rely on those exemptions. However, as discussed above, general solicitation used in the Rule 144A or Rule 506(c) offering could pose gun jumping issues for a concurrent or proximate public offering.

Will the use of general solicitation in a Rule 144A or Rule 506(c) offering result in the loss of the Section 3(c)(1) or Section 3(c)(7) exemptions under the Investment Company Act of 1940 (the "1940 Act")?

No. As the Commission noted in the Adopting Release, the language of the JOBS Act itself made clear that offers and sales exempt under Rule 506, as revised to permit general solicitation, will not be deemed public offerings under the federal securities laws, including the 1940 Act.[36] The same should also be true for Rule 144A offerings.

[36] See Adopting Release, at 48-49. Some private funds that trade in commodities and certain derivatives will need to continue avoiding the use of general solicitation – two principal exemptions under Commodity Futures Trading Commission (the "CFTC") regulations, Rule 4.7 and Rule 4.13(a)(3), do not allow "marketing to the public in the United States." It is unclear whether the CFTC will take steps to harmonize those exemptions with Rule 506(c).

III. Other Practical Implications

Rule 144A

How will purchase agreements change?

Rule 144A purchase agreements typically contain representations by the issuer and the initial purchaser that the securities covered by the agreement have not been and will not be (a) offered or sold in the United States to anyone not reasonably believed to be a QIB or (b) offered or sold in the United States by any means of general solicitation or general advertising. We expect that, upon effectiveness of the new rule, offering participants will move to eliminate the second of these representations entirely and limit the first to sales. As discussed above, however, the Blue Sky implications of general solicitation should be considered for non-reporting issuers, which may result in keeping these or similar representations in that case.

Although the new rules technically permit an issuer and its agents to discuss a Rule 144A offering orally or in writing with whomever they choose, we also expect that, in practice, offering participants will want to agree on communications in light of Rule 10b-5 liability concerns. Accordingly, existing purchase agreement provisions to that effect, and the related indemnity provisions, are unlikely to change.

How will disclosure change?

Offering memoranda for Rule 144A offerings today include legends and disclosures about resale restrictions that will change to remove references to offers. Some offering memoranda also include confidentiality provisions to restrict prospective purchasers from forwarding offering materials to others. While broader dissemination of offering materials now is not technically prohibited, we do not expect restrictions on widespread dissemination to change significantly, in light of potential liability concerns and in some cases potential concerns regarding Regulation FD, as discussed above.

Can banks now publish pre-deal research in Rule 144A offerings?

While no longer problematic under Section 5 of the Securities Act, liability concerns will likely outweigh any potential benefit of publishing pre-deal research or disseminating it any more broadly than is current practice. This has been the experience, for example, with respect to pre-deal research in offerings by emerging growth companies, despite now being permitted pursuant to Title I of the JOBS Act.

In addition, although it can be argued that the provisions of the Global Research Settlement[37] and FINRA rules[38] that prohibit certain interactions between research analysts and

[37] The Global Research Settlement among the Commission, the New York Stock Exchange, the National Association of Securities Dealers, Inc. (the predecessor to FINRA) and other securities regulators, on the one hand, and ten of the largest investment banking firms, on the other, entered by the U.S. District Court for the Southern District of New York on Oct. 31, 2003.

[38] In particular, Rule 2711 imposes a number of restrictions on the publication of research, among other things.

investment bankers are not intended to apply to the distribution of pre-deal research in the United States (particularly for a foreign private issuer), we believe the type of interaction between investment bankers and research analysts typically involved in the issuance of pre-deal research may be inconsistent with the principles underlying the Settlement and those rules. This concern has led investment banking firms to refrain from distributing pre-deal research in the United States even to eligible investors in Rule 144A offerings and traditional private placements. In Rule 144A/Regulation S offerings by foreign private issuers, some banks do have a practice of distributing pre-deal research that was published abroad only to QIBs in the United States, but most banks have "ring-fencing" policies to keep this research out of the United States. We do not expect these policies to change.

Regulation S

How will documentation change in Regulation S offerings?

