COVINGTON

COVINGTON & BURLING LLP

ADVISORY | Securities

July 17, 2013

SIGNIFICANT CHANGES TO RULES FOR PRIVATE SECURITIES OFFERINGS

- General Solicitation and General Advertising Permitted in Rule 506 and Rule 144A Offerings
  - "Bad Actors" Prohibited from Participating in Rule 506 Offerings
    - SEC Proposes Other Changes for Regulation D Offerings

The Securities and Exchange Commission ("SEC") has adopted significant changes to its rules governing private offerings of securities. First, general solicitation and general advertising will now be permitted both in certain private placements conducted under Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act") and in sales of securities under Securities Act Rule 144A.[1] Second, the SEC amended Rule 506 to disqualify certain bad actors from participating in private placements conducted under the rule.[2] Both are overdue rulemakings, the former under the Jumpstart Our Business Startups Act ("JOBS Act"), which was enacted in 2012, and the latter under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted in 2010. In adopting these rule amendments simultaneously, the SEC, under the leadership of its new chair, Mary Jo White, balanced the often counterpoised considerations of promoting capital formation and protecting investors. Both adoptions become effective 60 days after publication in the Federal Register.[3]

At the same time, the SEC proposed several further changes to Regulation D and Form D that are intended to provide the SEC with additional information about the private placement market and strengthen its ability to protect investors.[4] These proposals would, if adopted, impose a number of new compliance burdens on companies seeking to raise capital under Rule 506. Two commissioners dissented from the proposed rules, arguing that they carried investor protection concerns too far and would impede capital formation if adopted in the form proposed.

USE OF GENERAL SOLICITATION AND GENERAL ADVERTISING

Rule 506 Offerings

The final rules lifting the ban on general solicitation and general advertising from certain Rule 506 offerings were adopted largely in the form proposed by the SEC in August 2012.[5]

---

[1] *See* Release No. 33-9415 (July 10, 2013), which is available on the SEC's website here. The SEC vote in favor of the final rules was 4-1, with Commissioner Aguilar voting against.

[2] *See* Release No. 33-9414 (July 10, 2013), which is available on the SEC's website here. The SEC vote in favor of the final rules was unanimous.

[3] The effective date for each should be in late September 2013.

[4] *See* Release No. 33-9416 (July 10, 2013), which is available on the SEC's website here. The SEC vote in favor of these proposed rules was 3-2, with Commissioners Paredes and Gallagher voting against.

[5] *See* Release No. 33-9354 (Aug. 29, 2012), which is available on the SEC's website here. The rule changes are mandated by Section 201(a) of the JOBS Act. Our Covington & Burling LLP advisory describing the proposed rules is available here. Rule 506 is a safe harbor under the exemption from registration in Section 4(a)(2) of the Securities Act for non-public offerings. Rule 506 is one of three exemptions from Securities Act

The focal point of this change is new Rule 506(c), which removes, as a condition of the Rule 506 safe harbor, compliance with Rule 502(c)'s prohibition on general solicitation and general advertising in offerings where the following two conditions are met:

- all purchasers in the offering must be accredited investors (meaning, under Rule 501(a), that all purchasers had, or the issuer reasonably believed that they had, such status); and
- the issuer must have taken reasonable steps to verify that all purchasers are accredited investors.[6]

Thus, issuers making offers and sales of securities in Rule 506(c) compliant offerings will be permitted to use general solicitation and general advertising in such offerings (including, for example, via articles, notices and other communications in newspapers and magazines, and broadcasts over television, radio and the internet). Issuers may also hold seminars and meetings for such offerings where attendees have been invited by general solicitation or general advertising and may create widely accessible websites from which potential purchasers can access information about the offering.

