SEC Adopts Significant Changes to Private Offering Rules

SEC Lifts the Ban on “General Solicitation” for U.S. Private Securities Offerings, Disqualifies Rule 506 Offerings Involving Certain Felons and Other “Bad Actors” and Proposes Additional Rules Related to Private Offerings

I. Executive Summary

On July 10, 2013, the Securities and Exchange Commission (the “SEC”):

• Approved final rules (the “General Solicitation Rules”)1 eliminating the prohibition against general solicitation and general advertising in connection with certain private offers and sales of securities in which sales are made exclusively to accredited investors, conducted in reliance on Rule 506 of Regulation D under the Securities Act of 1933 (the “Securities Act”) and allowing general solicitation in connection with securities offerings conducted under Rule 144A under the Securities Act;

• Approved final rules (the “Bad Actor Rules”)2 disqualifying securities offerings from relying on Rule 506 if they involve certain felons or other “bad actors”; and

• Proposed rules (the “Proposed Rules”)3 requiring issuers making offerings under amended Rule 506 to make additional Form D filings, add certain legends to marketing materials and submit marketing materials to the SEC and amending Form D to add further information about such offerings.

These developments will significantly affect the way private securities offerings are conducted in the United States, as the SEC’s longstanding prohibition against general solicitation in connection with Rule 506 offerings will no longer apply to a wide range of offerings, subject to certain compliance requirements.

1 “Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings,” Securities Act Release No. 9415 (July 10, 2013), available here. Previous Sidley Updates on this topic can be found at:

SEC Takes Step toward Fulfilling Congressional Mandate to Eliminate Ban on General Solicitation in Connection with Certain Unregistered Securities Offerings

Congress Liberalizes Securities Offering Regulation

U.S. Congress Enacts JOBS Act, Increasing 499 Investor Limit for Private Funds to 1,999 and Eliminating Prohibition Against General Solicitation in Connection with Certain Private Offerings

2 “Disqualification of Felons and Other ‘Bad Actors’ from Rule 506 Offerings,” Securities Act Release No. 9414 (July 10, 2013), available here. The previous Sidley Update on this topic can be found at SEC Proposes New Rule 506(c) under the Securities Act of 1933 to Implement “Bad Actor” Disqualifications under Section 926 of Dodd-Frank

The amendments will be significant not only for corporate and foreign sovereign issuers and managers of hedge funds, private equity funds and other private funds who intend to advertise in the conventional sense — through television, print or open web sites — but also for issuers and private fund managers who wish to take advantage of the flexibility afforded under the General Solicitation Rules to discuss themselves or their private funds in public forums. Any such communications will remain subject to the prohibition against material misstatements or omissions of fact in connection with the offer and sale of securities.

For example, historically, issuers of securities relying on the private offering exemption, including fund managers, have avoided discussing specific terms, strategies or performance in public statements, lest they jeopardize the funds’ private offering exemptions. Under the General Solicitation Rules, principals and employees of fund managers may be able to discuss these details in public forums, including on web sites, at industry conferences and in interviews, subject to compliance with the General Solicitation Rules.

Any issuer or fund manager seeking to take advantage of the General Solicitation Rules should take steps to ensure that it complies with the new rules.

The General Solicitation Rules and Bad Actor Rules will be effective 60 days after their respective publication in the Federal Register.4 Until that date, the SEC’s existing regime regulating Rule 506 and Rule 144A offerings remains unchanged. The Proposed Rules will be open for public comment for 60 days from their publication in the Federal Register.

II. Elimination of Prohibition Against General Solicitation

As mandated by Section 201(a) of the Jumpstart Our Business Startups Act, the so-called “JOBS Act,” the SEC approved final rules eliminating the prohibition against general solicitation5 for the offer and sale of securities conducted under Rule 506 of Regulation D6 of the Securities Act and Rule 144A under the Securities Act, as long as all purchasers are “accredited investors”7 in Rule 506 offerings or “qualified institutional buyers” (“QIBs”)8 in Rule 144A offerings. Under the General Solicitation Rules, issuers will be able to advertise in the media, solicit through open web sites and conduct general investment seminars,9 although the adopting release accompanying the General Solicitation Rules includes a number of key points of discussion and interpretation.