Because the prohibition on directed selling efforts continues to be a condition for relying on Regulation S for non-U.S. offerings, we do not believe directed selling effort-related representations in purchase agreements should be eliminated or otherwise change, nor do we believe guidance regarding the importance of avoiding marketing efforts designed to target non-QIBs in the United States should change. Accordingly, Regulation S-related legends and other disclosures also should not change. In Regulation S-only offerings, foreign private issuers should continue to look to Rule 135e to ensure that publicity efforts abroad are not construed as directed selling efforts in the United States.

Rule 506(c)

What policies and procedures should an issuer implement with respect to the new "reasonable steps to verify" the accredited investor status of prospective investors?

It will be important for issuers relying or expecting to rely on Rule 506(c) to develop formal verification procedures. To minimize the administrative burden of reviewing IRS forms, bank statements and other documents, issuers could adopt a streamlined approach by requiring each investor to obtain written verification from a third party professional. Emergence of an industry "pre-screened" accredited investors database (similar to the "QIB list" used in Rule 144A offerings) could facilitate this verification process, although both privacy and competitive concerns are likely to raise issues with such a development in the case of individual investors. Verification procedures equivalent to those set forth in the safe harbor for natural persons should constitute reasonable steps for other types of investors. It may also be reasonable to rely on a certification from the investor if the issuer or its agents have taken reasonable steps to verify the investor in another recent offering (*e.g.*, within the past 12 months).[39]

An issuer has the burden of demonstrating that its offering is entitled to an exemption from registration and thus should retain all records evidencing its "reasonable steps to verify." As a best practice, issuers and their counsel should consider maintaining a detailed list of the

[39] As discussed in Section IV, the proposed amendments to Form D would require public disclosure of the verification methods used.

steps taken and materials reviewed for each investor. Thorough records will also facilitate delivery of a legal opinion by counsel to the effect that the issuer has conducted a valid private offering.

An issuer that begins by conducting a Rule 506(b) or Section 4(a)(2) offering but converts to a Rule 506(c) offering upon deciding to engage in general solicitation or discovering that it inadvertently engaged in general solicitation will, of course, need to take reasonable steps to verify each accredited investor in the offering. As noted above, a Rule 506(b) offering does require the issuer to take steps to support the reasonable belief requirement under the definition of accredited investor. In practice, these two sets of steps may converge over time, as having one set of procedures that satisfy both requirements may be more efficient.

Can an issuer use the grandfathering safe harbor for investors in an affiliate that now want to invest in the issuer's offering?

The new rules include a "grandfathering" provision for natural persons that invested in a Rule 506(b) offering by the issuer prior to the effective date of the new rules. This safe harbor, however, only applies to offerings by the same issuer. It does not, in the private fund context for example, apply to natural persons who previously invested in other funds managed by the same fund sponsor.

Can an issuer amend a Form D to check Rule 506(b) instead of Rule 506(c) or vice versa?

It appears that an issuer, upon deciding to engage in general solicitation or discovering that it inadvertently engaged in general solicitation, may amend a Form D that initially indicated a Rule 506(b) offering to instead indicate a Rule 506(c) offering and vice versa. Such a Form D amendment would result in the entire offering being made pursuant to the new claimed exemption—*i.e.*, sales made both before and after the filing of the Form D amendment.[40] In the Adopting Release, the Commission reminded issuers that once the purchasers in an offering become interested in the offering because of or through general solicitation, an issuer is precluded from relying on Rule 506(b) for that offering.[41] The Commission also acknowledged, however, that purchasers may become interested in the offering "through some means other than the general solicitation, such as through a substantive, pre-existing relationship with the company or direct contact by the company or its agents outside of the general solicitation,"[42] and as discussed earlier, sales to these purchasers should still be permitted.

Further, Rule 508, which provides that certain insignificant deviations from the Regulation D rules will not preclude issuers from relying on the exemptions thereunder, deems noncompliance with the ban on general solicitation to be *per se* significant. Therefore, discovery of inadvertent general solicitation under an intended Rule 506(b) offering appears to

[40] As noted above, an issuer that changes to the Rule 506(c) exemption will, of course, need to take reasonable steps to verify each accredited investor in the offering. As discussed in Section IV, the proposed amendments to require an "Advance Form D" may not permit conversion to the Rule 506(c) exemption in practice.

