Private Offering Reform: Analysis and Implications

July 29, 2013

On July 10, 2013, the SEC adopted amendments to the Regulation D and Rule 144A private-placement safe harbors, as mandated by the JOBS Act of 2012. The amendments, which will become effective on September 23, 2013, will eliminate the prohibition on widespread advertising and other forms of "general solicitation" or "general advertising" in private offerings under Rule 506 of Regulation D of the Securities Act of 1933 or under Rule 144A of the Securities Act of 1933, so long as all purchasers of the securities are reasonably believed to be accredited investors upon taking reasonable steps to verify as much (under Rule 506) or are reasonably believed to be qualified institutional buyers or "QIBs" (under Rule 144A). The amendments, however, did not extend the ability to engage in general solicitation to private placements that are not conducted in reliance on Rule 506 or Rule 144A, such as Section 4(a)(2) of the Securities Act of 1933.

In a companion release, the SEC also adopted amendments to Rule 506 that disqualify issuers from relying on Rule 506 if certain "felons and other bad actors" are participating in the Rule 506 offering, as mandated by the Dodd-Frank Act of 2010. These amendments will become effective at the same date as the above amendments cutting back the general solicitation ban.

Finally, the SEC proposed additional amendments to Regulation D, Form D and Rule 156 under the Securities Act of 1933, which would impose new filing and disclosure requirements on offerings made in reliance on Rule 506. According to the SEC, these amendments are intended to enhance its ability to evaluate the development of market practices in the wake of issuers being permitted to engage in general solicitation in Rule 506 offerings, although two of the SEC's five commissioners opposed proposing the amendments on the grounds that they are inconsistent with the Congressional intent in the JOBS Act to lift certain limitations on general solicitation. Comments on the proposed amendments are due by September 23, 2013.

We issued a summary of the adopted and proposed amendments in our **July 10, 2013 client newsflash**. This memo provides a more detailed examination of these amendments and proposals and their implications.

General solicitation or advertising in Rule 506 and Rule 144A offerings

Rule 506 of Regulation D under the Securities Act of 1933 is a non-exclusive safe harbor that permits the unregistered sale of securities in private placements to "accredited investors" (including individuals with more than $1 million in net worth, excluding primary residence, or with annual income of more than $200,000 in the prior two years and a reasonable expectation of meeting the threshold in the current year, and companies with more than $5 million in assets), subject to certain conditions. Until the effective date of the amendments, one of those conditions is that the issuer is precluded from relying on Regulation D if the issuer or any person acting on its behalf offers or sells the securities using any form of general solicitation or advertising.

Rule 144A under the Securities Act of 1933 is also a non-exclusive safe harbor, permitting the unregistered resale of securities to QIBs (which includes institutions with at least $100 million in investment securities). Until the effective date of the amendments, Rule 144A also precludes general solicitation or advertising in the offering as it contains the condition that the securities be offered only to persons reasonably believed to be QIBs, even if all the purchasers end up being QIBs, and any broad general solicitation or general advertising could be viewed as an offer to all recipients, including non-QIBs.

Industry professionals have long noted that each safe harbor restricts offers, despite the requirement that the purchasers be accredited investors or QIBs. The JOBS Act addressed this asymmetry by directing the SEC to amend its rules to permit general solicitation or general advertising in offerings under either safe harbor, so long as the purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify such status (under Rule 506) or are reasonably believed to be QIBs (under Rule 144A). As a result, the SEC's adoption of these amendments moves the SEC away from regulating offers to regulating only the sale of unregistered securities. Notably, however, these amendments do not extend to private placements not conducted in reliance on Rule 506 or Rule 144A, such as Section 4(a)(2) of the Securities Act of 1933, as we discuss below.

Rule 506 offerings to accredited investors with reasonable verification

The amendments will permit issuers and their designees to make offers to non-accredited investors, including through widespread advertising and other forms of general solicitation as long as the issuer takes "reasonable steps to verify that purchasers of securities sold in [the offering] are accredited investors." It is important to note that this "reasonable verification" requirement is separate and apart from the requirement that all sales be limited to accredited investors. In other words, reliance on Rule 506's safe harbor is conditioned on satisfying this "reasonable verification" requirement even if all purchasers in the Rule 506 offering are accredited investors.