The elimination of the prohibition against general solicitation represents a fundamental change in the nature of offerings made by many issuers, including private funds, to modernize the SEC’s rules in an age of free distribution of information over the internet and bring them more in line with international practice.

4 These rules have not yet been published. We anticipate they will be effective in mid- to late September 2013.

5 “General solicitation” and “general advertising” include newspaper and magazine advertisements, television and radio communications and seminars where persons in attendance were invited by general solicitations or advertisements. The SEC has construed other media accessible to the public, such as web sites not protected by password, as possible general solicitations or advertisements.

6 Rule 506 allows unregistered offerings in unlimited dollar amounts to an unlimited number of investors, provided that no more than 35 of the purchasers are unaccredited investors.

7 “Accredited investor,” as defined in Rule 501(a), means anyone who comes within certain categories, or who the issuer reasonably believes to come within those categories. A similar “reasonable belief” standard appears in Rule 2a51-1(h) under the Investment Company Act of 1940 (the “Investment Company Act”) regarding the term “qualified purchaser” as used in Section 3(c)(7) of the Investment Company Act. The proposing and adopting release of Rule 2a51-1 indicate the SEC intended the reasonable belief standard in Rule 2a51-1(h) to reflect the same approach taken in Rule 501(a) of Regulation D and Rule 144A(d)(i).

8 Rule 144A is a safe harbor from registration under the Securities Act for resales of certain eligible securities to QIBs.

9 The SEC stated that investment advisers to private funds should carefully review their policies and procedures to determine whether they are reasonably designed to prevent the use of fraudulent or materially misleading private fund advertising and make appropriate amendments to those policies and procedures, particularly if the private funds intend to engage in general solicitation activity.
Amendments to Rule 506

New Rule 506(c) eliminates the prohibition against unregistered sales of securities made by means of general solicitation, provided that:

- Sales satisfy all terms and conditions of Rule 501 and Rules 502(a) and (d);
- All purchasers of the securities are accredited investors (which includes anyone who the issuer reasonably believes is an accredited investor); and
- The issuer takes “reasonable steps to verify” that the purchasers of the securities are “accredited investors.”

Existing Rule 506, redesignated as Rule 506(b), will remain available for issuers not wishing to engage in general solicitation, thereby creating two potential “flavors” of Rule 506 offerings – those involving general solicitation and conducted under Rule 506(c) and those not involving general solicitation and conducted under Rule 506(b). However, issuers and fund managers that conduct both Rule 506(b) and Rule 506(c) offerings will need to consider the practicability and consistency of using two separate accreditation models given that both rules incorporate a reasonable belief standard.

“Reasonable Steps to Verify” Accredited Investor Status. An issuer relying on Rule 506(c) must take “reasonable steps to verify” that purchasers of the issuer’s securities are accredited investors. We refer to this condition as the “RSV requirement.” Whether the steps taken are “reasonable” will, in the SEC’s view, be an “objective” determination by the issuer (or those acting on its behalf) under the facts and circumstances relating to each purchaser and transaction. The factors identified by the SEC as being relevant include:

- 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.

The SEC acknowledged that these factors are interconnected, and the information gained by looking at these factors “would help an issuer assess the reasonable likelihood that a potential purchaser is an accredited investor.” How to interpret the factors themselves, how to determine the manner in which the factors interrelate and the weight given to any particular factor are each open questions. In many instances, the “reasonableness” of the steps used by an issuer will require a number of subjective judgment calls.

- **Nature of Purchaser.** The SEC’s commentary suggests that greater care may be appropriate in verifying the accreditation of natural persons than of corporate or other institutional investors.