[41] See Adopting Release, at 46-47.

[42] Id., at 46 n.142.

require conversion into a Rule 506(c) offering, unless sales are limited to investors identified (without general solicitation) prior to the inadvertent activity.

IV. Proposed Changes to Regulation D, Form D and Rule 156

The proposed rules were designed to address concerns about the liberalization described above, particularly with respect to Rule 506 offerings. Many of them are intended to enhance the Commission's ability to evaluate the development of market practices in these offerings, which could lead to additional future rule changes or enforcement activity. At the same time, some of the proposals seem likely to have a chilling effect on the use of general solicitation in Regulation D offerings and the use of the exemption more generally, which would be contrary to Congress' intent under the JOBS Act.[43] We expect that comments on the proposal will be extensive and, like the comments on the August 2012 proposal, range from adamant disagreement to strong approval. We highlight below the most significant aspects of the proposed rules.

Rule 503 – Advance and Closing Form Ds

Under existing Rule 503, an issuer offering or selling securities in reliance on any of the Regulation D exemptions must file with the Commission a Form D notice no later than 15 calendar days after the first sale of securities in the offering. The Commission has proposed amending Rule 503 to require issuers intending to offer securities under Rule 506(c) to file a Form D at least 15 calendar days prior to "any general solicitation activities" (an "Advance Form D"). The Commission notes in the Proposing Release that the impetus for the filing of an Advance Form D is to allow it to gather information about Rule 506(c) offerings, as well as providing state regulators and investors more timely information about these offerings. The Advance Form D would require an issuer to complete a subset of the items required by Form D,[44] with an amendment to provide the remaining information within 15 calendar days after the first sale of securities in the offering (the current timing for filing Form D). The Commission also proposes to require issuers to file a final amendment to Form D (a "Closing Form D") no more than 30 calendar days after termination or abandonment of any Regulation D offering[45] unless all required information had already been filed previously and the box for a closing filing was checked. As it does now, Rule 503(a)(3) would continue to require amendments of a previously filed Form D "as soon as practicable" to correct a material mistake, reflect a change in

[43] Commissioner Paredes, in his statement accompanying his dissent from the issuance of the proposed rules, expressed concern that the proposed rules, if adopted, would "unduly burden and restrict the capital formation process" and undermine the JOBS Act (available at http://www.sec.gov/news/speech/2013/spch071013tap.htm).

[44] Advance Form D would require disclosure of, among other things, (a) the issuer's identity, principal place of business and industry group; (b) information about related persons; and (c) the type of securities being offered, the exemption claimed, information about broker/dealer sales compensation and use of proceeds, and whether it relates to a business combination transaction. See proposed Rule 503(a)(1).

[45] The Commission notes in the Proposing Release that when Regulation D was originally adopted (see Release No. 33-6389 (Mar. 8, 1982)), issuers were required to file a final Form D within 30 days of the final sale of securities in the offering. Amendments every six months during an ongoing offering were also required. These requirements were eliminated in 1986 (see Release No. 33-6663 (Oct. 2, 1986)). See Proposing Release, at 27.

information previously provided (except with respect to a number of specified items) and on an annual basis for ongoing offerings.

We believe the requirement to file an Advance Form D is potentially the most problematic of the proposed rules. In practice, the requirement to file an Advance Form D at least 15 calendar days in advance of any general solicitation activities would impose a regulatory "speed bump," or artificial delay in the process, that could impede use of Rule 506(c) for capital raising.[46] This becomes particularly problematic where an issuer starts an offering using the Rule 506(b) exemption but either decides to engage in general solicitation or discovers that it inadvertently engaged in general solicitation (discussed further below), and consequently wants to change to the Rule 506(c) exemption. In this case, the Advance Form D filing could be practically impossible.