The amendments generally do not apply to an issuer electing to conduct a Rule 506 offering without utilizing general solicitation or general advertising. In that case, the issuer would not be required to take reasonable steps to verify the accredited investor status of purchasers, but would need to comply with the current requirement that it have a reasonable belief, at the time of sale, that the purchasers are accredited investors.

Reasonable verification. The determination of the reasonableness of the steps taken to verify an accredited investor will be based on the particular facts and circumstances of the purchaser and the transaction. Factors that the issuer may consider include: (i) the nature of the purchaser and the type of accredited investor that the purchase claims to be, (ii) the amount and type of information that the issuer has about the purchaser and (iii) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

The amendments include a non-exclusive list of methods that issuers may use to verify the accredited investor status of natural persons. None of these methods is mandatory. However, an issuer that uses one of the below methods will be deemed to have satisfied the "reasonable verification" requirement, so long as the issuer does not have knowledge that a particular person is not an accredited investor.

- ***On the basis of income.*** To verify that a purchaser is an accredited investor on the basis of income, an issuer may review any IRS form (including Forms W-2, 1099 and 1040 and Schedule K-1 to Form 1065) that reports that the purchaser's income exceeded $200,000 (or that the purchaser had joint income of $300,000 with his or her spouse) for the two most recent years and obtain a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.
- ***On the basis of net worth***. To verify that a purchaser is an accredited investor on the basis of net worth, an issuer may review a number of financial documents for assets (including bank, brokerage and other statements, certificates of deposits, tax assessments and independent appraisal reports) and for liabilities (a consumer report from a nationwide consumer reporting agency). The documents must be dated within the trailing three months. In addition, to satisfy this method, the issuer will need to obtain a written representation from the purchaser that all liabilities necessary to make a determination as to net worth have been disclosed.

- ***Third-party verification***. An issuer may also rely on a third party to verify accredited-investor status by receiving a written confirmation from a registered broker-dealer, a registered investment adviser or a licensed attorney or certified public accountant in good standing to the effect that it, he or she has within the prior three months taken reasonable steps to verify, and has determined, that the purchaser is an accredited investor. In this case, the implication is that the third party may (but need not) rely on any of the above verification methods.
- ***Existing investors***. If any person purchased an issuer's securities in a Rule 506 offering as an accredited investor prior to the effective date of the amendments and continues to hold those securities, then the issuer may verify accredited-investor status by obtaining a certification from that person at the time of sale that he or she qualifies as an accredited investor.

Whether the issuer uses one of these non-exclusive methods or another method, it will be important for the issuer to establish procedures and maintain records that show the "reasonable verification" steps, since the burden will rest with the issuer to prove that this requirement was satisfied.

Form D. Issuers relying on Regulation D's safe harbor are required to file a Form D with the SEC within 15 calendar days after the first sale of securities. The amendments modify Form D to add a separate box for issuers to check if they used general solicitation in a Rule 506 offering. In adopting this modification, the SEC noted that it expected this additional information would assist its efforts in analyzing the use of general solicitation in Rule 506 offerings. That, however, is only the first step toward the SEC's stated goal as we discuss in greater detail below.

Private funds. Despite significant pressure on the SEC from investor rights advocates to prevent private funds from engaging in general solicitation, the SEC included private funds within the scope of the amendments, consistent with the clear statutory language of the JOBS Act. We would expect some private funds to take advantage of the ability to engage in general solicitation in a limited manner. For example, a private fund may place advertisements for offerings in magazines targeting high-net-worth individuals, where many readers (albeit perhaps not all) likely satisfy the accredited investor definition.

However, there are at least a few scenarios in which private funds may refrain from engaging in general solicitation:

- ***3(c)(7) funds***. Private funds relying on Section 3(c)(7) of the Investment Company Act for exemption from registration as an investment company need to ensure that all purchasers are "qualified purchasers" or QPs (which includes any individual with at least $5 million in investments). Given that the QP standard is significantly higher than the accredited investor standard, there are significantly fewer QPs than accredited investors. As a result, for those private funds that rely on Section 3(c)(7) and require that their investors be QPs, the ability to use general solicitation or general solicitation may be of limited utility.
- ***CEA and CFTC rules***. Any private fund manager intending to take advantage of general solicitation or general advertising under Rule 506 should consider whether that offering would render unavailable exemptions it may rely upon under the Commodity Exchange Act and the rules of the Commodity Futures Trading Commission. For example, many private fund managers whose funds trade in commodity interests rely on the *de minimis* exemption from registration as a commodity pool operator. That exemption requires that the interests in such funds not be "marketed to the public in the United States." As such, a manager may not be able to use general solicitation for such a fund and still be able to rely on the *de minimis* exemption
- ***Employee participation***. The amendments did not modify the accredited investor definition and, instead, the SEC sought comment on whether the net worth and income tests set forth in that definition are appropriate, as described below. As a result, funds relying on the exemption in Section 3(c)(7) of the Investment Company Act that wish to offer interests to "knowledgeable

employees" (as defined in the Investment Company Act) who do not also meet the accredited investor definition will be precluded from engaging in general solicitation or general advertising.

