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together

Adopted and Proposed Changes to  
Private Offering Rules

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# Agenda

- Pre-September 23, 2013 Structure for Private Offerings
- JOBS Act
- Revisions to Private Offering Rules
- Bad Actors
- Proposed Additional Changes
- Market Impact

# Pre-9/23/2013 Structure for Private Offerings

- Section 4(a)(2) of the 1933 Act exempts transactions from the registration requirement under Section 5 of the 1933 Act by an issuer that is not involved in any public offering.
  - Rule 506(b) of Regulation D under the 1933 Act is a non-exclusive safe harbor whereby an issuer that meets the Rule 506 conditions will be deemed to fall under the Section 4(a)(2) exemption.
    - *No limit as to dollar amount*
    - *Sales must be only to accredited investors and up to 35 other investors with sufficient knowledge and experience*
    - *No general solicitation or general advertising permitted*

# Pre-9/23/2013 Structure for Private Offerings

- Similarly, Rule 144A provides a non-exclusive safe harbor from the Section 5 registration requirements for re-sales of restricted securities (e.g., securities originating from a non-public offering such as a 4(a)(2) or Reg S offering), so long as offers and sales for such restricted securities are only made to “qualified institutional buyers” and no form of general solicitation or general advertising is used in the U.S.
  - *“Qualified Institutional Buyer” is defined in Rule 144A(a)(1)*
- Rule 144A is often used in initial offerings where an issuer sells to a financial intermediary in a non-public offering and the financial intermediary immediately resells the securities to qualified institutional buyers.

# JOBS Act

- Jumpstart our Business Startups Act (April 5, 2012)
  - Senate: 73-26 (March 22, 2012)
  - House: 380-41 (March 27, 2012)
  - 90<sup>th</sup> day after enactment was July 3, 2012
- Section 201(a)(1) – directed SEC to amend Rule 506
- Section 201(a)(2) – directed SEC to amend Rule 144A

# Revisions to Private Offering Rules

- August 29, 2012 - SEC proposed rule changes that would eliminate the prohibition against general solicitation and general advertising in certain Rule 506 and Rule 144A offerings. (33-9354)
- July 10, 2013 – SEC adopted private offering rule changes as directed by the JOBS Act. (33-9415)
- July 10, 2013 - SEC also adopted “bad actors” disqualification for private placements, as directed by Section 926 of the Dodd-Frank Act. (33-9414)
- July 10, 2013 – SEC proposed additional rule changes designed to further monitor private offerings and protect investors (33-9416)

# Revisions to Private Offering Rules

- Rule 506(b) (existing safe harbor)
  - If a manager does not want to bother with implementing a verification process or if the manager wants to be able to sell to up to 35 non-accredited investors who meet applicable sophistication requirements, the traditional non-solicitation safe harbor under Rule 506(b) will remain available
- Rule 506(c) (new safe harbor)
  - General advertising and general solicitation may be used
  - Purchasers must be accredited investors
  - Issuer must take reasonable steps to verify that purchasers are accredited investors

# Revisions to Private Offering Rules

- Reasonable steps to verify accredited investor status
  - Factors to consider in determining what reasonable steps would be are
    - *the nature of the purchaser and the type of accredited investor that the purchaser claims to be*
      - Relatively easy for institutional investors (e.g., checking a broker-dealer's status on FINRA Broker Check would be sufficient)
      - May be difficult for natural persons due to financial privacy
    - *the amount and type of information that the issuer has about the purchaser*
    - *the nature of the offering (e.g., solicitation, terms and minimum investment)*
      - General advertisement vs. solicitation solely to database of pre-screened investors
      - Direct cash investment of high minimum investment (without third-party financing) could be taken into consideration
  - The SEC has stated that exclusive reliance on subscriber responses in a fund application form would not alone be an adequate verification
  - Verification requirement is separate from requirement that investor actually be an “accredited investor”

# Revisions to Private Offering Rules

- Reasonable steps to verify accredited investor status - non-exclusive, non-mandatory lists of ways to satisfy the requirement (absent issuer's knowledge to the contrary)
  - **Income level verification**
    - *IRS Forms with two years of income, and*
    - *Representation from investor regarding expected income*
  - **Net worth (assets minus liabilities) verification (within prior three months)**
    - *Assets: bank, brokerage or other securities holding statements, certificates of deposit, tax assessments and appraisal reports*
    - *Liabilities: credit report from national agency, and*
    - *Representation that all liabilities have been disclosed*
  - **Third-party verification (within prior three months)**
    - *Broker-dealer, registered investment adviser, lawyer or accountant*
  - **Existing accredited investor**
    - *Existing holder of issuer's 506(b) securities, and*
    - *Representation of continued accredited investor status*

# Revisions to Private Offering Rules

- Form D
  - Issuers now must indicate whether filing is being made in reliance on Rule 506(b) or 506(c)
  - Could result in greater oversight by SEC
- Rule 144A
  - Removed “offered” and “offeree” from Rule 144A(d)(1), which effectively permits a Rule 144A offering to use general advertising or general solicitation so long as all purchasers are either (1) qualified institutional buyers, or (2) persons who the seller (or person acting on seller’s behalf) reasonably believes are qualified institutional buyers
  - Must be able to demonstrate “reasonable belief”
  - General solicitation by a Rule 144A initial purchaser will not affect ability of issuer to rely on 4(a)(2) or Regulation S
    - *(Background note: Regulation S is a safe harbor that deems complying offers and sales outside the U.S. to non-U.S. Persons as not being subject to the registration requirements of the Securities Act)*

# Revisions to Private Offering Rules

- With respect to concurrent U.S. offerings (relying on 4(a)(2), Reg D or Rule 144A) and non-U.S. offerings (relying on Regulation S), the SEC stated that Regulation S offerings will continue to not be integrated with domestic offerings.
  - Absent further guidance from the SEC, general solicitation in a Reg S offering should be segregated from general solicitation in a Rule 506(c) or Rule 144A offering/sale to preserve the Reg S requirement that no directed selling efforts take place in the U.S.