The new rules leave Rule 506 otherwise intact. So, issuers may choose to use general solicitation and general advertising by meeting the conditions of new Rule 506(c) or proceed under existing Rule 506(b), which will continue to permit sales to up to 35 non-accredited investors while including, along with other conditions, Rule 502(c)'s prohibition on general solicitation and general advertising. It is also worth noting that new Rule 506(c) does not affect private placements relying upon the statutory exemption for non-public offerings in Section 4(a)(2) of the Securities Act.[7]

Reasonable Steps to Verify Accredited Investor Status

As with the 2012 proposal, the SEC declined to mandate uniform procedures that issuers must follow to verify accredited investor status of purchasers participating in an offering under new Rule 506(c). Instead, the SEC stated that whether the steps taken by an issuer to verify accredited investor status are "reasonable" would be "an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction."[8]

As a significant addition, however, new Rule 506(c) includes a list of four verification methods, each of which will be deemed a reasonable method of verifying the accredited investor status of a natural person purchaser (so long as the issuer does not have knowledge that such person is not an

---

registration in Regulation D, subject to definitions and conditions generally common to all three of the exemptions. One such common condition, set forth in Rule 502(c) of Regulation D, is that, to qualify for an exemption from registration, an offering must not involve any "general solicitation" or "general advertising."

[6] The definition of "accredited investor" in Rule 501(a) of Regulation D includes eight categories of investors, five institutional and three natural persons. The categories of natural person investors are as follows: (i) any natural person whose net worth, individually or jointly with such person's spouse, exceeds $1,000,000 (excluding the value of such person's primary residence); (ii) any natural person who had an individual income in excess of $200,000, or joint income with such person's spouse in excess of $300,000, in each of the two most recent years and has a reasonable expectation of reaching the same income level in the current year; and (iii) any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of such issuer.

[7] Although the SEC reiterated, in the adopting release, its longstanding position that "public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)," court decisions interpreting the statutory language have not uniformly emphasized general solicitation and general advertising as key factors, particularly for offerings to sophisticated investors.

[8] *See* Release No. 33-9415, at 27.

accredited investor). These verification methods, which are intended to provide greater certainty to issuers, are as follows:

- when determining accredited investor status based on income, reviewing copies of IRS forms reporting income (*e.g.*, Form W-2, Form 1099, Schedule K-1, Form 1040) for the two most recent years, plus obtaining written representations that the purchaser has a reasonable expectation that his or her income for the current year will qualify for such status;
- when determining accredited investor status based on net worth, reviewing bank and brokerage statements, tax assessments, appraisal reports from third parties and consumer (credit) reports, dated within the prior three months, plus obtaining representations that the purchaser has disclosed all liabilities necessary to make a determination of net worth;
- obtaining written confirmation from a specified third party (*i.e.*, a registered broker-dealer, SEC-registered investment adviser, licensed attorney in good standing or certified public accountant duly registered and in good standing) that such person has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined such purchaser is an accredited investor; and
- for any natural person who invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of new Rule 506(c) and continues to hold such securities, obtaining a certification by such existing investor at the time of a subsequent Rule 506(c) offering by the same issuer that such investor qualifies as an accredited investor.

In order to verify the status of natural person purchasers where one of the four methods described above is not used—or the status of purchasers that are not natural persons—issuers may gauge the reasonableness of their verification efforts in accordance with principles-based guidance offered by the SEC. Under this principles-based approach, a number of factors may be relevant to the determination of whether "reasonable steps" have been used to verify accredited investor status, including, but not limited to:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- 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.[9]

The SEC reminded issuers that the burden of proving an exemption from registration is on the issuer. It also responded to concerns raised by numerous commenters about possible misuse of new Rule 506(c) by stating that the SEC staff will closely monitor the development of accredited investor verification practices by issuers, securities intermediaries and others. It is important, therefore, that issuers engaging in offerings under new Rule 506(c) develop adequate processes to verify accredited investor status of purchasers and retain adequate records documenting the steps they take in such regard.