As discussed in greater detail below, the proposed amendments to Regulation D would impose additional requirements on private funds if they use general solicitation materials.

Rule 144A offerings to QIBs

The amendments modify Rule 144A by allowing securities sold pursuant to Rule 144A to be offered to persons other than QIBs, including by means of general solicitation or general advertising, so long as the purchasers of the securities are QIBs. Unlike in Rule 506 offerings, there is no requirement of "reasonable verification" of QIB status, although the existing requirement that the seller and any person acting upon its behalf "reasonably believe" that each purchaser is a QIB remains.

No integration with Regulation S offerings

In the amendments, the SEC addressed the issue of concurrent unregistered offerings, one in reliance on Rule 506 or Rule 144A and another in reliance on the SEC's safe harbor set forth in Regulation S for offers and sales in offshore transactions. One condition to rely on Regulation S's safe harbor is that there be no "directed selling efforts," which includes activities that may be seen as conditioning the market in the United States for the securities being sold in reliance on Regulation S. The SEC made it clear that an offshore offering conducted in reliance on Regulation S will not be integrated with a domestic unregistered offering that uses general solicitation or advertising and is otherwise conducted in compliance with Rule 506 or Rule 144A. Therefore, general solicitation or advertising in this context will not constitute impermissible "directed selling efforts" in the Regulation S offering.

Implications

The new general solicitation flexibility will permit companies and their advisers to use the full panoply of advertising tools to find investors in private offerings, including by placing newspaper, Internet or TV ads, so long as the buyers all end up being accredited investors or QIBs.

We see several key implications as a result of the SEC paring back the ban on general solicitation.

Integration no longer relevant when private placements are conducted pursuant to Rule 506 or Rule 144A. As noted above, both Rule 506 and Rule 144A have historically imposed the condition that there be no general solicitation (in the case of Rule 506) or offers to persons that are not QIBs, including by way of general solicitation (in the case of Rule 144A). As a result, a company conducting concurrent offerings, one publicly on a registered basis and another privately pursuant to a private placement exemption, had to consider whether the publicity surrounding the public offering tainted the availability of Rule 506 or Rule 144A – *i.e.*, whether the public and private offerings should be "integrated," which would render the private placement exemption unavailable. If so, the company is left with a choice in the absence of deciding not to go forward with the private offering: either rely on another private placement exemption or register the private offering, neither of which may be a viable alternative.

Issuers and their advisers historically applied various rules, facts-and-circumstances tests and other SEC guidance such as no-action letters to address the integration question. That analysis will no longer be necessary for concurrent offerings, where the private offering is being conducted in reliance on Rule 506 or Rule 144A. As a result, companies will have previously unavailable flexibility to raise capital on a registered basis, a private basis or both, all without needing to consider the SEC's prior guidance as to whether the private and public offerings should be integrated. An issuer will, however, need to consider whether the general solicitation materials implicate the free writing prospectus rules applicable to the concurrent registered offering, which may trigger various legend, filing and other requirements. It should be noted that the integration doctrine will still be relevant for private placements that are not conducted in reliance on Rule 506 or Rule 144A, such as Section 4(a)(2), as discussed below.

Rule 506 offerings to accredited investors. Unlike the Rule 144A market where the identity of QIBs is generally known, smaller issuers relying on Rule 506 for a private offering may now have a much easier time finding accredited investors by virtue of being able to engage in widespread advertising and other forms of general solicitation. We would, in turn, expect this to result in smaller issuers reaching a greater number of potential investors than they could under the current regulatory regime and, therefore, increasing their access to sources of capital. This may particularly be the case where the cost of using general solicitation in a private offering is minimal, such as using the Internet, social media or mass emails to facilitate the general solicitation.

