HUNTON& WILLIAMS

Client Alert

July 2013

SEC Adopts Significant Changes to Private Placement Rules

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. First, the Commission adopted rules required by the Jumpstart Our Business Startups Act (JOBS Act) 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 and 144A of the Securities Act of 1933, as amended (the Securities Act). Second, the Commission adopted rules required under the Dodd-Frank Act that will disqualify certain "bad actors" from participating in Rule 506 offerings on a going-forward basis. As described in our companion alert, at the open meeting the Commission also proposed new rules that could limit private placement marketing. The newly adopted rules will take effect on September 23, 2013.

Lifting the Ban on General Solicitation

At the July open meeting, as required under Section 201(a)(1) of the JOBS Act, the Commission created a new Rule 506(c)[1] that (1) permits general solicitation for securities offerings so long as all purchasers of securities are accredited investors and (2) requires that issuers in Rule 506(c) offerings take "reasonable steps to verify" that the purchasers of the securities are indeed accredited investors.

The requirement that issuers take "reasonable steps to verify" that purchasers of the offered securities are accredited investors is independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers are accredited investors. Whether the steps taken are "reasonable" will be an objective determination by the issuer, or its verification service provider, in the context of the particular facts and circumstances of each purchaser and transaction and should include the considerations set forth below.

- Nature of the Purchaser. The definition of "accredited investor" in Rule 501(a) includes natural persons and entities that come, or that the issuer reasonably believes come, within any of eight enumerated categories at the time of the sale of securities, and include a natural person's net worth and certain relationships with the issuer. The steps that will be reasonable to verify whether a purchaser is an accredited investor will vary depending on the type of accredited investor that the purchaser claims to be.

- Amount and Type of Information that the Issuer Has About the Purchaser. An issuer should consider the amount and type of information it has about a purchaser. Examples of information that issuers could review or rely upon include: publicly available information in filings with a federal, state or local regulatory body; third-party information that provides reasonably reliable evidence that a person falls within one of the enumerated categories in the accredited investor definition; or verification of a person's status as an accredited investor by a third party, provided that the issuer has a reasonable basis to rely on such third-party verification.

[1] The full text of the adopting release is available at http://www.sec.gov/rules/final/2013/33-9415.pdf.

- The Nature of the Offering. An issuer should consider the manner in which the purchaser was solicited to participate in the offering. An issuer that solicits new investors through a website accessible to the general public, through a widely disseminated email or through print media will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of prescreened accredited investors, created and maintained by a reasonably reliable third party. An issuer will be entitled to rely on a third party that has verified a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on such third-party verification.

- Terms of the Offering. An issuer should also consider the terms of the offering, such as a minimum investment amount. A purchaser's ability to meet a high minimum investment amount could be a relevant factor to the issuer's evaluation of the types of steps that would be reasonable to take in order to verify that purchaser's status as an accredited investor.

After consideration of the facts and circumstances of the purchaser and of the transaction, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status. Conversely, the less likely it appears that a purchaser qualifies as an accredited investor, the more steps the issuer would have to take to verify accredited investor status. Regardless of the particular steps taken, because the issuer has the burden of demonstrating that its offering is entitled to an exemption from the registration requirements of the Securities Act, it is important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor.

Final Rule 506(c) also includes four specific nonexclusive "safe harbor" methods of verifying accredited investor status for natural persons that, if used, are deemed to satisfy the verification requirement in Rule 506(c).[2] This nonexclusive list of verification methods is as follows:

- if verifying on the basis of income, by reviewing copies of any Internal Revenue Service form that reports income (such as a Form W-2) for the two most recent years and a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

- in verifying on the basis of net worth, by reviewing one or more of the following, dated within the prior three months:

    - for income: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and

    - for liabilities: a credit report from at least one of the nationwide consumer reporting agencies and a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed;

- by obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant that such person or entity within the prior three months has taken reasonable steps to verify that the purchaser is an accredited investor and has determined that such purchaser is an accredited investor; and

- solely for an existing investor who was an accredited investor in a Rule 506(b) offering prior to the effective date of Rule 506(c) and continues to hold such securities, by obtaining a self-certification at the time of sale that he or she is an accredited investor.

