CLIENT ADVISORY

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SEC Lifts General Solicitation and Advertising Ban in Certain Private Offerings

On July 10, 2013, the Securities and Exchange Commission ("SEC") adopted final rules eliminating a longstanding ban on the use of general solicitations and advertising in private offerings conducted under Rule 506 of Regulation D. Rule 506 is a widely-used safe harbor that allows issuers to offer securities to U.S. investors without registering those securities with the SEC. Under new Rule 506(c), issuers such as privately-held companies, hedge funds and private equity funds will be permitted to advertise private offerings to the public through social media, television and other forms of mass communication. Issuers may alternatively rely on existing Rule 506(b) for private offerings, which will continue to prohibit general solicitations and advertisements. Rule 506(c) takes effect on September 23, 2013.

In addition to adopting Rule 506(c), the SEC separately adopted final rules barring Rule 506 offerings that involve "bad actors" and proposed new rules that would heighten the compliance and disclosure requirements for Rule 506 offerings. This Client Advisory summarizes the SEC's final and proposed changes to Rule 506 and highlights key aspects that issuers will need to consider before advertising their private offerings in reliance on Rule 506(c).

CONDUCTING PRIVATE OFFERINGS UNDER RULE 506(B) AND RULE 506(C)

General Solicitations and Advertising Under Rule 506(c)

Issuers seeking to offer securities to U.S. investors must either register those securities with the SEC or rely on a registration exemption. Under existing Rule 506 – the most widely-used exemption – issuers may raise an unlimited amount of capital through the sale of securities to an unlimited number of "accredited investors" [1] and up to 35 non-accredited investors, provided that the offering does not involve any form of general solicitation or advertising. The SEC has historically interpreted the terms "general solicitation" and "general advertising" very broadly to include advertisements, articles, notices or other communications published or broadcast through publicly available media such as unrestricted websites, newspapers, television or radio.

The Jumpstart Our Business Startups Act of 2012 ("JOBS Act") required the SEC to adopt rules lifting the ban on general solicitation or advertising for Rule 506 offerings. The SEC implemented the JOBS Act mandate by adopting new Rule 506(c) under Regulation D. Once effective, issuers may rely on Rule 506(c) to advertise their private offerings and broadly solicit potential investors if they:

[1] The final rules do not amend the definition of "accredited investor", which includes various institutional investors and natural persons with either a minimum net worth of $1 million (excluding equity in a primary residence) or annual income for two consecutive years exceeding $200,000 ($300,000 jointly with spouse).

- Sell their securities exclusively to accredited investors;
- Take "reasonable steps" to verify that all purchasers are accredited investors; and
- Otherwise comply with applicable provisions of Regulation D, such as restrictions on the transfer of securities.

Issuers may also continue to rely on existing Rule 506(b) when conducting private offerings. Rule 506(b) offerings prohibit the use of general solicitations and advertising, but they are also not subject to Rule 506(c)'s prohibition on sales to non-accredited investors or heightened accredited investor verification requirements (discussed below). Issuer's currently engaged in Rule 506 offerings may elect to continue the offering in accordance with the requirements of either Rule 506(b) or Rule 506(c), once effective. An issuer, however, is precluded from relying on Rule 506(b) once a general solicitation has been made to a purchaser.

The SEC release adopting Rule 506(c) (the "Adopting Release") also amends Form D to require that issuers conducting a Rule 506 offering check a box indicating whether they are relying on Rule 506(b) or Rule 506(c).

Verification of Accredited Investor Status

Pursuant to a JOBS Act directive, Rule 506(c) also requires that issuers take "reasonable steps" to verify that all purchasers are accredited investors. This requirement must be satisfied independently even if all purchasers happen to be accredited investors. Importantly, the Adopting Release unequivocally states that an issuer will not have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, follow only the customary practice under Rule 506 of having purchasers check a box in a questionnaire or sign a form attesting to their accredited investor status. (This customary approach will continue to be viable for private offerings under Rule 506(b) not involving general solicitation or advertising.)