Separately, issuers may not wish to file an Advance Form D before they have made a final determination to conduct a Rule 506(c) offering for a number of reasons, including uncertainty regarding the use of general solicitation or because of an unwillingness to disclose prematurely the possibility of capital-raising activity generally. The Commission acknowledged a concern about available information in the Proposing Release, suggesting it was addressed by the more limited scope of the information required in the Advance Form D, which need not describe specific offering activities that might constitute general solicitation,[47] but did not address concerns about signaling to the markets and competitors. The Commission noted that information about offerings that are initiated but are ultimately unsuccessful would be helpful to it in determining "which issuers are facing challenges raising capital under Rule 506(c) and whether further steps by the Commission are needed to facilitate issuers' ability to raise capital under Rule 506(c)."[48] Nevertheless, in practice, offering participants may, notwithstanding what the Commission believes are steps to accommodate concerns, be reluctant to file any public advance notice of a potential upcoming offering, which could have a chilling effect on the use of the Rule 506(c) exemption that would outweigh any potential benefit that the Commission perceives.

These timing concerns could be addressed by instead requiring a Form D to be filed at the time of the first use of general solicitation[49] (but in any event no later than 15 days after the first sale). This might also serve to eliminate one of the required filings, as all of the required information might be available at this time (as proposed, an issuer relying on Rule 506(c) would generally be required to file Form D at least three times—an Advance Form D 15 days prior to using general solicitation, an amendment no later than 15 days after the first sale and a Closing

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[46] Other Commission rule proposals in the past have ultimately not been adopted in part because they created unnecessary speed bumps. One example is the 1998 Aircraft Carrier proposal, Release No. 33-7606 (Nov. 3, 1998), as amended by Release No. 33-7606A (Nov. 13, 1998). See, *e.g.*, ABA comment letter on that proposal (Sept. 28, 1999) ("The prospectus and term sheet delivery requirements are structured to interpose "artificial" delays and regulatory "speed bumps" prior to sale, with no discernible benefits to investors that outweigh the costs to issuers and underwriters or the burdens imposed on domestic capital markets.").

[47] See Proposing Release, at 23.

[48] Id., at 22-23.

[49] This timing would be similar to the required filing of a free writing prospectus in a registered offering under Rule 433(d)(1) under the Securities Act.

Form D 30 days after the termination of the offering[50] – a procedural burden that seems excessive).

Offering participants may similarly be reluctant to file a Closing Form D disclosing an abandoned or otherwise unsuccessful offering. If the Commission believes it would be beneficial to markets and investors for it to gather information about unsuccessful offerings, it should consider non-public methods of gathering that information, which could include roundtables or other surveys, or perhaps a confidential notice process, instead of using a public Form D filing for this purpose.

As mentioned above, a further timing issue not currently addressed in the proposed rules relates to inadvertent general solicitation (often referred to as "foot faults") because it would be impossible to file the required Advance Form D 15 days prior to the foot fault. Although the 30-day cure period contemplated by the disqualification provision, discussed below, may be interpreted to permit the late filing of the Advance Form D, an explicit cure mechanism for inadvertent general solicitation might be helpful and could be modeled on the corresponding provision in Rule 433(f) under the Securities Act for a written offer that is deemed to be a free writing prospectus, which must be filed within four business days of the issuer or other offering participant becoming aware of the communication.

Finally, with respect to the timing for amendments, while the flexibility of the "as soon as practicable" standard is beneficial, the proposed consequences of a failure to file any required Form D, including amendments, raise concerns about the lack of certainty afforded by this standard. The Commission should consider providing a four business day safe harbor.

Proposed Changes to Disclosure Items in Form D

The proposal seeks to revise Form D to require additional disclosure items, some of which would apply to all Regulation D offerings and some only to Rule 506(c) offerings (for example, the methods of general solicitation used and the methods used to verify accredited investor status). Some of this information may be problematic as public disclosure; other items, whether filed publicly or submitted confidentially to the Commission, seem overly burdensome, particularly in the private offering context. Taken in the aggregate, the additional disclosure requirements, which in some cases are more burdensome and far-reaching than the analogous requirements in the public offering or public reporting context, will have the effect, whether or not intended, of discouraging issuers from undertaking private offerings using general solicitation, as well as Regulation D more generally. In particular:

- *Controlling persons (Item 3):* An issuer would be required to disclose "controlling persons" (for Rule 506(c) offerings only), which the revised instructions to the Form describe as "each person who directly or indirectly controls the issuer." This requirement goes well beyond current disclosure requirements for reporting companies, which require disclosure of certain specified information with respect to "control persons" (similarly defined) in an initial public offering and immediately