[2] None of the methods will be deemed to satisfy the verification requirement if the issuer or its agent has knowledge that the purchaser is not an accredited investor.

If a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, the issuer will generally not lose the ability to rely on Rule 506(c) for that offering if the issuer (1) took reasonable steps to verify that the purchaser was an accredited investor and (2) had a reasonable belief that such purchaser was an accredited investor at the time of sale.

For an ongoing offering under Rule 506 that commences before Rule 506(c) becomes effective, the issuer may choose to continue the offering after the effective date in accordance with the requirements of either Rule 506(b) or Rule 506(c). If an issuer chooses to continue the offering in accordance with the requirements of Rule 506(c), any general solicitation that occurs after the effective date will not affect the exempt status of offers and sales of securities that occurred prior to the effective date in reliance on Rule 506(b).

An issuer offering or selling securities without registration under the Securities Act in reliance on Rule 504, 505 or 506 must file a Form D with the Commission for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering. Among other technical corrections, Form D will now include a new check box for issuers conducting Rule 506(c) offerings to indicate that they are relying on the Rule 506(c) exemption.

Amendments to Rule 144A

As required by the JOBS Act, the Commission also revised Rule 144A(d)(1) to provide that securities sold pursuant to Rule 144A may be offered to persons other than qualified institutional buyers (QIBs), including by means of general solicitation, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believes is a QIB.

For an ongoing Rule 144A offering that commences before the amendment to Rule 144A(d)(1) becomes effective, offering participants will be entitled to conduct the portion of the offering following the effective date of the amendment to Rule 144A(d)(1) using general solicitation, without affecting the availability of Rule 144A for the portion of the offering that occurred prior to the effective date of the amended rule.

The Commission's adopting release also makes clear that the use of general solicitation in a Rule 506(c) or Rule 144A offering will not constitute "directed selling efforts" under Regulation S for offerings made outside the United States.

Bad Actor Disqualification

At the July 10 open meeting, as required by Section 926 of the Dodd-Frank Act, the SEC adopted new Rule 506(d) to remove the protection of the Rule 506 safe harbor from offerings in which enumerated covered persons, so-called "bad actors," participate. [3]

The disqualification provisions of Rule 506(d)(1) apply to the following "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;

[3] The full text of the adopting release is available at http://www.sec.gov/rules/final/2013/33-9414.pdf.

- any promoter (as defined in Rule 405) connected with the issuer in any capacity at the time of sale;

- any investment manager to an issuer that is a pooled investment fund;

- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering (a "compensated solicitor");

- any general partner or managing member of any such investment manager or compensated solicitor; or

- any director, executive officer or other officer participating in the offering of any such investment manager or compensated solicitor or general partner or managing member of such investment manager of compensated solicitor.

Rule 506(d)(3) provides that the disqualification provisions do not apply to events that predate the affiliate relationship if the affiliated entity is not (i) in control of the issuer or (ii) under the common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

The covered persons in Rule 506(d)(1) are generally consistent with those in the proposed version of the rule, but there are three key differences. First, instead of covering all officers of the issuer and of any compensated solicitors, the rule is limited to executive officers and officers who participate in the offering. The officers participating in an offering will be a question of fact. Participation is more than transitory or incidental involvement, but could include activities such as participating in due diligence activities, involvement in the preparation of the disclosure documents, or communication with offering participants. Second, rather than covering beneficial owners of 10 percent or more of any class of the issuer's securities, the rule covers beneficial owners of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power. While there is no specific definition of "voting securities," the Commission intends the term be applied based on whether securityholders have the ability to control or significantly influence the management and policies of the issuer through the exercise of a voting right. Third, for issuers that are pooled investment funds, the rule covers the funds' investment managers and their principals.