---

[9] The SEC reiterated that, under the principles-based approach, consideration of these interconnected factors should help the issuer assess the reasonable likelihood that a potential purchaser is accredited, which, in turn, would help inform what steps would be reasonable to verify such status. For example, if an issuer has less information about a potential purchaser because the purchaser was newly introduced to the issuer, it would stand to reason that more verification procedures should be performed by the issuer for such purchaser than for purchasers with whom the issuer has a pre-existing relationship. Perhaps not surprisingly, the SEC stated that it did not believe that an issuer will have taken reasonable steps to verify accredited investor status if it requires only that a purchaser check a box or sign a form, absent other information about the purchaser indicating accredited investor status.

Reasonable Belief as to Accredited Investor Status

The SEC reiterated that the amendments to Rule 506(c) do not override the reasonable belief component of the definition of the term accredited investor in Rule 501(a), which provides that a purchaser may be accredited if the issuer "reasonably believes" the investor has that status. Under this standard, an issuer conducting an offering under new Rule 506(c) would not lose the ability to rely on Rule 506(c) if an investor provided false information to an issuer, but the issuer took reasonable steps to verify the investor's accredited status and, as a result, had a reasonable belief that the investor was accredited.

Rule 144A Offerings

The SEC also adopted amendments to subsection (d)(1) of Rule 144A, substantially in the form proposed, to provide that securities sold under such revised exemption may be offered to persons other than qualified institutional buyers ("QIBs"), provided that securities are sold only to persons that the seller (or a person acting on the seller's behalf) reasonably believes are QIBs.[10] The removal of restrictions on offers of securities under Rule 144A effectively permits the use of general solicitation and general advertising in such offerings.[11] In the past, although Rule 144A has not had an explicit prohibition on general solicitation and general advertising, there has been concern about how to use means of general distribution under Rule 144A when the "offering" must be limited to QIBs. The change provides certainty to market participants that general solicitation and general advertising of restricted securities made in connection with resales will not alone bar reliance on the rule.

Rule 506 Offerings by Private Funds

The SEC reaffirmed its statement in the 2012 proposing release that private funds will not lose the ability to rely upon certain exclusions from the definition of "investment company" in the Investment Company Act of 1940 (the "Investment Company Act") as a result of engaging in general solicitation and general advertising in offerings of their securities under new Rule 506(c).[12] In response to certain comment letters, however, the SEC included an explicit reminder to investment advisers to private funds that they are subject to the anti-fraud provisions embodied in Rule 206(4)-8 under the Investment Advisers Act of 1940.

Implications for Offerings under Regulation S

Similarly, the SEC reaffirmed its guidance from the 2012 proposing release that an offshore offering that is conducted in compliance with Regulation S would not be integrated with a concurrent

---

[10] Rule 144A is a safe harbor under the definition of underwriter in the Securities Act to facilitate private resales of securities to certain institutional investors. Any person, other than the issuer or a dealer, who offers or sells securities in compliance with Rule 144A is deemed not to be engaged in a distribution of such securities and, therefore, not to be an underwriter within the meaning of Sections 2(a)(11) and 4(a)(1) of the Securities Act.

[11] Indeed, Section 201(a)(2) of the JOBS Act, which directed the SEC to revise Rule 144A, explicitly contemplates that offers to persons other than QIBs may be made by means of general solicitation or general advertising.

[12] These private funds often rely on the exclusions from the definition of "investment company" set forth in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Both of these exclusions require that the issuer not conduct any public offering of its securities. Section 201(b) of the JOBS Act provides that offers and sales exempt under revised Rule 506 will not be deemed public offerings under the Federal securities laws as a result of general solicitation or general advertising.

domestic offering that is conducted in compliance with Rule 506(c) or amended Rule 144A, notwithstanding the use of general solicitation and general advertising in the domestic offering.

BAD ACTOR DISQUALIFICATION IN RULE 506 OFFERINGS

The final rules relating to bad actor disqualifications in Rule 506 offerings were adopted generally in the form proposed, with some changes, however, to the list of covered persons and disqualification events, as well as an important change regarding how otherwise disqualifying events occurring prior to the effective date of the final rules will be handled.[13] New Rule 506(d)(1) describes (i) persons affiliated with the issuer or other offering participants to be covered by the rule and (ii) disqualifying events. Issuers are prohibited from relying on the Rule 506 safe harbor if any such covered person has experienced or is the subject of an enumerated disqualifying event within the applicable time periods spelled out in the rule.