- **Information about the Purchaser.** The more information an issuer has about a prospective purchaser, the fewer steps the issuer will need to take to verify the investor’s status. According to the SEC, an issuer could review or rely upon, for example, publicly available government filings (such as proxy statements indicating a corporate officer’s compensation) or third-party information that provides reliable evidence of accredited investor status, such as pay stubs, or verification of a person’s status by a third party, such as an attorney or certified public accountant.\(^\text{10}\)

- **Nature and Terms of the Offering.** The nature and terms of the offering, such as the means by which the issuer publicly solicits purchasers, may also be relevant in determining whether the steps taken to verify accredited investor status are reasonable. For example, solicitation through a publicly accessible web site, through broadly

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\(^{10}\) The SEC also acknowledged that in the future services may develop that verify a person’s accredited investor status and permit issuers to check the accredited investor status of possible investors, particularly for web-based Rule 506 offering portals that include offerings for multiple issuers. This third-party service provider, as opposed to the issuer itself, could obtain appropriate documentation or otherwise take reasonable steps to verify accredited investor status.
disseminated email or social media or through print media, such as a newspaper, will likely require more extensive verification measures than a solicitation through a pre-screened database of accredited investors maintained by a credible third party. The use of a high minimum investment amount could also be relevant in determining what verification steps are reasonable under the circumstances. A minimum investment that is sufficiently high such that only accredited investors could reasonably be expected to meet the minimum with a direct cash investment is a relevant factor in determining the extent of verification required. An investor’s use of borrowed funds, however, whether from the issuer or from a third party, would make it more difficult to rely merely on a high minimum investment requirement. For example, many private funds have minimum investment requirements in excess of the $1 million net worth required for a natural person to be an accredited investor. Such private funds may therefore be able to rely on their high minimums without undertaking substantial additional diligence on potential investors, but may, nevertheless, need to gather information about an individual investor’s liabilities.

“Check-the-Box” Approach Inadequate. The SEC indicated that an issuer likely will not have taken reasonable steps to verify a purchaser’s accredited investor status if it required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status. This contrasts with current practice for Rule 506 offerings which often rely on self-accreditation.11

RSV as a Stand-Alone Requirement. The requirement that the issuer take reasonable steps to verify that investors are accredited is separate from and independent of the requirement that all investors be accredited. An issuer seeking to rely on Rule 506(c) must satisfy the RSV requirement even if all purchasers ultimately are accredited investors. If a sale of securities is made pursuant to Rule 506(c) to a person later discovered to not have been an accredited investor (for example, because the investor provided false information or documentation), the issuer will not lose the ability to rely on the Rule 506(c) safe harbor, provided that the issuer took reasonable steps to verify the purchaser’s status as an accredited investor. The SEC has emphasized that adequate records must be retained documenting the steps taken to verify accredited investor status in Rule 506(c) offerings.

RSV Safe Harbors for Natural Person Investors. In response to comments, the SEC provided four optional, non-exclusive methods for verification of the accreditation of natural persons. If an issuer meets the terms of any of these safe harbors, it will be deemed to have satisfied the verification requirement in Rule 506(c), unless the issuer or its agent has actual knowledge that the purchaser is not an accredited investor. An issuer will be deemed to have met its RSV requirement by doing any of the following:

- **Income Basis.** Reviewing any Internal Revenue Service form that reports the purchaser’s income for the two most recent years, along with obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify during the current year;

- **Net Worth Basis.** Reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:
  - *With respect to assets:* bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and
  - *With respect to liabilities:* a consumer report from at least one credit agency;

- **Licensed Professional Confirmation.** Obtaining a written confirmation from a (i) registered broker dealer; (ii) registered investment adviser; (iii) licensed attorney; or (iv) certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor; or

11 Existing accredited investors in an issuer at the effective date of the General Solicitation Rules may self-certify their accredited status for additional investments in the issuer.
• **Prior Investor.** With respect to any person who (i) purchased securities in an issuer’s Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c), (ii) continues to hold such securities and (iii) seeks to invest in the same issuer’s Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

**Ongoing Offerings.** An issuer may choose to continue an ongoing offering under Rule 506 that commences before the effective date of Rule 506(c) in accordance with the requirements of either Rule 506(b) or Rule 506(c) after the effective date. Any general solicitation that occurs after the Rule 506(c) effective date will not affect the exempt status of offers and sales of securities that occurred pursuant to Rule 506(b) prior to the effective date, nor will it require retroactive RSV procedures for existing investors.