The final rule includes eight categories of disqualifying events:

- criminal convictions (1) in connection with the purchase or sale of a security, (2) involving the making of a false filing with the SEC or (3) arising out of the conduct of the business of an underwriter, broker, dealer, investment adviser or paid solicitor;

- court injunctions and restraining orders against engaging in or continuing conduct or practices (1) in connection with the purchase or sale of a security, (2) involving the making of a false filing with the SEC or (3) arising out of the conduct of the business of an underwriter, broker, dealer, investment adviser or paid solicitor;

- final orders from the Commodity Futures Trading Commission, federal banking agencies, the National Credit Union Administration or state regulators of securities, insurance, banking, savings associations or credit unions that (1) bar a person from engaging in securities, insurance, banking, saving association or credit union activities, or from association with an entity regulated by the regulator issuing the order, or (2) are based on a violation of any law or regulation prohibiting fraudulent, manipulative or deceptive conduct;

- certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons;

- SEC cease-and-desist orders related to violations of scienter-based antifraud violations and violations of Section 5 of the Securities Act;
- SEC stop orders and orders suspending the Regulation A exemption;
- suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member; and
- US Postal Service false representation orders issued within five years before the proposed sale of securities.

Rule 506(d)(2)(iv) creates an exception from disqualification for offerings where the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of another covered person. In order to rely on the reasonable care exception, the issuer would need to conduct a factual inquiry, the nature and scope of which would vary based on the particular facts and circumstances. If the issuer is given reason to question the veracity of the responses to its inquiries, then reasonable care would require the issuer to take further steps to provide a reasonable level of assurance that no disqualifications apply.

Rule 506(d)(2)(i) provides that disqualification will not arise as a result of triggering events that occurred before the effective date of the final rule amendments. However, Rule 506(e) requires written disclosure to investors of matters that would have triggered disqualification, except that they occurred before the effective date of the new disqualification provisions. Issuers should give reasonable prominence to the disclosure to ensure that information about preexisting bad actor events is appropriately presented in the total mix of information available to investors. If disclosure is required and not adequately provided to an investor, Rule 508 relief for insignificant deviations from Rule 506 will be unavailable. For Rule 508 to apply, the failure to comply with a Regulation D requirement must not pertain to a term, condition or requirement directly intended to protect that offeree or purchaser, and, therefore, this condition of Rule 508 cannot be met where the required disclosure is not provided. Failure to furnish the required disclosure on a timely basis will not prevent an issuer from relying on Rule 506, if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, of the existence of the undisclosed matter or matters. The disclosure statement required to be furnished to investors is not required to be presented in any particular format and is not required to be filed with the Commission.

The bad actor disqualification provisions of Rule 506(d) and the mandatory disclosure provisions of Rule 506(e) will apply to each sale of securities made in reliance on Rule 506 after the rule amendments go into effect.

Sales of securities made before the applicable effective dates will not be affected by any disqualification or disclosure requirement, even if such sales are part of an offering that continues after the effective date. Only sales made after the effective date of the final rule amendments will be subject to disqualification and mandatory disclosure. Disqualifying events that occur while an offering is underway will be treated in a similar fashion. Sales made before the occurrence of the disqualification trigger will not be affected by it, but sales made afterward will not be entitled to rely on Rule 506 unless the disqualification is waived or removed, or, if the issuer is not aware of a triggering event, the issuer can rely on the reasonable care exception.

Impact of the New Rules

Removal of the ban on general solicitation has the potential to remake the private placement market in a fundamental way by allowing issuers to reach a larger number of potential investors than current fundraising techniques generally allow. Various small businesses have announced their intentions to begin marketing securities in print media, via billboards and on the radio, with others setting their sights on online and social media advertising. One entrepreneur has even suggested he will begin printing T-shirts advertising his securities. Several securities intermediaries have announced plans to launch online platforms for advertising private placements or vetting potential purchasers. And the SEC staff has granted limited no-action relief to two operators of crowdfunding platforms that offer securities only to accredited investors.[4] More of these "accredited crowdfunding" platforms may proliferate in light of the adoption of Rule 506(c).

While the new rules are revolutionary, issuers of securities under Rule 506(c) should bear in mind that all offerings will remain subject to the antifraud provisions of state and federal securities laws. As with any securities offering, marketing materials should continue to present a balanced view of an issuer's business, providing appropriate risk disclosure and generally avoiding puffery or other aggressive statements about an issuer's future prospects. Capturing this balance may prove challenging in 30 seconds of airtime or 140 characters of text.