Covered Persons and Disqualifying Events

A general description of the persons and disqualification events set forth in new Rule 506(d)(1) is set forth below. A more detailed outline of Rule 506 (d)(1) is provided in the Appendix to this advisory.

Persons covered by the rule are the following:

- the issuer, any predecessor of the issuer or any affiliated issuer;
- any of the issuer's directors, executive officers, other officers participating in the offering, general partners or managing members;
- any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any investment manager of 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 the sale;
- any general partner or managing member of any such investment manager or solicitor; and
- 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.

Disqualifying events covered by the rule are, in general terms, the following:

- a criminal conviction within 10 years before the sale (or five years in the case of issuers, their predecessors and affiliated issuers), which relates to the purchase or sale of a security, a false filing with the SEC or conduct as a securities intermediary;

---

[13] *See* Release No. 33-9211 (May 25, 2011), which is available on the SEC's website here. The rules are mandated by Section 926 of the Dodd-Frank Act. The statute requires the rules to be "substantially similar" to the disqualification rules in Rule 262 under the Securities Act, which applies to offerings under Regulation A and Rule 505 of Regulation D. The Dodd-Frank Act also prescribes, however, that the rules must cover more conduct than just that itemized in Rule 262, including conduct resulting in certain actions by state regulators.

- a court injunction or restraining order entered within five years before the sale, which relates to the conduct described in the preceding bullet;[14]
- a final order of an enumerated state or federal regulator that (i) at the time of sale, bars a person from association with or engagement in entities or activities regulated by that regulator, or (ii) constitutes a final order based on violation of a law or regulation prohibiting fraudulent, manipulative or deceptive conduct entered into within 10 years prior to such sale;[15]
- an SEC disciplinary order relating to a broker, dealer, municipal securities dealer or investment adviser that, at the time of sale, revokes or suspends such person's registration, places limitations on his or her activities or bars such person from being associated with an entity or from participating in offering penny stock;
- an SEC cease-and-desist order entered within five years prior to the sale, which relates to a scienter-based anti-fraud provision of the federal securities laws or Section 5 of the Securities Act;
- a suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization for an act or omission inconsistent with just and equitable principles of trade;
- an SEC stop order of a registration statement or suspension order of a Regulation A offering within five years before the sale or, at the time of the sale, an investigation or proceeding related to such a stop order or suspension; and
- a U.S. Postal Service false representation order entered within five years before the sale or, at the time of the sale, a temporary restraining order or preliminary injunction with respect to certain fraudulent conduct alleged by the U.S. Postal Service.[16]

Transition Issues

In a turnaround from the 2011 proposal, the SEC will not apply the disqualification provisions of new Rule 506(d)(1) to any events that occur prior to the effectiveness of the new rule. Thus, any otherwise disqualifying event that occurred before the effective date of the new rule will not bar use of Rule 506. However, an issuer must furnish each purchaser, a reasonable time prior to sale, a written description of any matters that would have triggered disqualification under Rule 506(d)(1) if such events had occurred after the effective date of the rule.[17] Unless an issuer can rely on the reasonable care exception described below, its failure to provide the disclosure would preclude reliance on Rule 506.[18]

---

[14] The SEC affirmed its prior guidance that a disqualifying event applies only to the person "subject to" (*i.e.*, specifically named in) an order.

[15] As used in the final rule, a "final order" means a written directive or declaratory statement issued by an enumerated agency under applicable statutory authority that provides for notice and an opportunity for hearing, which constitutes a final disposition or action by that agency. *See* Rule 501(g).

[16] New Rule 506(d)(2)(iii) provides that, if before the relevant sale of securities, the court or regulatory authority that entered the relevant action advises the SEC in writing that disqualification under Rule 506(d)(1) should not arise as a consequence of such action, such action shall not bar use of the Rule 506 safe harbor. This written advice may be set forth in the judgment, order or decree itself or may be provided to the SEC or its staff separately.