[50] An issuer relying on Rule 506(b) would generally be required to file Form D at least twice.

thereafter (but *not* disclosure of every "control person"),[51] but otherwise generally require this kind of disclosure using bright line ownership levels.[52] The determination of direct or indirect control is a subjective one that requires, among other things, costly consultations with counsel. This seems overly burdensome in the private offering context, with limited benefit. Instead, a bright line ownership level could be specified, and for private offerings, a threshold of 20% might be appropriate, consistent with the approach taken in new Rule 506(d) for disqualification of "bad actors."[53] Requiring even this information to be made public is inconsistent with privacy considerations for companies that have chosen to remain privately held. Accordingly, this information would be better submitted to the Commission confidentially.

- *Issuer size (Item 5):* The instructions to the Form would be modified to require disclosure of an issuer's revenues (or aggregate net asset value in the case of a fund) if that information has been made public in any way, including in general solicitation materials. However, not all general solicitation materials will necessarily be public information—communications to a large number of prospective investors with which the issuer or its agent does not have any "substantive pre-existing relationship" may be general solicitation,[54] even if subject to a confidentiality agreement. Accordingly, this instruction should be revised to require disclosure only if this information has truly been made public.

- *Investor information (Item 14):* The proposed revisions to the investor information item would include disclosure of the number of natural persons included in each category of accredited investors and, in the case of Rule 506(b) offerings, non-accredited investors, as well as the amount raised from each category. This level of detail seems excessive as public disclosure and adds requirements that currently do not exist for Rule 506 offerings not using general solicitation.

- *Use of proceeds (Item 16):* The proposed use of proceeds disclosure is extremely detailed—indeed, more so than that currently required in connection with registered public offerings pursuant to Item 504 of Regulation S-K. It seems fundamentally inconsistent in the private offering context to require more information than would be

[51] See Item 401(g) of Regulation S-K, which requires the disclosure of certain legal proceedings with respect to control persons.

[52] For example, Item 403 of Regulation S-K requires disclosure of all beneficial owners of more than five percent of any class of voting securities known to the issuer. Item 404(a) of Regulation S-K, which requires disclosure of transactions with certain "related parties," uses the same threshold for shareholders as Item 403.

[53] Under new Rule 506(d), one category of persons that will disqualify an issuer from using the Rule 506 exemptions if they have been convicted of or sanctioned for securities fraud or other specified legal violations is "any beneficial owner of 20% or more of the issuer's outstanding voting securities, calculated on the basis of voting power." The adopting release for this rule change, Release No. 33-9414 (July 10, 2013), is available at http://www.sec.gov/rules/final/2013/33-9414.pdf. For more information, see our Alert Memo dated July 11, 2013, available at http://www.cgsh.com/private-offerings-sec-liberalizes-the-rules-but-also-proposes-new-requirements/.

[54] See discussion of what may be "general solicitation" or "general advertising" above in Section I.

required in a public offering. In addition, as above, this change adds requirements that currently do not exist for Rule 506 offerings not using general solicitation.

- *Verification methods of accredited investor status (new Item 22):* In a Rule 506(c) offering, an issuer would be required to list the verification methods used to confirm accredited investor status and, for methods that do not fall within one of the safe harbors, specify the information or documentation used. This specification requirement seems overly burdensome, particularly given the Commission's principles-based approach to the verification requirement, which contemplates a consideration of the specific facts and circumstances of each case. In practice, this item is likely to instead lead to a more generic, check-the-box approach to verification that would undercut the rule itself.

Rule 507(b): One-Year Disqualification for Failure to File Form D

While the filing of Form D is a requirement under Rule 503, it is not a condition for use of the Regulation D safe harbor. Rule 507 currently disqualifies an issuer from relying on the Regulation D safe harbor prospectively if the issuer or any of its predecessors or affiliates have been enjoined by a court for violating the filing requirements of Rule 503. In practice, enforcement actions related to the failure to file a Form D are rare, and the Commission, in light of what it has identified as the perceived current levels of non-compliance with the filing requirement, believes "it is appropriate to strengthen the incentives for issuers to comply with Rule 503."[55]

Several commenters to the proposed rules for the elimination of general solicitation suggested that the Commission should require compliance with Rule 503 as a condition to the use of Rule 506, or at least to the use of Rule 506(c). The Commission acknowledges, however, that doing so could result in a violation of Section 5 of the Securities Act (and the availability of a strict liability "put" or rescission right for the purchasers under Section 12(a)(1) of the Securities Act) and applicable state securities laws for the entire offering, a result the Commission believes to be disproportionate to the failure to file.[56] The Proposing Release seeks comment on whether compliance with Rule 503 should be a condition to the use of Rule 506. We believe the Commission properly recognizes the draconian result of making such a change.