**Impact on Investment Company Act Exclusions.** Many private funds rely on one of the exclusions from the definition of an “investment company” under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, which require, among other things, that the issuer not make or propose to make a public offering of its securities. The SEC confirmed that an offering by a private fund or other issuer that offers and sells its securities using general solicitation under Rule 506(c) would not thereby lose the benefit of the Section 3(c)(1) or Section 3(c)(7) exclusion.

Private funds that rely on the Section 3(c)(7) exclusion will continue to be required to confirm that all of their investors are both accredited investors and qualified purchasers. Private funds advised by registered investment advisers and that rely on the Section 3(c)(1) exclusion and charge a “performance” or “incentive” fee (i.e., any compensation based on a share of capital gains) must also confirm that investors are “qualified clients” as defined by Rule 205-3 under the Investment Advisers Act of 1940 (the “Advisers Act”).

**Impact on Commodity Pools.** Operators of “commodity pools” that offer and sell interests in the pools pursuant to Rule 506(c) must ensure that they comply with applicable provisions of the Commodity Exchange Act and rules of the Commodity Futures Trading Commission (“CFTC”). Commodity pool operators (“CPOs”) of pools that are subject to CFTC Rule 4.21 will need to comply with the disclosure document delivery requirements under that rule and should carefully consider the interplay of CFTC requirements with any means of publicity used in connection with the Rule 506(c) offering. Furthermore, CPOs that operate pools pursuant to CFTC Rules 4.7(b) or 4.13(a)(3) must evaluate whether a Rule 506(c) offering is consistent with the requirements under those rules.12

**Consideration of Other Offering Requirements.** Advertisements for private funds must comply with any applicable advertising restrictions under SEC rules applicable to investment advisers, as well as any Financial Industry Regulatory Authority Inc. (“FINRA”) rules to the extent a broker-dealer is involved in the offering.13 Further, if a private fund is also a “commodity pool,” the CPO of the pool will need to comply with applicable CFTC and National Futures Association (“NFA”) rules on advertising (depending on whether the CPO is a member of NFA and registered with the CFTC).

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12 The prohibition against “marketing to the public” in CFTC Rule 4.7(b) should apply only to certain collective trust funds offered pursuant to Section 3(a)(2) of the Securities Act by banks that are registered as CPOs (Rule 4.7 Adopting Release, 57 Fed. Reg. 34857 (1992)), although the CFTC has been asked to confirm that point. Rule 4.13(a)(3), which provides an exemption from CPO registration for CPOs that operate pools that engage in limited commodity interest trading, exempts the CPO if “[f]or each pool for which the person claims exemption from registration under [Rule 4.13(a)(3)] . . . Interests in the pool are exempt from registration under the Securities Act of 1933, and such interests are offered and sold without marketing to the public in the United States”. The Managed Funds Association has asked the CFTC to confirm that a pool that offers its interests in a securities offering conducted pursuant to SEC Rule 506(c) (i.e., that involves general solicitation) would not run afoul of the Rule 4.13(a)(3) requirement that the pool not engage in marketing to the public. The CFTC has not yet provided such assurance, and until the CFTC takes some action in this regard, pools operated under Rule 4.13(a)(3) may not be able to take advantage of the liberalized offering regime presented by Rule 506(c).

13 Broker-dealers participating in offerings in conjunction with issuers relying on Rule 506(c) will continue to be subject to FINRA rules regarding communications with the public, which, among other things, (1) generally require all member communications to be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service; and (2) prohibit broker-dealers from making false, exaggerated, unwarranted, promissory or misleading statements or claims in any communication.
Amendments to Form D. The General Solicitation Rules amend Form D, a notice form required by Rule 503 of Regulation D to be filed by issuers offering or selling securities in reliance on Rule 504, 505 or 506, to add a new checkbox for indicating that an issuer is relying on the new Rule 506(c) exemption. Issuers will not be permitted to check both the 506(c) and 506(b) boxes at the same time for the same offering because the use of general solicitation in connection with an offering would be inconsistent with an offering made pursuant to Rule 506(b). Once a general solicitation has been made, an issuer will be precluded from making a claim of reliance on Rule 506(b) for that same offering.\(^\text{14}\) At present, filing the Form D notice, although a requirement of Rule 503, is not a condition to the availability of the exemption from registration provided by Rule 506, but is proposed to be (as discussed below).