[17] Further, the SEC stated in the adopting release that it expects issuers to give "reasonable prominence" to the disclosure regarding such matters, to ensure that such information is "appropriately presented in the total mix of information available to investors."

[18] The SEC also stated that an issuer's failure to provide the required disclosure will preclude relief under Rule 508, which affords relief for "insignificant deviations" from a term or condition of Regulation D.

Reasonable Care Exception

Importantly, the SEC adopted, substantially as proposed, a "reasonable care" exception to the Rule 506 disqualification provisions. This new exception to the disqualification provisions provides issuers comfort that the Rule 506 safe harbor will remain available, despite non-compliance with the bad actor disqualification requirements, if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a bad actor disqualification existed under Rule 506(d)(1). The SEC declined to prescribe specific steps as being necessary or sufficient to establish reasonable care, but it did provide some guidance suggesting that factual inquiry by means of questionnaires or certifications, possibly in tandem with contractual representations, covenants and undertakings, may be sufficient in some circumstances, especially when there are no red flags indicating bad actor involvement.[19]

This new reasonable care exception was not required by Section 926 of the Dodd-Frank Act, nor is it found in current rules containing bad actor disqualifications.[20] The SEC adopted the exception, however, out of concern that without it issuers might be reluctant to use Rule 506 because of the difficulty in ascertaining disqualifying events, particularly for persons that are not affiliated with the issuer.

SEC Waiver For Good Cause

The SEC may, upon a showing of good cause, determine that the Rule 506 safe harbor should not be denied an issuer. Consistent with application of the waiver provisions of Rule 262, the SEC has delegated its authority to grant waivers under Rule 506(d)(1)'s bad actor requirements to the Director of the Division of Corporation Finance. The SEC declined to articulate standards for granting such waivers. The adopting release, however, identifies certain circumstances that could, depending on the specific facts, be relevant to the evaluation of a waiver request, including a change of control of an issuer or other entity after the occurrence of a disqualifying event and the issuance of an order without notice or an opportunity for hearing.

Lack of Uniformity

The new bad actor disqualification provisions in Rule 506(d)(1) will apply only to Rule 506 offerings. In the 2011 proposal, the SEC had considered also applying the new provisions uniformly to offerings under Regulation A, Regulation E and Rules 504 and 505 of Regulation D. However, given ongoing rulemakings to Regulation A mandated by the JOBS Act, the SEC determined it could address uniformity issues in the future.

Similarly, the SEC decided not to apply uniform look-back periods for the disqualifying events enumerated in Rule 506(d)(1). Thus, for some disqualifying events, an event occurring five years prior to the applicable sale of securities will be encompassed by the rule, while for others an event occurring 10 years prior to such sale will be covered.

---

[19] The SEC noted that, in the case of continuous or extended offerings, the issuer will need to keep up-to-date on gathering information about potential disqualifying events from all covered persons affiliated with the offering.

[20] *See, e.g.*, Securities Act Rules 262, 505 and 602. Rule 602(b) sets forth "bad actor" disqualification criteria with respect to exempt offerings by small business investment companies.

CONFORMING AMENDMENTS TO FORM D

In connection with the amendments to Rule 506 described above, the SEC has adopted complementary amendments to Form D.[21] These involve providing (i) a new box to check if an issuer is relying on the proposed new exemptive provision in Rule 506(c) and (ii) an issuer certification that it is not disqualified from relying on Regulation D for any of the reasons stated in new Rule 506(d).

PROPOSED AMENDMENTS TO REGULATION D, FORM D AND RULE 156

In consideration of possible concerns that permitting general solicitation and general advertising in Rule 506(c) offerings would lead to greater fraud in the Rule 506 market, the SEC proposed a group of rules that, if adopted, would give the SEC additional insight into the market and help prevent such fraud.[22] The SEC staff will also undertake, upon effectiveness of Rule 506(c), a "work plan" to monitor practices that emerge from Rule 506(c) offerings. The deadline for comments on the proposed amendments is 60 days after publication in the Federal Register, which deadline should occur in late September 2013.