The Adopting Release explains that the reasonableness of an issuer's verification procedures will be an "objective determination" by the issuer (or those acting on its behalf) based on the facts and circumstances for each purchaser and transaction. Nevertheless, the SEC has articulated three interconnected principles to help guide issuers' verification procedures:

1. Nature of Purchaser. Issuers should consider whether purchasers fall under one of the eight enumerated categories of "accredited investor" under Rule 501 of Regulation D, such as a broker-dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act") or a natural person with either a net worth exceeding $1 million (excluding equity in a primary residence) or annual income exceeding $200,000 for two consecutive years. Issuers might be able to verify a broker-dealer's registration status solely by locating it on FINRA's BrokerCheck website. Such verification may be more difficult for natural persons, however, as individuals may have privacy concerns about disclosing documents verifying their net worth and annual salaries. Thus, a determination of what constitutes a "reasonable" verification for certain types of purchasers may depend on the total mix of information available about such purchasers, as discussed below.

2. Available Purchaser Information. Issuers should look to the amount and type of information available for a purchaser when determining such purchaser's accredited investor status. For example, if a purchaser is a named executive officer of an Exchange Act reporting company, his or her

annual compensation will be listed in the company's proxy materials filed publicly on EDGAR. A purchaser's pay stubs for the two most recent years and current year or publicly available information about the average salary of similarly-situated persons at a purchaser's workplace might also reasonably demonstrate such purchaser's accredited investor status. The Adopting Release also contemplates that issuers may be able to reasonably rely on representations made by certain investment companies, brokers, attorneys, accountants and web-based Rule 506 offering portals as to a purchaser's accredited investor status.

3. Nature of Offering. The terms of an issuer's Rule 506(c) offering and the manner in which a purchaser is solicited may also be relevant for verifying accredited investor status. As the Adopting Release notes, an issuer that solicits purchasers through a widely distributed email, social media campaign or newspaper article will likely need to take greater measures to verify accredited investor status than an issuer that solicits purchasers through a third-party "database of pre-screened accredited investors", provided that the issuer has a reasonable basis to rely on that third-party's representations. The Adopting Release also suggests that offering terms, such as a purchaser's ability to meet a high minimum investment threshold may be relevant in assessing such purchaser's accredited investor status.

According to the Adopting Release, the three factors above are intentionally interconnected and flexible. Strong evidence of a purchaser's accredited investor status under one factor may reduce or eliminate an issuer's need to look to the other factors to determine accredited investor status. Regardless, issuer's should retain adequate records of steps taken to verify a purchaser's accredited investor status since the issuer bears the ultimate burden of demonstrating compliance with Rule 506(c).

While the SEC declined to adopt an exclusive list of specific methods for verifying a purchaser's accredited investor status, the Adopting Release lists four specific, non-exclusive steps that will constitute reasonable verification for natural persons (provided that the issuer does not have actual knowledge that the purchaser is a non-accredited investor):

1. For a natural person that is an accredited investor based on income, (a) reviewing copies of any IRS form that reports income (e.g., Forms W-2, 1099, or 1040) for the two most recent years and (b) obtaining a representation from the purchaser that he or she reasonably expects to reach the same or higher income level in the current year;

2. For a natural person that is an accredited investor based on net assets, (a) reviewing one or more of the following types of documents dated within the past three months: (i) for assets: bank statements, brokerage or other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by satisfactory, independent third parties and (ii) for liabilities: a consumer report (i.e., a credit report) from at least one nationwide consumer reporting agency, and (b) obtaining a representation from the purchaser that all liabilities necessary to determine net worth have been disclosed;

3. Obtaining written confirmation from a registered broker-dealer, an SEC registered investment adviser, a licensed attorney (in good standing) or a certified public accountant that such third-party has taken steps to reasonably verify a purchaser's accredited investor status within the past three months and has concluded that such purchaser is an accredited investor; and

4. Obtaining a certification as to accredited investor status from an existing investor of the issuer who previously participated as an accredited investor in a Rule 506 offering that occurred before Rule 506(c) became effective.

"Bad Actor" Disqualification from 506 Offerings

Also on July 10, 2013, the SEC separately adopted new Rules 506(d) and 506(e) under Regulation D. Rule 506(d) prohibits issuers from offering securities in reliance on Rule 506(b) or 506(c) if the issuer (including its predecessors and affiliated issuers) or a covered person has had a "disqualifying event." Covered persons under Rule 506(d) include the issuer's principals (e.g., directors, executive officers, general partners), greater than 20% beneficial owners, promoters, compensated solicitors (including their principals) and investment managers and principals of pooled investment funds. Rule 506(d) will take effect on September 23, 2013.

