

Client Alert

July 2013

SEC Proposes Additional Limitations on Private Placement Marketing

At an open meeting on July 10, 2013, the Securities and Exchange Commission (Commission) adopted a comprehensive set of measures that fundamentally change the manner in which businesses are permitted to raise capital through the private placement markets. As described in our [companion alert](#), the Commission (1) adopted rules to permit issuers to use general solicitation and public advertising to reach accredited investors who may wish to invest in certain nonpublic securities offerings under Rules 506(c) and 144A of the Securities Act of 1933 (the Securities Act) and (2) barred certain “bad actors” from participating in Rule 506 offerings on a going-forward basis. Additionally, at the open meeting the Commission proposed new rules intended to enable the agency to better monitor how the general solicitation private placement market develops and to provide additional protections to investors participating in offerings made on the basis of general solicitation. The proposed rules will be open for public comment until September 23, 2013.

Additional Disclosure Proposals

Throughout the July 10 opening meeting, several commissioners and members of the SEC senior staff noted the Commission’s general lack of visibility into the private placement market and expressed concern that an increase in the use of general advertising may also lead to increased incidence of fraud or other unscrupulous behavior. Accordingly, the Commission voted to propose an additional package of measures that, if subsequently adopted, would allow for greater SEC monitoring of the Rule 506(c) market and provide investors with increased disclosure about the risks attendant with investing in private placements. Importantly, some of the proposed measures would impact any Rule 506 offering.

Under the Commission’s proposing release¹ (the Proposing Release), the Commission proposed to:

- amend Rule 503 of Regulation D to require: (i) the filing of a Form D no later than 15 calendar days in advance of the first use of general solicitation in a Rule 506(c) offering, and (ii) the filing of a closing Form D amendment within 30 calendar days after the termination of any Rule 506 offering;
- amend Form D to require additional information concerning all offerings conducted in reliance on Rule 506, such as identifying the types of accredited investors participating in the offering along with including information specific to Rule 506(c) offerings, such as the types of general solicitation used and the methods used to verify the accredited investor status of purchasers; and
- amend Rule 507 of Regulation D to disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with all Form D filing requirements in a Rule 506 offering, subject to a 30-day cure

¹ The full text of the Proposing Release is available at: <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>.

period.²

Proposed Legends

Additionally, the Commission proposed a new Rule 509 that would require issuers to include prescribed legends in any written communication that constitutes a general solicitation in any Rule 506(c) offering. Under proposed Rule 509, all issuers relying on Rule 506(c) would be required to include some version of each of the following legends prominently in all written general solicitation materials:

- 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;
- 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 investment funds (such as hedge funds, venture capital funds and private equity funds) would also be required to place a legend on written general solicitation materials noting that the securities offered are not subject to the protections of the Investment Company Act of 1940. Further, any private funds that make written general solicitations including performance data must also include a legend disclosing that:

- performance data represents past performance;
- past performance does 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
- the performance of the fund may not be directly comparable to the performance of other private or registered funds.

The proposed rule would require the legend to identify either a telephone number or a website where investors may obtain current performance data. The proposal also would require that any performance data be of the most recent practicable date considering the type of private fund and the media through which the data will be conveyed. The proposed rules would also require private funds that include performance data that does not reflect the deduction of fees and expenses in their written general

² Currently, the filing of a Form D is not a condition to complying with Regulation D, and many issuers choose not to make the filing for various reasons, especially since there are no meaningful consequences for failing to file a Form D. If Rule 507 is amended as proposed, this would be a significant policy change by the Commission. In particular, disqualifying an issuer from relying on Rule 506 due to a failure of an “affiliate” to comply with a Form D filing requirement may have broad implications for larger institutions.

solicitation materials to disclose that fees and expenses have not been deducted, and that if such fees and expenses had been deducted, performance may be lower than presented. Under proposed Rule 509, an issuer would be disqualified from relying on Rule 506 for future offerings if the issuer has been subject to any order, judgment or court decree enjoining it for failure to comply with proposed Rule 509. As part of its efforts to solicit comment on the legend proposal, the SEC questioned whether other types of issuers should also be subject to the legend or other disclosure requirements, and specifically singled out nontraded REITs as issuers that could be included.