Proposed Amendments to Regulation D

The SEC proposed several amendments to Regulation D. First, the SEC proposed new Rule 509, which would require issuers to include, in a prominent manner, prescribed legends in any written communication that constitutes a general solicitation or general advertising in a Rule 506(c) offering. Among other things, the legends would state that (i) the securities may be sold only to accredited investors, (ii) the securities are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements, (iii) the SEC has not passed on the merits of the securities or the offering, (iv) the securities are subject to transfer restrictions, and (v) investing in the securities involves risk. Legends similar to these are often used in private placements under Rule 506 which involve written disclosure materials.

As part of proposed new Rule 509, issuers that are private funds would be required to include additional disclosures in any written communication that constitutes a general solicitation or general advertising in a Rule 506(c) offering.[23] If such written communications include performance data, the materials would have to include various specific cautionary statements regarding such data.

Second, the SEC proposed new Temporary Rule 510T requiring issuers to submit to the SEC—privately via a new portal on the SEC's website, not on EDGAR—any written communication that constitutes a general solicitation or general advertising in any offering conducted in reliance on Rule 506(c) no later than the date of first use.[24] Although this would not be required until the

---

[21] An issuer relying on an exemption from registration provided by Regulation D is required to file a Form D. *See* Rule 503 of Regulation D. Filing of the Form D is not currently a condition to any exemption, however.

[22] The SEC did not propose any change to the definition of "accredited investor" in Rule 501(a). However, it did request comment on whether the definition of "accredited investor" as it relates to natural persons should be amended, for example, to include a financial knowledge or investment experience component. In this regard, it will be interesting to see if the SEC is asked to return to proposed rules to amend the accredited investor definition which it considered in 2007. *See* Release No. 33-8828 (Aug. 3, 2007), which is available on the SEC's website here.

[23] The SEC also requested comment on whether, in light of the removal of the prohibition against general solicitation and general advertising, other manner and content restrictions were necessary or appropriate for Rule 506(c) offerings by private funds.

[24] A private placement memorandum used in a Rule 506(c) offering presumably would not need to be provided to the SEC unless it was, itself, used in a manner constituting general solicitation or general advertising.

effectiveness of Temporary Rule 510T, the SEC stated that it would establish the new submission portal upon the effectiveness of Rule 506(c), thereby allowing issuers voluntarily to submit written general solicitation materials starting then. The temporary rule would expire two years after its effective date.

Finally, the SEC proposed to amend Rule 507 to provide that the Rule 506 safe harbor would not be available for any issuer that has been enjoined for failing to comply with the legending requirements of proposed new Rule 509 or the requirement to submit written offering materials under proposed new Temporary Rule 510T.

Proposed Amendments to Rule 503 and Form D

With respect to Form D, the SEC proposed to amend Rule 503 to provide that an issuer intending to offer or sell securities under new Rule 506(c) must file a notice on Form D no later than 15 calendar days prior to the first use of general solicitation or general advertising in such offering. Under form instructions, this advance Form D filing would not be required to include all of the information called for by Form D, but it would need to identify, among other things, basic information about the issuer and its related persons, the type of securities offered (to the extent known), any sales compensation (to the extent known), and the use of proceeds of the offering. In addition, under the proposed amendment to Rule 503 an issuer selling securities under either Rule 506(b) or 506(c) (*i.e.*, whether using general solicitation and general advertising or not) would be required to file a final Form D no later than 30 calendar days after the termination of the offering.

A proposed amendment to Rule 507 would provide an incentive for issuers to comply with the new Form D filing requirements. Specifically, the proposed amendment would preclude an issuer (or predecessor affiliate of the issuer) that has failed to satisfy, within the preceding five years, a Form D filing requirement in a Rule 506 offering, from using Rule 506 for a period of one year following the date it cures the Form D filing deficiency.[25] By its terms, this provision would apply to all required Form D filings, including an advance Form D filing in connection with an offering under Rule 506(c), as well as required amendments.