The amendments to Rule 506 do not alter the statutory private placement exemption found in Section 4(a)(2) of the Securities Act. Most courts and the SEC interpret Section 4(a)(2) to prohibit general solicitation. Historically, an issuer that committed a technical breach of Rule 506 for which Rule 508 relief was not available could nonetheless rely on the statutory private placement exemption found in Section 4(a)(2), but the statutory backup will not be available now to a busted Rule 506(c) offering involving general solicitation. The consequence for an affected issuer is a potential violation of the registration and prospectus delivery requirements of Section 5 of the Securities Act. To avoid this undesirable outcome, issuers should take steps to verify accredited investor status and vet the participation of bad actors in the offering. Doing so will likely require revisions to standard questionnaires and subscription agreements currently in widespread use. It is also advisable that issuers document the procedures they use as part of their vetting and maintain copies of all due diligence records.

While the prospect of marketing an offering to a larger audience will be tempting to many issuers, issuers should be cautious when accepting subscriptions from investors with whom they have no prior relationship. For corporate issuers, purchasers of equity securities in Rule 506(c) offerings will have all the rights of shareholders, including access to certain corporate books and records, and will be owed fiduciary duties by the board and, in some jurisdictions, controlling shareholders. For partnerships and LLCs, investors may have similar rights and may also be owed fiduciary duties. Additionally, potential later-stage investors may be discouraged from investing in an issuer with a capital structure that has been complicated by accepting large numbers of early-stage investors. Although the new rules will require issuers to verify the accredited investor status of all purchasers, issuers may wish to exercise additional due diligence over potential investors to be sure they are the right fit and do not pose undue risk. An issuer's organizational documents may need revision to take into account the admission of minority investors and the changed governance dynamic they present. Private investment funds should also exercise caution that an influx of new investors does not cause them to lose their Section 3(c)(1) exemption under the Investment Company Act (for example, by crossing the 100-investor threshold) or Section 3(c)(7) exemption (for example, by accepting investors who are not "qualified purchasers").

Several commissioners and members of the SEC senior staff have expressed concern that the use of general solicitations could lead to increased incidence of fraud. Along those lines, several consumer advocates and state securities regulators have been especially critical of the SEC's rulemakings. It is clear from statements made at the open meeting and language in the various releases that the SEC will be closely monitoring developments in this new market and will be looking to bring enforcement actions against parties whose conduct violates the law. The SEC's Division of Enforcement recently announced the formation of a task force focused on microcap fraud, which would be well suited to investigating claims of wrongdoing in Rule 506(c) offerings. Several of the states may also be active in pursuing antifraud charges when warranted. It is also likely the plaintiff's bar will see an opportunity to solicit potential clients who claim they have been harmed through investing in a Rule 506(c) offering.

---

[4] See FundersClub Inc. and FundersClub Management LLC (avail. Mar. 26, 2013) and AngelList LLC and AngelList Advisors LLC (avail. Mar. 28, 2013).

Although the new rules will at first be attractive to start-up and smaller businesses that do not have existing relationships with traditional funding sources, issuers of all sizes are eligible to offer securities under Rule 506(c). Over time we may see the development of a hybrid market in which larger issuers conduct Rule 506(c) offerings using a disclosure document very similar to the prospectus required in a registered offering, not unlike current market practice in Rule 144A offerings. Capital-intensive businesses, such as those in the real estate, energy and biotech industries, may also make use of Rule 506(c) offerings to obtain growth capital. Considerable media attention has focused on the ability of hedge funds, private equity funds and other private pools of capital to market their securities through general solicitations. Given the significant minimum investment levels these funds typically require, coupled with other regulatory restrains on their ability to admit investors, it remains to be seen whether such funds will rely heavily on the new rules to source investors.

Contacts

Sean P. Ducharme
sducharme@hunton.com

Susan S. Failla
sfailla@hunton.com

Scott H. Kimpel
skimpel@hunton.com

Scott D. McKinney
smckinney@hunton.com

J. Steven Patterson
spatterson@hunton.com

James S. Seevers, Jr.
jseevers@hunton.com

W. Lake Taylor, Jr.
tlake@hunton.com