Instead, the Commission proposes to amend Rule 507 to add a new subsection (b), which would disqualify an issuer and its affiliates from using Rule 506 prospectively if it has failed to comply with the Rule 503 Form D filing requirements, including any of the successive amendments required under the proposed rules, in connection with any Rule 506 offering within the past five years. The rule would allow a 30-day cure period for late filings unless the issuer had previously missed a filing deadline in connection with the same offering. In addition, if the issuer subsequently makes all missed filings for all ongoing offerings and all missed Closing Form D filings for all terminated offerings, the issuer would become eligible to use Rule 506 one

[55] Proposing Release, at 49.

[56] See id., at 50-51.

year after making the corrective filings. The Commission would be able to waive the disqualification through delegated authority to the Director of the Division of Corporation Finance, as under existing Rule 507. Disqualification would arise only for missed filings occurring after the effectiveness of new Rule 507(b).

As noted above, the Commission recognizes the draconian result of making Form D filings a condition to the use of Rule 506; it also acknowledged in the Proposing Release the "possible disruptions in the Rule 506 market if market participants could not be certain of the availability of Rule 506 for an offering until after the offering was terminated and all filings required under Rule 503 were made."[57] Given the potential for inadvertent general solicitation and various other uncertainties with respect to the filing requirements, as discussed in this memorandum, proposed Rule 507 still presents these potential consequences—namely, that filing failures with respect to past offerings, whether completed or abandoned, will only be identified later and potentially after a new Rule 506 offering has begun.

As a result, the disqualification provision seems overly harsh, as proposed. Most issuers and their advisers would, of course, prefer the elimination of the proposed change to Rule 507 entirely. Recognizing the Commission's desire to incorporate an effective incentive for issuers to comply with the Form D filing requirement, and the Commission's view that this requires "meaningful consequences for failing to file the form, without requiring action on the part of the Commission or the courts,"[58] however, one alternative might be for the disqualification to be triggered only by the failure to file the Form D required under the current rules (*i.e.*, within 15 calendar days after the first sale of securities in the offering). Under the proposed rules, this Form D would still be required, unless the information had been fully provided in a previous Form D filing. The requirements for this filing are quite clear, which would eliminate many of the concerns related to the uncertainty of when the other Form D filings are required. The other Form D filings could still be required (subject to the concerns discussed above), but failure to file would not trigger disqualification.[59]

In addition, the disqualification should reference the "timely filing" of required Form Ds, rather than "compliance with the requirements of Rule 503," as currently proposed. Rule 507(b) as proposed does not clarify what would constitute a "failure to comply" with Rule 503 for purposes of Rule 507(b) disqualification. The discussion in the Proposing Release about the cure period suggests that even an immaterial, inadvertent or technical error, if not cured within the 30-day period, would result in disqualification. This is overly harsh. It would, for example, go well beyond the standard for filing of Exchange Act reports (10-Ks, 10-Qs and 8-Ks for domestic issuers) on a timely basis, as opposed to compliance with reporting requirements, that triggers one-year loss of eligibility for use of short-form registration under the Securities Act.[60]

[57] Id., at 51.

[58] Id., at 50.

[59] This is a similar approach to that taken with respect to Form 8-K, where certain items that require management to make rapid materiality and similar judgments within a compressed timeframe are subject to a safe harbor. See Form S-3, General Instruction I.A.3(b); Release Nos. 33-8400, 34-49424 (Mar. 16, 2004), at 29.