Under Rule 506(d), a "disqualifying event" includes:

- Criminal convictions, court injunctions and restraining orders within five years of a proposed sale (10 years for non-issuer criminal convictions) in connection with the purchase or sale of securities or false SEC filings;

- Final orders from the Commodity Futures Trading Commission ("CFTC") or federal or state banking, credit union or insurance regulators within 10 years of a proposed sale based on violations of anti-fraud regulations or that otherwise bar certain associations or business activities;

- Receipt of certain SEC disciplinary orders relating to broker-dealers, investment companies, investment advisers and their related persons;

- Receipt of an SEC cease and desist order within five years of a proposed sale for violations of certain anti-fraud provisions or securities registration requirements;

- Suspension or expulsion from a self-regulatory organization; or

- Receipt of an SEC stop order issued within five years of a proposed sale.

Rule 506(d) bad actor disqualifications apply only for disqualifying events that occur after the final rule's effective date. However, new Rule 506(e) requires that issuers disclose in writing to purchasers, in a reasonable time prior to a sale under Rules 506(b) or 506(c), any matter that would have constituted a disqualifying event had it occurred after the effective date of Rule 506(d). Rule 506(d) permits the SEC to waive any disqualifying event upon a showing of good cause and includes a reasonable care exception for issuers who, after reasonable inquiry, did not and could not have known that a covered person with a disqualifying event had participated in the offering. The adopting release also amends Form D to require that issuers sign a signature block certifying that the offering is not subject to a disqualifying event under Rule 506(d).

Proposed Rules – Implications for Rule 506 Offerings

In conjunction with the Rule 506(c) Adopting Release, the SEC also published proposed rules intended to allow the SEC to evaluate the development of market practices for Rule 506(c) offerings (the "Proposed

Rules"). If adopted, the Proposed Rules could significantly affect the way Rule 506(c) offerings are conducted. Specifically, companies and private funds relying on either Rule 506(b) or Rule 506(c) would be subject to the following:

- Advance Filing of Form D for Rule 506(c) Offerings. Currently, issuers that conduct Rule 506 offerings must file a Form D within 15 calendar days of the first sale of securities in that offering. The Proposed Rules would require that, in addition to the current Form D filing requirement, issuers intending to rely on Rule 506(c) file a Form D at least 15 calendar days before engaging in general solicitation or general advertising. The SEC anticipates that issuers will be allowed to file an advance Form D without contemplating a specific 506 offering, so that they may have the flexibility to engage in general solicitations once they begin offering securities. However, an issuer that checks the box for Rule 506(c) on Form D and engages in general solicitations may not subsequently amend a Form D to rely on Rule 506(b).

- Form D Closing Amendments for Rule 506 Offerings. The Proposed Rules would require that issuers in both Rule 506(b) and Rule 506(c) offerings file a final Form D amendment within 30 calendar days of the termination of an offering. Termination would occur after the final sale of securities in the offering or upon the issuer's determination to end the offering.

- Additional Form D Disclosure Requirements. The Proposed Rules would also amend Form D to require issuers to disclose various additional information not currently required in Form D, including:

    - If the issuer conducts a Rule 506(c) offering, the types of methods used or to be used to verify a purchaser's accredited investor status;

    - The types of communications used to publicly advertise and solicit purchasers (e.g., email, public websites, social media, print media, broadcast media);

    - A breakdown of the issuer's use of proceeds from the offering through the checking of applicable boxes (e.g., working capital);

    - If the issuer used a broker-dealer, whether any general solicitation materials were filed with FINRA; and

    - For pooled investment vehicles, the name and SEC file number for each investment adviser who acted as a promoter of the issuer.

- Disqualification for Untimely Form D Filings. In a potentially significant departure from current law, the Proposed Rules would disqualify an issuer from engaging in Rule 506 offerings for one year if the issuer (including its predecessor and affiliates) has failed to make timely Form D filings within the past five years, including the failure to file an initial Form D or an amendment required under Rule 503 of Regulation D. The one-year ban would commence after all required Form D filings are made. Importantly, the disqualification would only apply prospectively for Rule 506 offerings that commence after the Proposed Rules take effect (i.e., the five-year look-back period will not apply retroactively). Under the proposed rules, issuers would also be able to rely on a 30-day cure period for a late Form D filing and apply for waivers from the SEC.

- Disclosures Regarding General Solicitation Materials. The Proposed Rules would also require that issuers include various legends on all general solicitation materials distributed to potential purchasers in a Rule 506(c) offering regarding risks relating to an investment in unregistered securities. Private funds would also be subject to enhanced disclosures on their general solicitation materials, as discussed below.