Amendments to Rule 144A

The General Solicitation Rules amend Rule 144A to remove the reference to offers in the conditions to the exemption. This action, in the SEC’s view, means that sales under Rule 144A may be made by means of general solicitation. Sales under Rule 144A may be made only to persons that the seller and any person acting on its behalf reasonably believe are QIBs. Rule 144A has never included any limitation on the manner of offering, but the SEC staff has long contended that general solicitation or advertising would be incompatible with the exemption.

Under the General Solicitation Rules, an issuer of an ongoing Rule 144A offering that commenced before the effective date of the General Solicitation Rules may conduct a general solicitation after the effective date without affecting the availability of Rule 144A for the portion of the offering that occurred prior to the effective date of the amended rule.

Impact on Global Offerings Relying on Regulation S

The General Solicitation Rules also clarify that general solicitation in connection with a Rule 506(c) or 144A offering will not constitute prohibited “directed selling efforts” under Regulation S. The General Solicitation Rules do not change the fact that contemporaneous domestic and foreign offerings by the same issuer are treated separately in applying the Regulation S prohibition against directed selling efforts.

III. Adoption of “Bad Actor” Disqualifying Provisions

Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to adopt rules disqualifying securities offerings involving certain “felons and other ‘bad actors’” from reliance on Rule 506 of Regulation D.

Under new Rule 506(d), an issuer will not be permitted to rely on the Rule 506 exemption from Securities Act registration if the issuer or any other person covered by the rule has experienced a “disqualifying event.” Rule 506 previously did not impose any bad actor disqualification requirements. The Bad Actor Rules apply to all Rule 506 offerings, not just offerings in which an issuer engages in general solicitation pursuant to new Rule 506(c).

Impact of Disqualification Under Rule 506(d)

Rule 506 establishes a non-exclusive safe harbor exemption from registration under the Securities Act. If an offering is disqualified under Rule 506(d) from reliance on Rule 506, the offering could still be conducted pursuant to the exemption set forth in Section 4(a)(2) of the Securities Act, as construed by the SEC and the courts, or through another available exemption.

\(^{14}\) An issuer, such as a private fund or commodity pool, conducting a continuous offering under Rule 506(c) would have to stop both offers and sales for a period of six months should the issuer want to offer and sell under Rule 506(b).
Rule 506 also establishes a so-called “covered securities” offering pursuant to Section 18(b)(4)(E) of the Securities Act that results in the preemption of the securities registration, disclosure and merit review requirements under the various states’ securities (i.e., “Blue Sky”) laws. A private offering that is disqualified under Rule 506(d) would not be eligible to be conducted in accordance with Rule 506 and hence would not be deemed to be a covered securities offering pursuant to Section 18(b)(4)(E). This loss of “covered security” offering status would subject the offering to the general securities registration or exemption requirements in each state where an offer or sale is made.

Disqualifying Events

Under Rule 506(d), a disqualifying event (or trigger event) has occurred if a “covered person” (as defined below):

- Has been convicted within the last 10 years before the 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 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;
- 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;
- Is subject to a final order 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 or officer of a state performing like functions); an appropriate federal banking agency; the CFTC; or the National Credit Union Administration that (a) at the time of such sale, bars the person from (1) association with an entity regulated by such commission, authority, agency or officer, (2) engaging in the business of securities, insurance or banking or (3) 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;
- Is subject to an SEC order that, at the time of the 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;
- Is subject to any SEC order entered within five years before the sale that, at the time of the 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 or (b) Section 5 of the Securities Act;
- 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;
- Has filed, was an underwriter in, 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; or
- 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.