The SEC also proposed to amend Form D to require issuers to provide more information, primarily in regard to offerings conducted in reliance on Rule 506. The new information would cover, among other things:

- the number and types of accredited investors that purchased securities in an offering;
- if the issuer used a registered broker-dealer for the offering, whether any general solicitation materials were filed with FINRA; and
- for Rule 506(c) offerings, the types of general solicitation used or to be used, and the methods used or to be used to verify accredited investor status of purchasers.

The SEC stated that the purpose of these changes is to allow it to gather additional information on the use of Rule 506 and on the impact of new Rule 506(c) on the market.

[25] Solely for purposes of determining an issuer's disqualification for failing to comply with Form D's filing requirements, the proposal includes a grace period for required Form D filings—a required Form D filing will be deemed timely if filed within 30 days of its due date.

Proposed Amendments to Rule 156

Rule 156 currently serves as an anti-fraud provision governing the sales literature used by registered investment companies. The SEC has proposed amending Rule 156 to expand its coverage to sales literature used by private funds (whether or not using Rule 506(c)).

PRACTICE IMPLICATIONS

Taking into account the final rules relating to general solicitation and general advertising, as well as the final rules related to bad actor disqualifications, a number of practice implications emerge:

- Issuers have a choice under Rule 506: Following the effective date of the final amendments, issuers raising capital under Rule 506 will have a choice of whether or not to use general solicitation and general advertising. Rule 506(b) remains available for issuers that do not wish to use general solicitation and general advertising or that wish to include non-accredited investors in the offering. Even for issuers that do not intend to use general solicitation or general advertising, however, Rule 506(c) may be the preferred alternative if only to avoid complications from inadvertent general solicitations, such as when a private placement is described in a news article.
- Accredited investor verification: Issuers engaging in offerings under new Rule 506(c) must develop adequate processes to verify the accredited investor status of purchasers and retain adequate records documenting the steps they take in such regard. For issuers relying on Rule 506(b), which remains unchanged, there may be a question as to whether they should take similar reasonable steps to verify the accredited investor status of purchasers in those offerings. This might be relevant, for instance, where there is an intent to exclude non-accredited investors (and avoid the related information requirements).
- Bad actor diligence: All issuers using Rule 506 (whether or not including general solicitation and general advertising) must develop new systems for obtaining (and retaining) information about disqualifying events for covered persons.
- Section 4(a)(2) practice: Issuers conducting offerings under Rule 506(c) that employ general solicitation and general advertising will need to consider more carefully the relationship between that rule (a safe harbor under Section 4(a)(2) of the Securities Act) and the statutory exemption itself, given the SEC's view that general solicitation and general advertising are incompatible with the Section 4(a)(2) exemption.
- Legal opinions: Issuers, counsel and legal opinion recipients will need to consider the extent to which the issuer's burden of verifying accredited investor status and ensuring the absence of bad actors will influence legal opinion practices in Rule 506 offerings.
- Cross Border Offerings: Relaxation of general solicitation and general advertising restrictions should facilitate concurrent public offshore and private U.S. capital raising transactions. On the other hand, private placements under Rule 506 in the U.S. involving foreign investors and solicitors may be marginally more complicated insofar as investor verification and bad actor due diligence are concerned.

CONCLUSION

While the final amendments related to Rule 506 and Rule 144A were required by legislation and the SEC was late in completing both, the agency will be given credit for having adopted them together, thereby balancing considerations of capital formation with concerns for investor protection. Also weighing on the side of investor protection were the SEC's and its staff's comments about closely monitoring the new Rule 506(c) marketplace to see that issuers using general solicitation and general advertising are complying with the requirements to sell only to accredited investors and take reasonable steps to verify the status of such purchasers.