Advertising by Private Investment Funds

Furthermore, the Proposing Release seeks to amend Rule 156 to apply guidance contained in the rule to sales literature for private investment funds. Rule 156 provides guidance on the types of information in sales literature for registered investment companies that could be deemed misleading under the antifraud provisions of the federal securities laws. This proposal seems responsive to concerns raised by some registered mutual funds that they would be placed at a competitive disadvantage if private investment funds were permitted to advertise publicly without being held to the same disclosure standards. Relatedly, the Proposing Release also seeks comment on whether additional manner and content restrictions on written general solicitation materials used by private funds are appropriate.

Submission of Materials to SEC

The Commission also proposed Rule 510T to require issuers, on a temporary basis, to submit any written general solicitation materials used in Rule 506(c) offerings to the Commission no later than the date of the first use of these materials. These materials would be required to be submitted through the Commission's website on a nonpublic basis and not via the EDGAR system. Under proposed Rule 510T, an issuer would be disqualified from relying on Rule 506 for future offerings if the issuer has been subject to any order, judgment or court decree enjoining such person for failure to comply with proposed Rule 510T. The proposed rule would expire two years after its effective date.

Seeking Comment on New Accredited Investor Standard

Finally, the Proposing Release seeks comment on the definition of accredited investor as it relates to natural persons as part of a broader review of the issue. Under the current definition, a natural person is accredited if he or she has (i) an individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person or (ii) income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. The dollar amounts in the current definition have not been amended or inflation-adjusted since the thresholds were first set in 1982, and the SEC could consider increasing those thresholds if it determines that the dollar amounts are no longer a reliable proxy for high net worth and financial sophistication, as some consumer advocates have argued. Section 413 of the Dodd-Frank Act limits the ability of the SEC to amend the net worth component of the accredited investor definition before July 2014.

The Commission voted to propose these rules by a 3-2 vote, with Commissioners Paredes and Gallagher dissenting. The dissenting commissioners expressed concerns that the package of proposed measures would unduly burden issuers and could chill the nascent Rule 506(c) market in a manner inconsistent with the general objectives of the JOBS Act.

The Commission's "Work Plan" to Monitor the New Market

At the SEC open meeting, several SEC speakers commented on the establishment of a "Work Plan" to undertake a broader effort to review and analyze the new Rule 506(c) market. The Work Plan is described in the Proposing Release and would involve lawyers, economists, examiners and other SEC personnel from multiple Commission offices and divisions, including the Division of Enforcement. Under the Work Plan, SEC staff will:

- evaluate the range of purchaser verification practices used by issuers and other participants in Rule 506(c) offerings, including whether verification practices are excluding or identifying nonaccredited investors;
- evaluate whether the absence of the prohibition against general solicitation has been accompanied by an increase in sales to nonaccredited investors;
- assess whether the availability of Rule 506(c) has facilitated new capital formation or has shifted capital formation from registered offerings and unregistered non-Rule 506(c) offerings to Rule 506(c) offerings;
- examine the information submitted or available to the Commission on Rule 506(c) offerings, including the information in Form D filings and the form and content of written general solicitation materials submitted to the Commission;
- monitor the market for Rule 506(c) offerings for increased incidence of fraud and develop risk characteristics regarding the types of market participants that conduct or participate in Rule 506(c) offerings and the types of investors targeted in these offerings, to assist with this effort;
- incorporate an evaluation of the practices in Rule 506(c) offerings in the staff's examinations of registered broker-dealers and registered investment advisers; and
- coordinate with state securities regulators on sharing information about Rule 506(c) offerings.

Conclusion

While the Rule 506(c) and bad actor amendments will take effect on September 23, 2013, the rules described in the Proposing Release are still subject to a public comment period and will require further deliberation and action before their adoption, should the SEC determine to move forward with them. Thus, the final rules adopted in July will be in place for some time before the accompanying proposals may take effect, if at all. While it is always difficult to predict the future actions of the SEC, it appears there is some momentum for adopting some set of the measures described in the Proposing Release. Thus, in the future issuers may indeed be subject to more burdens in conducting Rule 506(c) offerings than they will be subject to at the time the rules first become effective.

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