**Covered Persons**

The disqualification provisions of Rule 506(d) arise if any one or more of the following persons (“covered persons”) is, or becomes subject to, a disqualification event set forth in the Bad Actor Rules:

- The issuer, any predecessor of the issuer or an affiliated issuer;
- Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- Any beneficial owner of 20% 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 sales of securities in the offering in question (such as a placement agent or finder);
- Any general partner or managing member of any such investment manager or compensated solicitor; or
- Any director, executive officer or other officer participating in the offering, general partner or managing member of any such investment manager or compensated solicitor.

Rule 506(d) covers executive officers (i.e., those persons performing policy-making functions) of covered entities and other officers who participate in the offering. Participation in an offering, the SEC commented, would mean “more than transitory or incidental involvement” and could include activities such as involvement in due diligence activities, involvement in the preparation of disclosure documents and communication with the issuer, prospective investors or other offering participants.

**“Reasonable Care” Exception**

An issuer will not lose the benefit of the Rule 506 safe harbor in respect of an offering that is subject to one or more disqualification events if the issuer can establish that at the time of any sales, it did not know and, in the exercise of reasonable care, could not have known of the existence of any such event.

To rely on the exception, an issuer must establish that it made a factual inquiry into whether or not any disqualification event exists, although the nature and scope of such inquiry will “vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.” The SEC in the adopting release does not prescribe or delineate the steps an issuer must take to show reasonable care. The adopting release notes that the timeframe for inquiry should also be reasonable in relation to the circumstances of the offering and the participants.

The SEC stated that “for continuous, delayed or long-lived offerings, reasonable care includes updating the factual inquiry on a reasonable basis.” In the absence of facts indicating that closer monitoring would be required, the SEC indicated that it “would expect that periodic updating could be sufficient.” The SEC noted its expectation that issuers will manage this through contractual covenants from covered persons to provide bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases and other steps, depending on the circumstances.
Disqualification Applies Only to Triggering Events That Occur After Effectiveness

Disqualification will not arise as a result of triggering events that occurred before the effective date of the rule amendments, but disclosure to investors regarding such events is required. Sales of securities made before the effective date will not be affected by any disqualification or disclosure requirement, even if such sales are part of an offering that continues after the effective date. Only sales made after the effective date of the amendments will be subject to disqualification and mandatory disclosure.

Disqualifying events that occur while an offering is underway will be treated similarly. Sales made before the occurrence of the disqualification trigger will not be affected, but sales made afterward will not be entitled to rely on Rule 506 unless the disqualification is waived or removed, or, if the issuer is not aware of a triggering event, the issuer can rely on the reasonable care exception.

Mandatory Disclosure of Triggering Events Before Effectiveness

Rule 506(d) requires written disclosure of pre-existing events that otherwise would trigger disqualification but occurred before the effective date of the new disqualification provisions. The SEC stated its expectation that issuers “will give reasonable prominence” to the disclosure and will provide disclosure “a reasonable time prior to sale.”

Similar to the “reasonable care” exception to disqualification, the rule amendments include a “reasonable care” exception to the disclosure requirement that will preserve an issuer’s claim to reliance on Rule 506 if disclosure is required but the issuer can establish that it did not know, and in the exercise of reasonable care could not have known, of the undisclosed matters. In order to establish that it has exercised reasonable care, the issuer must have made, in light of the circumstances, factual inquiry into whether any disqualifications exist.

SEC Waivers From Disqualification

The SEC can grant a waiver of disqualification if it determines that the issuer has shown good cause that it is not necessary under the circumstances that an exemption be denied.

IV. Proposed Amendments to Regulation D, Form D and Rule 156

The SEC proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act. The SEC stated that these amendments are intended to facilitate its understanding and response to changes in the private securities markets brought about by the General Solicitation Rules.

The Proposed Rules were approved for publication on a 3-2 vote. Chairman White indicated that the SEC would move quickly to implement these proposed rules. As the Proposed Rules may have a deterring effect on the use of general solicitation for Rule 506(c) offerings, active participation by issuers, financial intermediaries and the investment funds industry in the public rulemaking process is important to ensure that the SEC adopts final rules that allow issuers to make practical use of the proposed Rule 506(c) offering process.