[60] See, *e.g.*, Form S-3, General Instruction I.A.3. An error in an Exchange Act report only results in that report being considered not to have been timely filed, and therefore affects the issuer's eligibility to use Form S-3 or F-3, if it renders the report "materially deficient"—a result generally reserved only for major omissions. See, *e.g.*, Commission

Use of "timely filing" as the standard would instead mirror those eligibility requirements. Alternatively, Rule 507(b) could include a materiality threshold and a list of items that would not trigger disqualification, similar to the approach in current Rule 503 with respect to required amendments of Form D.

Finally, although Rule 507 currently disqualifies affiliates upon disqualification of an issuer, the proposed introduction of an automatic disqualification for compliance failures makes the affiliate consequence much more burdensome. A company would need assurances from all its affiliates (upstream or downstream) that they had made all required Form D filings within the past five years before it could itself be comfortable relying on any Rule 506 exemption. Furthermore, in the analogous framework discussed above, the eligibility of a reporting issuer to use short-form registration, an issuer's failure to file Exchange Act reports does not result in the disqualification of affiliates for Form S-3/F-3 eligibility. Instead, Rule 507(a)—the existing provision—could retain the reference to affiliates, but Rule 507(b) could refer only to the issuer. If the Commission is concerned that a company would make use of an affiliate to evade disqualification, it could address a scheme to evade directly as it does in many other contexts.[61]

Rule 509: Legend and Content Requirements for General Solicitation Materials

Despite some commenter suggestions to impose various content restrictions on general solicitation materials, the Commission generally decided to wait to observe market practice in Rule 506(c) offerings, proposing only certain limited legend and content requirements.[62] However, the Proposing Release explicitly solicits comment on whether the Commission should propose additional manner and content restrictions for general solicitation materials, particularly those used by private funds, and the Commission indicates that "further consideration following experience with offerings under new Rule 506(c) is needed with respect to potential content restrictions for issuers' general solicitation materials."[63]

Proposed new Rule 509 would establish (a) a legend requirement for all written[64] general solicitation materials used in a Rule 506(c) offering and (b) additional disclosure requirements for general solicitation materials used by private funds that include performance

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Division of Corporation Finance Compliance and Disclosure Interpretations, Question 115.02 (July 3, 2008) (omission of management's report on internal control over financial reporting renders Form 10-K "materially deficient"), available at http://www.sec.gov/divisions/corpfin/guidance/safinterp.htm.

[61] Most recently, for example, the Commission staff indicated that it may question an issuer's status as an emerging growth company "if it appears that the issuer or its parent is engaging in a transaction for the purpose of converting a non-emerging growth company into an emerging growth company, or for the purpose of obtaining the benefits of emerging growth company status indirectly when it is not entitled to do so directly." JOBS Act Frequently Asked Questions, Generally Applicable Questions on Title I of the JOBS Act, Question 53 (Sept. 28, 2012), available at http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

[62] See Proposing Release, at 63-64.

[63] Id.

[64] The term "written communication" is not defined in the proposed rules; the definition in Rule 405 under the Securities Act should therefore apply: "Except as otherwise specifically provided or the context otherwise requires, a *written communication* is any communication that is written, printed, a radio or television broadcast, or a graphic communication as defined in this section."

data. The proposed rules would disqualify an issuer from relying on any Rule 506 exemption if it or any of its predecessors or affiliates have been enjoined by a court for failure to comply with Rule 509.

The legend for all general solicitation materials would require an issuer to disclose 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;[65]
- the securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act;
- the Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials;
- the securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and
- investing in securities involves risk, and investors should be able to bear the loss of their investment.

Private fund legends would also need to disclose that the securities being offered are not subject to the protections of the 1940 Act. In addition, if private fund materials include performance data, the data would be required to be as of the most recent practical date, and certain other disclosure about the data would be required, including certain limitations on the usefulness of the data.

The proposal does not address the use of legends in communications where they might not be readily practicable, such as in certain forms of social media, for example. The proposal also does not address how failures to include legends, including for inadvertent general solicitation, might be remedied. Registration statements filed prior to or concurrently with a Rule 506(c) offering could also constitute general solicitation and thus technically require the inclusion of the proposed legend, which presumably is not intended. A possible solution for all these situations would be to permit an issuer to comply with the legending requirement by sending potential investors in the Rule 506(c) offering a separate notice containing the Rule 509 legends, similar to that permitted by Rule 155.[66]

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[65] This part of the legend would be modified if more stringent requirements are applicable to purchasers in a particular offering.