Rule 144A offerings to QIBs. We do not expect issuers relying on Rule 144A to take advantage of the flexibility to use general solicitation to find potential investors who are QIBs. As a general matter, it is the larger and more sophisticated issuers that generally rely on Rule 144A in conducting unregistered offerings. In such offerings, Wall Street-based investment banks are typically engaged and they are generally well aware of which investors meet the QIB definition. However, other changes in market practice may occur:

- ***Press releases***. Rules 135c and 135e are safe harbors on which issuers frequently relied in issuing press releases with limited information about certain proposed unregistered offerings, under Rule 144A. These safe harbors will no longer be needed in Rule 144A offerings, and, as a result, we expect issuers to include the names of the initial purchasers or placements agents in press releases announcing private offerings being conducted in reliance on Rule 144A (which is not currently within the scope of Rule 135c's safe harbor). Issuers and their advisers may also decide to include in press releases other factual information that was previously outside the scope of these safe harbors. The permission to use general solicitation will also assist issuers that inadvertently have generated, or are concerned that they may generate, publicity or granted interviews that previously may have run afoul of SEC rules on publicity.
- ***Foreign Private Issuers and Publicity Restrictions***. Historically, publicity guidelines have been put in place in connection with offerings (particularly equity offerings) by foreign private issuers where there is a Rule 144A placement into the United States. In light of the amendments to Rule 144A and the SEC's view of no integration between a Rule 144A placement and a concurrent Regulation S offering, we expect that guidelines in such transactions will be revised to eliminate portions that were specifically meant to address general solicitation and general advertising concerns. In particular, in addition to relaxation of certain guidelines related to issuance of certain press releases and other offering materials, we expect that the restrictions placed on website postings of such materials to be relaxed. We anticipate that it will not generally be necessary to put press releases relating to the offering and other offering materials behind website firewalls or "click throughs" (which require certain certifications, including as to non-U.S. resident status, before being able to view the press release) as has generally been the practice. However, given continuing potential liability under the anti-fraud provisions of the U.S. securities laws as well as more commercial (and control) considerations, we expect other portions of the traditional guidelines to be retained.
- ***Purchase and placement agent agreements***. Currently, purchase agreements for Rule 144A private placements contain representations and covenants to assure that neither the issuer nor the initial purchasers have conducted any general solicitation or advertising. Going forward, these representations and covenants will no longer be required to establish compliance with Rule 144A. However, we note that, in the context of registered offerings where the rules have been liberalized in recent years to permit broad marketing outside the context of the prospectus, underwriters continue to insist on representations and covenants assuring that no such marketing has occurred without the underwriters' consent in order to maintain a controlled offering process. We expect that initial purchasers and placement agents will take the same approach in Rule 144A purchase agreements and Rule 506 placement agreements.

General solicitation flexibility does not extend to 4(a)(2) offerings

Section 4(a)(2) (formerly 4(2)) of the Securities Act of 1933 exempts from registration “transactions by an issuer not involving any public offering.” Despite the availability of Rule 506 of Regulation D and Rule 144A, issuers frequently rely on Section 4(a)(2) in certain private placements. For example, an issuer may offer securities not only to QIBs in reliance on Rule 144A but also to institutional accredited investors in reliance on Section 4(a)(2) without complying with the requirements of Regulation D (such as the filing of a Form D). However, the adopted amendments make clear that the newfound flexibility to engage in general solicitation for Rule 506 and Rule 144A offerings does not extend to offerings in reliance on Section 4(a)(2), where that offering is being conducted in a manner such that it does *not* otherwise satisfy the requirements of a Rule 506 offering without general solicitation. As a result, private placements conducted in reliance on Section 4(a)(2) will continue to be subject to existing rules and practice, which will prohibit the use of general solicitation or advertising. For foreign private issuers, this means that rights offerings will continue to be subject to the full set of publicity guidelines as disclosed above. In addition, as a practical matter, this means that it will be particularly important for an issuer and its advisers to confirm the exemption from registration being used for a particular transaction before engaging in any general solicitation or advertising.

General solicitation flexibility does not alter anti-fraud prohibitions or FINRA rules

Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 are the provisions that impose liability for fraud under the federal securities laws in unregistered transactions. In particular, Rule 10b-5 prohibits any person from (i) employing “any device, scheme, or artifice to defraud”, (ii) making “any untrue statement of a material fact or [omitting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading” or (iii) engaging “in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”

Issuers and others participating in a Rule 506 or Rule 144A offering will remain subject to these liability provisions. As a result, issuers and their advisers will need to take appropriate measures to ensure that all general solicitation materials are properly reviewed for factual accuracy and completeness before being used.