More generally, one big question at this early stage is whether and how issuers will take advantage of the new freedoms in non-public offerings. Much capital raising involving only accredited investors already takes place without any need for general solicitation. With the SEC and perhaps many more now looking carefully at the private placement market (including in connection with the proposed rule amendments to Regulation D and Form D), it would not be irrational for many issuers to go slowly at first and stick to more traditional practices, particularly since those will be encumbered by the new rigors of checking for bad actors.

Another big question is the extent to which, as with other regulatory liberalizations, early users will set an appropriate tone for how the changes are perceived. It will be unfortunate if early users employ practices that yield bad facts and enforcement precedent that chill careful evolution of workable practices. It would also be unfortunate if these practices encourage the SEC to adopt all of the newly proposed rules governing Regulation D and Form D discussed above, which in several important respects seem to go too far.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our securities practice group:

Bruce Bennett	+1.212.841.1060	bbennett@cov.com
Warren Caywood (co-author)	+1.212.841.1069	wcaywood@cov.com
David Engvall (co-author)	+1.202.662.5307	dengvall@cov.com
Nora Gibson	+1.415.591.7044	ngibson@cov.com
David Martin (co-author)	+1.202.662.5128	dmartin@cov.com
Kristian Wiggert	+44.(0)20.7067.2280	kwiggert@cov.com
James Wawrzyniak (co-author)	+1.202.662.5663	jwawrzyniak@cov.com

APPENDIX

Rule 506(d) of Regulation D
Bad Actor Disqualification Provisions

COVERED PERSONS:

1. The issuer, any predecessor of the issuer or any affiliated issuer;
2. Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
3. Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
4. Any promoter connected with the issuer in any capacity at the time of the sale;
5. Any investment manager of an issuer that is a pooled investment fund;
6. Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale;
7. Any general partner or managing member of any such investment manager or solicitor; and
8. 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.

DISQUALIFYING EVENTS:

1. **CRIMINAL CONVICTIONS.** The covered person has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:
    a. in connection with the purchase or sale of any security;
    b. involving the making of any false filing with the Securities and Exchange Commission ("SEC"); or
    c. arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.
2. **COURT INJUNCTIONS AND RESTRAINING ORDERS.** The covered person is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:
    a. in connection with the purchase or sale of any security;
    b. involving the making of any false filing with the SEC; or
    c. arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.

3. **FINAL ORDERS OF CERTAIN FEDERAL AND STATE REGULATORS.** The covered person is subject to a final order[i] of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency of officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:
    a. at the time of such sale, bars the person from:
        i. association with an entity regulated by such commission, authority, agency, or officer;
        ii. engaging in the business of securities, insurance or banking; or
        iii. engaging in savings association or credit union activities; or
    b. constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale.

4. **SEC DISCIPLINARY ORDERS.** The covered person is subject to an order of the SEC entered pursuant to Section 15(b) or 15(B)(c) of the Securities Exchange Act of 1934 ("Exchange Act") or Section 203(e) or (f) of the Investment Advisers Act of 1940 ("Advisers Act") that, at the time of such sale:
    a. suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;
    b. places limitations on the activities, functions or operations of such person; or
    c. bars such person from being associated with any entity or from participating in the offering of any penny stock.

5. **SEC CEASE-AND-DESIST ORDERS.** The covered person is subject to any order of the SEC entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of:
    a. any scienter-based anti-fraud provision of the federal securities laws, including without limitation Section 17(a)(1) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 15(c)(1) of the Exchange Act and Section 206(1) of the Advisers Act, or any other rule or regulation thereunder; or
    b. Section 5 of the Securities Act.

6. **SUSPENSION OR EXPULSION FROM A SELF-REGULATORY ORGANIZATION.** The covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.

7. **STOP ORDERS AND REGULATION A SUSPENSION ORDERS.** The covered person has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the SEC that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.

8. **U.S. POSTAL SERVICE ORDERS.** The covered person is subject to a United States Postal Service false representation order entered within five years before such sale, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

---

[i] "Final order" means "a written directive or declaratory statement issued by a federal or state agency described 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." Rule 501(g).