[66] Rule 155(c) under the Securities Act provides that an abandoned registered offering (deemed to involve general solicitation) will not be integrated with a subsequent private offering if, among other things, the issuer notifies each offeree in the private offering that (i) the offering is not registered, (ii) the securities will be restricted securities, (iii) purchasers in the offering will not have Securities Act Section 11 protection and (iv) a registration statement was filed and withdrawn, with the effective date of the withdrawal. See Rule 155(c)(4).

Rule 510T: Submission of Solicitation Materials to the SEC

Proposed new Rule 510T would temporarily require all issuers that use written[67] general solicitation materials in Rule 506(c) offerings to submit those materials to the Commission no later than the date of first use. As proposed, the rule would expire two years after its effective date. The Commission explained in the Proposing Release that the rule would facilitate the Commission's ability to assess developing market practices with respect to solicitation materials. These materials would not be filed via EDGAR or otherwise made public and would not be treated as being "filed" or "furnished" for purposes of the Securities Act or Exchange Act, including the liability provisions of those Acts. (It is unclear, however, whether those materials could still potentially be obtained from the Commission pursuant to the Freedom of Information Act (FOIA).)

To allow the Commission to assess market developments prior to the adoption of proposed Rule 510T, the submission page will be open upon the effectiveness of Rule 506(c) for the voluntary submission of written solicitation materials used in Rule 506(c) offerings until Rule 510T is adopted.

As for Rule 509, the proposed rules would disqualify an issuer from relying on any Rule 506 exemption if it or any of its predecessors or affiliates have been enjoined by a court for failure to comply with Rule 510T.

Rule 510T does not address how failures to submit materials, including for inadvertent general solicitation, could be remedied, but presumably the materials could be submitted when the failure becomes known to the issuer.

Rule 156: Antifraud Provision for Sales Literature Extended to Private Funds

The Commission has proposed to amend Rule 156 under the Securities Act—which prohibits the use of materially misleading sales literature by registered investment funds—to include sales literature used by private funds. This change to Rule 156 does not create a right of action that otherwise did not already exist under the Securities Act.[68] If this change is adopted, private funds and their agents would want to ensure that their compliance frameworks adequately cover all of the materials covered by the rule, which include internal communications that may reasonably be expected to be communicated to prospective investors (*e.g.*, scripts for investor calls) and communications designed to be used in either written or oral form.[69]

[67] As for Rule 509, the Rule 405 definition of "written communication" should apply.

[68] The adopting release for Rule 156 notes with respect to the anti-fraud provision in Rule 156(a) that "the language of subsection (a) does not supplement or alter any existing applicable legal standards" and that "any unlawful acts referred to in the rule are made unlawful by existing anti-fraud provisions of the Federal securities laws and rules thereunder." Release No. 33-6140 (Oct. 26, 1979), 1979 SEC LEXIS 434, at 5.

[69] See Rule 156(c).

Staff Work Plan

In addition to the new rule proposals, the Commission stated in the Proposing Release that it has directed its staff to undertake a comprehensive work plan to review and analyze market practices resulting from eliminating the prohibition on general solicitation in Rule 506(c) offerings. The staff will:

- examine methods of accredited investor verification used by issuers,
- analyze whether sales to non-accredited investors increase following the effectiveness of Rule 506(c),
- examine the information submitted to the Commission on Form D and any general solicitation materials submitted voluntarily prior to the effectiveness of proposed Rule 510T,
- monitor Rule 506(c) offerings for increased incidence of fraud,
- incorporate an evaluation of Rule 506(c) practices in examinations of registered broker-dealers and registered investment advisers and
- coordinate with state securities regulators on sharing information about Rule 506(c) offerings.

The Commission staff has also begun a review of the definition of accredited investor as it relates to natural persons, and the proposal requests comment on that definition.

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Please feel free to call any of your regular contacts at the Firm or any of our partners and counsel listed under "Capital Markets" or "Corporate Governance" in the Practices section of our website (http://www.clearygottlieb.com) if you have any questions.

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