Broker-dealers participating in a Rule 506 or Rule 144A offering will have the additional burden of complying with applicable rules of FINRA. Most notably, this will include the requirement to comply with FINRA Rule 2210, which sets forth standards for broker-dealer’s communications with retail and institutional investors, including as to content, approval, recordkeeping and filing with FINRA.

Rule 506 disqualification for felons and other bad actors

In a companion release, the SEC adopted amendments to Rule 506 to preclude its availability if the offering involves certain felons or other bad actors, as mandated by the Dodd-Frank Act of 2010. The scope of the disqualification is broad and looks to the bad acts of not just the issuer but also a number of related or affiliated parties, including the issuer’s directors and executive officers, beneficial owners of 20% or more of the issuer’s outstanding voting equity securities and placement agents and their officers and directors. The list of disqualifying events is broad and includes certain securities-related felonies or misdemeanors and other regulatory discipline, such as SEC cease-and-desist orders barring future violations of certain securities laws and certain suspensions from registration with national securities exchanges or national securities associations such as FINRA. Only convictions, orders, suspensions and other triggering events that occur after the effective date of the amendments will be a cause for disqualification, although pre-existing matters that would have been disqualifying events if they had occurred after the effective date of the amendments will be subject to mandatory disclosure.

Given this broad list of disqualifying events and the broad list of covered persons, including officers and directors of placement agents, many SEC settlements may constitute a disqualifying event for which investment banks would need to seek a waiver from the SEC in order to avoid being precluded from relying on Rule 506.

Proposed amendments to Regulation D, Form D and Rule 156

According to the SEC, the proposed amendments are intended to enhance the SEC's "ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to engage in general solicitation and general advertising [in Rule 506 offerings]." To that end, the release seeks public comment on the following proposals:

Four Form D-related proposals

The SEC's proposal would amend Form D and Regulation D as it relates to Form D in the following ways:

- **Pre-offering Form D filings**. Issuers intending to conduct a Rule 506 offering in which general solicitation would be used would be required to file an "Advance Form D" no later than 15 calendar days before the first use of general solicitation or advertising. Regulation D currently requires only a post-sale Form D filing within 15 calendar days after the first sale of securities. The SEC stated that the purpose of the pre-filing requirement is to assist the SEC in evaluating the number of Rule 506 offerings with general solicitation, including issuers that initiated such offerings but were unsuccessful in completing a sale of securities – although the SEC noted that it does not expect to review each Advance Form D filing made.
- **Post-offering Form D filings**. The proposal would also require the issuer to file a Form D closing amendment with the SEC within 30 calendar days after the issuer terminates the Rule 506 offering, regardless of whether general solicitation was used. Until this closing amendment is filed, the SEC's proposed rules would deem the offering to be ongoing, which would mean that the issuer would be required to file periodic amendments to the Form D to keep the information set forth in the Form D current for so long as the offering remains ongoing.
- **Additional information**. Form D would also be modified to require additional information relating to the offering, including information relating to offerings in reliance on Regulation D that do not involve the use of general solicitation. In particular, the revised Form D would require the following in Rule 506 offerings in which general solicitation is being used:
  - the name and address of any person who directly or indirectly controls the issuer (which is in addition to the information currently required for related persons);
  - the number of accredited investors and non-accredited investors that have purchased in the offering, whether they are natural persons or entities and the amount raised from each category of investors (this information would also be required in a Rule 506 offering in which general solicitation was not used);
  - the percentage of the offering proceeds that was or will be used to repurchase existing securities, to pay offering expenses, to acquire assets in the non-ordinary course of business, for working capital and to discharge indebtedness;
  - the types of general solicitation being used (including, for example, mass mailings, emails, public websites, social media, print media and broadcast media); and
  - the methods used to verify accredited investor status.

  Regardless of whether general solicitation is used, the proposals would amend Form D to require, among other information, the identification of the issuer's publicly accessible website (if any), information regarding the issuer's size unless that information is not available to the public (which would replace the "Decline to disclose" box in the current Form D) and, to the extent applicable, the ticker symbol, CUSIP and certain other available identifying information about the securities being offered.

