SEC Acts To Eliminate Prohibition on General Solicitation and Expand 'Bad Actor' Disqualifications

The Securities and Exchange Commission (SEC) took long-awaited action on July 10, 2013, to finalize and adopt new rules that eliminate the current prohibition against general solicitation and advertising in certain Rule 506 and in Rule 144A securities offerings and expand the bar on "bad actors" from participating in private securities offerings.

In addition, the SEC issued proposed rules that would provide the SEC and the public with additional information where general solicitation and advertising are used in Rule 506 offerings.

Elimination of the Ban on Use of General Solicitation and Advertising

These final rules, first proposed in August 2012, implement the requirements of the Jumpstart Our Business Startups Act (JOBS Act) to eliminate the long-standing prohibition against use of general solicitation and advertising in private offerings. The final rules apply to offerings of securities that are sold only to accredited investors under Rule 506 of Regulation D or to qualified institutional investors (QIBs) under Rule 144A under the Securities Act of 1933. The ability to use general solicitation and advertising under Rule 506 is predicated on the requirement that the issuer take reasonable steps to verify that purchasers of securities are accredited investors. General solicitation and advertising may be used in a Rule 144A offering, provided that securities are sold only to investors whom the seller reasonably believes to be QIBs. There is no limitation on whom the issuer can solicit in the offering.

Acceptable means of soliciting or advertising such an offering will now include virtually any medium, including electronic mail solicitation, direct mail or targeted phone call campaigns, and advertising on the Internet, social media, television, radio, and billboards.

Under revised Rule 506, issuers, including hedge funds and other private equity funds, can use such general solicitation and advertising activities to offer securities, provided that the issuer takes reasonable steps to verify that the investors are accredited investors, and that all actual purchasers are accredited investors (based on specific income and net-worth standards), or the issuer reasonably believes that the investors are accredited investors, at the time of the sale. These verification activities are subject to objective standards.

Rule 506 now contains a non-exclusive list of methods that issuers can use to verify accredited investor status, including:

- Inspecting federal tax forms of the purchaser and obtaining a written representation that the purchaser will likely continue to meet the requisite income test in the current year

- Obtaining written confirmation from a third party – such as a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant – that such third party has taken reasonable steps to verify the purchaser's accredited investor status and has determined that such purchaser is an accredited investor

- For a natural person, reviewing one or more of the following types of documentation, dated within the prior three months, and obtaining a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed:

- For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties is deemed to be satisfactory

- For liabilities: a credit report from at least one of the nationwide consumer reporting agencies is required

- For a natural person who, as an existing investor of the issuer prior to the effective date of these amendments to Rule 506, was determined to be an accredited investor, by obtaining a certification from such person at the time of that sale that he or she continues to qualify as an accredited investor

Securities sold in reliance on Rule 144A can be offered to persons other than QIBs, including through the use of general solicitation, so long as the seller, and any person acting on the seller's behalf, reasonably believes that the only purchasers of the securities are QIBs.

These final rules were approved by a 4-1 vote, with dissenting Commissioner Aguilar stating that the rules lacked sufficient safeguards to protect investors. The final rules will become effective 60 days after publication in the Federal Register.

Disqualification of Bad Actors

The SEC also acted unanimously to implement the requirements of Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to bar felons and other "bad actors" from participating in certain securities offerings. Under the final rule, an issuer may not rely on the Rule 506 exemption for a private offering if the issuer or any other "covered person" subject to the rule has experienced a "disqualifying event." The most noteworthy changes from the proposed rule, issued in May 2011, were:

- The determination to consider only beneficial owners of 20 percent or more of the issuer's voting securities as covered persons, not 10 percent holders as proposed

- The addition of the Commodity Futures Trading Commission (CFTC) to the list of regulators whose regulatory bars and other final orders will trigger disqualification

- The addition of SEC cease-and-desist orders for scienter-based anti-fraud violations and Section 5 violations to the types of final orders triggering disqualification

- The addition of a definition of a "final order" that triggers disqualification

This final rule also will become effective 60 days after publication in the Federal Register.