- Submit Written General Solicitation Materials to the SEC. The Proposed Rules would temporarily require that issuers file privately with the SEC all general solicitation materials with the SEC prior to their first use. As proposed, this temporary rule would expire after two years, but in connection with a staff review of Rule 506(c) practices that the SEC announced on July 10, 2013, the SEC may conclude that such filings should continue indefinitely.

SPECIFIC ISSUES FOR PRIVATE FUNDS, ADVISERS AND BROKER-DEALERS

Private funds such as hedge funds, venture capital funds and private equity funds typically issue securities in reliance on the Rule 506 safe harbor in order to avoid Securities Act registration. These funds generally seek to avoid registration under the Investment Company Act of 1940 (the "1940 Act") as well by relying on exclusions from the definition of "investment company" under Section 3(c)(1) or 3(c)(7) of the 1940 Act. In addition to restricting which or how many investors private funds may sell to in reliance on these exemptions, both Section 3(c)(1) and 3(c)(7) prohibit private funds from publicly offering their securities. The Adopting Release clarifies that private funds may rely on Rule 506(c) to publicly advertise and solicit purchasers for their securities without losing either exemption under the 1940 Act.

In addition to the legends that the Proposed Rules would require for general solicitation materials in all Rule 506(c) offerings, the Proposed Rules would also require that private funds relying on either the Section 3(c)(1) or 3(c)(7) exemption under the 1940 Act include the following additional disclosures in general solicitation materials advertising their performance data:

- Performance data represents past performance and may not guarantee future results;
- Current performance may be lower or higher than the performance data presented;
- The private fund is not required by law to follow any standard methodology when calculating and representing performance data; and
- Performance of the fund may not be directly comparable to the performance of other private or registered funds.

The Proposed Rules would also require that private funds disclose performance data as of the most recent practicable date (considering the type of private fund and the media through which the data will be conveyed), disclose the period for which performance is being presented and disclose where the performance data reflects deductions for fees and expenses. Rule 156 under the Securities act provides guidance to registered investment companies on when their sales materials would violate the anti-fraud provisions of the U.S. securities laws. The Proposed Rules would extend Rule 156 to all sales literature of private funds relying on either the Section 3(c)(1) or 3(c)(7) exemption.

The Adopting Release states that investment advisers to private funds remain subject to the antifraud provisions of the Investment Advisers Act of 1940. Accordingly, investment advisers to private funds

engaging in general solicitation under Rule 506(c) should carefully review their policies and procedures regarding the treatment of private fund advertisements and sales literature to reasonably protect against the dissemination of fraudulent or materially false private fund sales materials. The Adopting Release also notes that broker-dealers will continue to be subject to FINRA rules governing broker communications with the public when intermediating Rule 506(c) transactions. Among other things, these FINRA rules require that broker communications with prospective purchasers be fair, balanced and not misleading and that brokers file with FINRA prior to first use any communications that will be disseminated to more than 25 retail investors during any 30-day period.

RE-SALES OF UNREGISTERED SECURITIES UNDER RULE 144A

The Adopting Release also amends Rule 144A of the Securities Act. Persons other than issuers, underwriters and dealers that want to sell securities offered in a private placement ("Restricted Securities") must register such Restricted Securities or rely on an exemption. Rule 144A under the Securities Act provides a safe harbor from the definition of "underwriter" for persons who sell Restricted Securities exclusively to "qualified institutional buyers", or "QIBs". Under revised Rule 144A(d)(1) under the Securities Act, such sellers may publicly advertise and solicit the sale of Restricted Securities to persons other than QIBs, provided that the Restricted Securities are sold only to QIBs or persons the seller reasonably believes to be QIBs.

FINAL THOUGHTS

Rule 506(c) should improve issuer capital raising efforts by increasing access to accredited investors through targeted social media campaigns, television ads and other advertising outlets. However, the SEC's new rules will likely also increase issuers' compliance costs, as issuers relying on Rule 506(c) will have to implement due diligence and recordkeeping procedures to verify each purchaser's "accredited investor" status and that their principals and affiliates are not "bad actors." For example, we expect that many issuers will incorporate into questionnaires for prospective and existing directors and executives questions intended to confirm that the director or executive has not had a "disqualifying event" as defined in Rule 506(d). We will continue to provide updates and analysis as changes to Rule 506 develop.

This advisory was prepared by the Emerging Companies Group at Nutter McClennen & Fish LLP. For more information, please contact Alex Glovsky, Michelle Basil or your Nutter attorney at 617-439-2000.

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