- **Disqualification.** The proposal would also impose significant consequences on an issuer's – or its predecessor's or affiliate's – failure to comply with any Form D filing requirement in a Rule 506 offering by precluding reliance on Rule 506 if the issuer or any such predecessor or affiliate has within the trailing five years failed to comply with that filing requirement. That disqualification would remain in effect until one year after all required Form D filings, including closing amendments, are made for each prior Rule 506 offering.

  The proposed amendments would disregard any failure to make required Form D filings that occurred prior to the effective date of the amendments, but the proposal would apply to all offerings in reliance on Rule 506, not just those in which general solicitation is used.

  Finally, the proposal would provide for a 30-day cure period for an issuer's *first* failure to timely file a Form D or Form D amendment for a particular offering and grant the SEC with authority to waive the disqualification upon a showing of good cause.

Legend requirements

The proposed rules would require all issuers in Rule 506 offerings to include in written general solicitation materials prominent legends to the effect 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;
- the securities are being offered in reliance on an exemption from the registration requirements of the Securities Act of 1933 and are not required to comply with specific disclosure requirements that apply to registered offerings;
- the SEC 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.

The proposal would not disqualify an issuer from conducting a Rule 506 offering for failure to include legends and other required disclosures in any written general solicitation materials. Instead, Rule 506 would be unavailable if any issuer was subject to any order, judgment or court decree enjoining the issuer for failure to include the required legends and other disclosures on the written general solicitation materials. The SEC acknowledged that this treatment would be disproportionate to the disqualification as a result of failure to comply with the Form D filing requirements, but justified this asymmetry by noting that inadvertent errors or omissions or inadvertent failure to comply with these legending requirements could result in disproportionate consequences, particularly given the large amounts of written general solicitation communications issuers may use in a Rule 506 offering.

Mandatory submission of written general solicitation materials to the SEC

The proposal would create a new temporary rule under Regulation D that would expire two years after its effective date. This temporary rule would require an issuer conducting a Rule 506 offering to submit to the SEC on a non-public basis any written general solicitation materials prepared by or on behalf of the issuer and used in the offering, no later than the date of first use.

Compliance with this rule would not be a condition to conduct a Rule 506 offering with general solicitation. Instead, the SEC is proposing that – similar to the consequences for failure to comply with the legending requirement described above – Rule 506 would be unavailable for an issuer that was subject to any order, judgment or court decree enjoining such person for failure to comply with the temporary rule.

Implications

There are a number of key implications of the SEC's proposals:

- ***Advance Form D filings***. This requirement would limit the ability of the issuer to conduct on short notice a Rule 506 offering involving general solicitation or advertising by effectively imposing a 15-day waiting period that begins upon filing of the Advance Form D. SEC comments on the Advance Form D could further delay the offering, although the proposing release seems to indicate that this requirement is being proposed to enhance the SEC's information available about the Rule 506 market, including to be able to assess the extent to which Rule 506 offerings are ultimately unsuccessful. It is worth pointing out that the advance filing requirement would not apply to a Rule 506 offering in which general solicitation is not used, allowing those offerings to continue to be conducted on short notice.
- ***Disqualification***. The definition of "affiliate" under SEC rules is very broad, and includes a person that directly or indirectly controls or is controlled by or is under common control with the specified person. As such, the proposal's disqualification provisions could create significant consequences for an issuer's future capital-raising activities. The SEC acknowledged as much in its release as the basis for including for comment the cure and waiver provisions described above. Even though the interests of issuers and their affiliates are often aligned, it is not uncommon for affiliates to be effectively outside the control of the issuer. It is not hard to imagine many scenarios in which an issuer could find itself unable to take advantage of those cure and waiver provisions and be otherwise disqualified from relying on Rule 506, given an affiliate's failure to comply with the Form D filing requirement and otherwise through no fault of the issuer, particularly for issuers who frequently rely on Rule 506, such as (i) a financial institution or insurance company that has a "Reg D" program for frequent issuances of its own securities in reliance on Rule 506 or (ii) a private fund that is part of a complex of funds with the same sponsor, all of which may have frequent Form D filing obligations.