Covered persons include the issuer, its predecessors and affiliates, its directors and executive officers or other officers participating in the offering, general partners or managing members, beneficial owners of 20 percent or more of the issuer's voting securities, promoters, investment managers and principals of pooled investment funds, and persons compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor.

Disqualifying events include:

- Felony or misdemeanor convictions in the prior 10 years (or five years for issuers) in connection with a securities transaction, the making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries

- Any court orders concerning the foregoing activities

- Final orders from a designated list of regulators, including state securities agencies, federal and state banking regulations, FINRA, and the CFTC that bar the issuer from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or are based on 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 for scienter-based anti-fraud violations and Section 5 registration requirements violations

- SEC stop orders, including orders suspending a Regulation A exemption

- Suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member

- U.S. Postal Service orders against false representations

As adopted, a "final order" is a written directive or declaratory statement issued by a federal or state agency designated in Rule 506(d)(1)(iii) under applicable statutory authority that provides for notice and an opportunity for hearing, which constitutes a final disposition or action by that federal or state agency. The final rule provides an exception from disqualification where the issuer can show that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. Disqualification applies only for disqualifying events that occur after the final rule's effective date. Matters that existed before the effective date and that would otherwise be disqualifying events, however, must be disclosed to investors.

Proposed Rule Covering Rule 506 Offerings Using General Solicitation and Advertising

As a companion to the Rule 506 amendments, the SEC also issued a proposed rule on July 10, 2013, intended to enhance its ability to monitor developments in the private placement market, as well as to address identified concerns about the use of general solicitation and advertising in Rule 506 offerings. The proposed rule, issued without the support of Commissioners Paredes and Gallagher, is subject to a 60-day public comment period.

The proposed rule would amend Regulation D, Form D, and Rule 156 under the Securities Act to:

- Require a pre-offering Form D filing at least 15 calendar days *before* engaging in general solicitation for the offering (as contrasted with the current post-sale filing requirement), with a requirement to amend the filing within 30 days after closing of the offering to update the offering information

- Disqualify, for a one-year period, an issuer from using the Rule 506 exemption if the issuer has failed to comply with the foregoing Form D filing requirements

- Require additional Form D disclosure by issuers using general solicitation and advertising in a Rule 506 offer, including investor-related disclosure, the use of proceeds from the offering, the type of general solicitation and advertising used, and the methods used to verify the accredited investor status of investors

- Add legends and cautionary statements to any written general solicitation materials

- Require issuers to submit written general solicitation materials to the SEC on a non-public basis

- Extend the Rule 156 prohibitions on fraudulent or misleading statements in sales literature of registered investment companies to hedge funds and other private equity funds

Impact of These Rules

The elimination of the ban on general solicitation paves the way for issuers, including hedge funds and other private equity funds, to reach a broad universe of potential new investors through the Internet, television, and newsprint. While issuers will be free to advertise broadly, they may sell only to accredited investors. To ensure they are selling to such investors, issuers should take certain steps now to document reasonable activities they expect to undertake to verify the accredited investor status of purchasers. The proposed rule would add reporting and disclosure obligations. It also would expand Rule 156 prohibitions to the sales literature of private hedge funds and other private equity firms making general solicitations under Rule 506. We will continue to monitor the proposed rule. Finally, the bad actor disqualifications final rule expands such requirements as applicable to all Regulation D offerings.

Members of Ballard Spahr's Securities Group are available to assist clients as they prepare to address these new requirements. Please contact Justin P. Klein at 215.864.8606 or kleinj@ballardspahr.com, Gerald J. Guarcini at 215.864.8625 or guarcini@ballardspahr.com, Mary J. Mullany at 215.864.8631 or mullany@ballardspahr.com, Debbie A. Klis at 301.664.6211 or klisd@ballardspahr.com, Katayun I. Jaffari at 215.864.8475 or jaffarik@ballardspahr.com, Andrew D. McCarthy at 215.864.8337 or mccarthya@ballardspahr.com, or any other member of the Group with whom you work.