# Bad Actors

- New Rules 506(d) and (e)
- Issuers cannot rely on Rule 506 if certain felons and other “bad actors” are involved in the offering
- Three components of the Rule
  - *Wide range of covered persons*
  - *Wide range of disqualifying events*
  - *Narrow list of exceptions*
- Three-part analysis:
  - *Who is covered?*
  - *Have they been subject to any disqualifying event during the applicable look-back period?*
  - *Is there an exception available?*
- Underscores critical importance of due diligence

# Bad Actors – Covered Persons

1. The issuer;
2. Any predecessor of the issuer;
3. Any affiliated issuer;
  - Events relating to any affiliated issuer that occurred before the affiliation arose will be not considered disqualifying if the affiliated entity is not:
    - *In control of the issuer; or*
    - *Under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.*
4. Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;

# Bad Actors – Covered Persons

5. Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
  - Voting security:
    - *The right to elect or remove the directors or equivalent controlling persons of the issuer*
    - *The right to approve significant transactions such as acquisitions, dispositions or financings*
    - *Securities that confer voting rights limited solely to approval of changes to the rights and preferences of the class would not be “voting securities”*
  - Based on the issuer's total outstanding securities; not class-by-class

# Bad Actors – Covered Persons

6. Any promoter connected with the issuer in any capacity at the time of such sale;
  - *“The category of ‘promoter’ is broad, and captures all individuals and entities that have the relationships with the issuer or to the offering specified in Rule 405.”*
  - Rule 405, promoter includes:
    - *Any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer; or*
    - *Any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10% or more of any class of securities of the issuer or 10% or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.*

# Bad Actors – Covered Persons

7. Any investment manager of an issuer that is a pooled investment fund;
8. Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities;
9. Any general partner or managing member of any such investment manager or solicitor;
10. Any director, executive officer or other officer participating in the offering of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor:

# Bad Actors – Disqualifying Events

- Disqualifying events (generally subject to a connection to the securities industry and to a certain look-back period)
  - *Certain felonies or misdemeanors*
  - *Subject of certain court orders, judgment or decree*
  - *Subject to state regulatory final order, federal banking agency final order, CFTC final order or National Credit Union Administration final order*
  - *SEC orders under 15(b) or 15B(c) of the Exchange Act or under 203(e) or 203(f) of the Advisers Act*
  - *SEC cease and desist orders with respect to the anti-fraud provisions or Section 5 of the Securities Act*
  - *Suspension, expulsion or barred from national securities exchange or a registered national or affiliated securities association*
  - *Filer or underwriter in Reg A offering that was refused, stopped or suspended or is the subject of a related investigation*
  - *Subject to U.S. Postal Service false representation order*

# Bad Actors

- Exception for due diligence
  - *If issuer did not know and in the exercise of reasonable care could not have known that a disqualification existed*
  - *Must make factual inquiry into whether any disqualifications exist*
  - *Facts and circumstances test*
- Prior disqualifying events
  - *Events that occurred prior to September 2013 are excepted*
  - *Issuer must disclose events to each purchaser at a reasonable time prior to sale*
- SEC waiver
  - *Must show good cause and no prejudice to any other action by the SEC*
- Exception if court or regulatory authority advises that Rule 506 disqualification should not arise as a consequence
  - *Will likely be a substantial negotiating chip in enforcement actions and regulatory suits*
- Events of affiliate prior to affiliation do not attach in the absence of a control relationship

# Proposed Additional Changes

- Rule 503 and Form D
  - Must file Form D no later than 15 calendar days prior to general advertising or general solicitation in reliance on Rule 506(c) (unless notice-of-sale Form D has been filed)
  - Must make termination filing within 30 calendar days of completing Rule 506(b) or (c) offering
  - New information requirements about the issuer, related persons, exemption, use of proceeds, security being offered and whether persons will receive sales compensation
  - Termination filing would require offering amount, total amount sold, types of advertising or solicitation used and methods used to verify accredited investors
  - Eight existing disclosure items on Form D would be amended; six new disclosure items would be added
- Rule 507
  - One year disqualification from Rule 506(b) or Rule 506(c) for non-compliance with Form D during five-year look-back
  - Look-back would not be retrospective
  - 30-day cure period and ability to get SEC waiver

# Proposed Additional Changes

- New Rule 509
  - Disclosure requirements for 506(c) solicitation materials
  - Specific requirements for private funds, particularly if past performance is included in materials
- Rule 510T
  - Written general solicitation materials distributed in reliance on Rule 506(c) must also be submitted to the SEC no later than the date of first use
  - Two-year initial period of the rule
  - Materials would not be “filed” with the SEC
- Rule 156
  - Guidance as to what statements in registered fund offering materials may be “materially misleading” would also be applied to private funds
- 60 day comment period ended 9/23/2013
  - 415+ comment letters received (and posted to SEC website) as of 9/25/2013

# Market Impact

- Critical importance of verification procedures
- Independence of U.S. and non-U.S. offerings
- Policies and procedures for review and use of marketing materials
- CFTC limitations on general marketing
- Increased SEC oversight via Form D and filed solicitation materials (continues trend of increased registration requirements, Form ADV, Form PF, Form 13H)
- Need for due diligence and employee screening
- Critical importance of Form D filings
- Rule proposals may have chilling effect on reliance on Rule 506(c), particularly due to firms already having waited an extra year past deadline