  The proposed rule also does not address how it would determine that an offering was a Rule 506 offering that did not comply with the Form D filing requirement, as opposed to a private placement in reliance on Section 4(a)(2) for which no Form D filing is required. In other words, the proposed rule leaves open the possibility that an issuer that sells to accredited investors without using general solicitation and does not make the required Form D filing but otherwise conducts the offering as a Rule 506 offering could simply take the position that the offering was exempt in reliance on Section 4(a)(2), such that no Form D filing was required.
- ***Legends***. The proposed forms of legends for Rule 506 offerings involving general solicitation are not dissimilar to legends and other disclaimers now typically found in private placement and other memoranda for private offerings. Issuers engaging in general solicitation may choose to proactively adopt these legending requirements while they remain in the proposal phase.
- ***Requirement to submit general solicitation materials***. The SEC explained that this temporary rule would facilitate the SEC's ability to assess market practice in Rule 506 offerings. However, this submission requirement may have a chilling effect on the new flexibility to engage in general solicitation in Rule 506 offerings. In other words, issuers and others may be discouraged from using general solicitation materials if they know that they have to submit those materials to the SEC.

Private funds

Additional legends. In response to particular concerns expressed by investor protection advocates about private funds and their ability to engage in general solicitation, the SEC's proposed rules would require additional legends and disclosure on written general solicitation materials for private funds to be included in offering materials to the effect that the securities are not subject to the protections of the Investment Company Act. The proposals would also require various disclaimers for written general solicitation materials that include performance data, including that:

- such data represents past performance and does not guarantee future results,
- current performance may be lower than the performance data presented and
- the fund is not required to follow any standard methodology when calculating performance data and, as such, these data may not be directly comparable to other funds' performance data.

The proposed rules would require funds showing performance data in written general solicitation materials that do not reflect the deduction of fees and expenses to disclose in the materials that fees and expenses have not been deducted, with a statement that performance may have been lower than presented if fees and expenses had been deducted.

It is worth noting that the SEC did not propose to supplement the proposed legend requirements with any additional content restrictions on general advertising by private funds, such as mutual fund-like performance-advertising content standards (although the SEC's proposal does solicit comments on whether such standards would be appropriate for private funds using general solicitation). While the proposed legend requirements are not especially burdensome, performance data that is included in general solicitation materials would be required to be "as of the most recent practicable date." Notably, the proposal made clear that, as it relates to performance data, the SEC does not expect a private fund to value its portfolio for the sole purpose of providing current performance information. Further, the SEC indicated that what constitutes current performance information could depend on the type of fund in question (*e.g.*, private equity funds with illiquid assets versus hedge funds with liquid assets).

Rule 156. Rule 156 of the Securities Act of 1933 sets forth the types of information in sales literature by investment companies registered under the Investment Company Act of 1940 that could be misleading for purposes of the federal securities laws, including various provisions imposing liability such as Rule 10b-5 under the Exchange Act. The SEC's proposal would extend Rule 156 to private funds and their sales literature.

Accredited investor definition

The SEC also sought comment on the Regulation D definition of accredited investor but did not go so far as to propose any actual amendments to the definition, which it is not permitted to do under Dodd-Frank until July 2014.

This definition currently includes individuals with a net worth of more than $1 million, excluding primary residence, or with annual income of more than $200,000 in the prior two years and a reasonable expectation of meeting the threshold in the current year, and companies with more than $5 million in assets. However, the definition (including whether to increase the net worth and income thresholds) has been the subject of fairly rigorous debate and numerous regulatory requirements in recent years, including mandated periodic studies pursuant to Dodd-Frank.

To that end, the SEC sought input on, among other things, whether the net worth and income tests are appropriate, whether the thresholds for the net worth and income tests are appropriate and whether it is appropriate to tie those thresholds to fixed dollar amounts. In particular, for the net worth and income tests, the SEC requested comment on whether these tests indicate whether an investor has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of a prospective investment and, if not, what other criteria should be considered as an appropriate test for investment sophistication.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Bruce K. Dallas	**650 752 2022**	**bruce.dallas@davispolk.com**
Alan F. Denenberg	**650 752 2004**	**alan.denenberg@davispolk.com**
Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Michael Kaplan	**212 450 4111**	**michael.kaplan@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Richard J. Sandler	**212 450 4224**	**richard.sandler@davispolk.com**
Richard D. Truesdell, Jr.	**212 450 4674**	**richard.truesdell@davispolk.com**
Martin A. Wellington	**650 752 2018**	**martin.wellington@davispolk.com**
Derek Dostal	**212 450 4322**	**derek.dostal@davispolk.com**