Form D Changes

“Advance Form D.” The Proposed Rules would require issuers that intend to engage in general solicitation for a Rule 506(c) offering to file an initial Form D (the “Advance Form D”) at least 15 calendar days before commencing general solicitation for the offering. The Advance Form D would include:

- Basic identifying information on the issuer;
- Information on the issuer’s principal place of business and contact information;
- Information on related persons;
• Information on the issuer’s industry group;
• Identification of the exemption or exemptions being claimed for the offering;
• Indication of whether the filing is a new filing or an amendment;
• Information on the type(s) of security to be offered (to extent the information is known at the time of filing);
• Indication of whether the offering is related to a business combination;
• Information on persons receiving sales compensation (to the extent the information is known at the time of filing); and
• Information on the use of proceeds from the offering.

Note that the releases addressing Rule 506(c) do not specifically define “general solicitation,” and therefore it is not entirely clear in all circumstances when that general solicitation will “commence,” particularly in the case of a private fund manager that manages multiple funds and accounts and generally advertises its services.

Form D Amendment. Under the Proposed Rules, an issuer would be required to file an amendment providing the remaining information required by Form D within 15 calendar days after the date of first sale of securities in the offering, as is currently required by Rule 503. An issuer that provided all of the information required by Form D in the Advance Form D would not need to file an additional amendment unless otherwise required under Rule 503. Additionally, under the Proposed Rules, an issuer could file an Advance Form D without contemplating a specific offering, in order to have the flexibility to conduct an offering using general solicitation.

“Closing Form D.” The SEC also proposed amending Rule 503 to require the filing of a Form D closing amendment within 30 calendar days after the termination of any offering conducted in reliance on Rule 506 (not just offerings involving a general solicitation). The requirement would be in addition to the existing provisions in Rule 503 that require the filing of an amendment to Form D to correct a material mistake of fact or error, to reflect a change in information previously provided and on an annual basis for ongoing offerings. The closing amendment would apply on any termination of any Rule 506 offering, whether closed or abandoned.

Additional Form D Information. The Proposed Rules would also revise Form D to add information requirements primarily for Rule 506 offerings to enable the SEC to gather additional information on the use of Rule 506 and assess the impact and use of Rule 506(c). The Proposed Rules would require the issuer to disclose:

- For Rule 506(c) offerings, the name and address of any person who directly or indirectly controls the issuer;
- Information on 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; and
- For issuers that are not pooled investment funds, information on the percentage of the offering proceeds from a Rule 506 offering that was or will be used to repurchase existing securities, pay offering expenses, acquire assets, finance acquisitions, for working capital and to discharge indebtedness.

New items in Form D filings for offerings under Rule 506 would call for the following information:

- The number and types of accredited investors that purchased securities in the offering;
- If a class of the issuer’s securities is traded on a national securities exchange, alternative trading system (“ATS”) or any other organized trading venue, and/or is registered under the Securities Exchange Act of 1934 (the “Exchange Act”), the name of the exchange, ATS or trading venue and/or the Exchange Act file number and whether the

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15 Currently, Form D is required to be filed only after the first sale of securities, which means that issuers that offer securities, but do not complete a sale, are not required to file a Form D.
securities being offered under Rule 506 are of the same class or are convertible into or exercisable or exchangeable for such class;

- If the issuer used a registered broker-dealer in connection with the offering, whether any general solicitation materials were filed with FINRA;

- In the case of a pooled investment fund advised by a registered investment adviser or exempt reporting adviser, the name and SEC file number for each investment adviser that functions directly or indirectly as a promoter of the issuer;

- For Rule 506(c) offerings, the types of general solicitation used or to be used; and

- For Rule 506(c) offerings, the methods used or to be used to verify accredited investor status.

**Additional Disqualification Provisions for Filing Failures**

Current Rule 507 of Regulation D disqualifies an issuer from using Regulation D if the issuer, a predecessor or an affiliate has been enjoined by a court for violating the Rule 503 filing requirements. The Proposed Rules would amend Rule 507 by adding new paragraph (b) so that an issuer would be automatically disqualified from using Rule 506 in any new offering for one year if the issuer, or its predecessor or affiliate, failed to comply, within the past five years, with Form D filing requirements in Rule 503 in connection with a Rule 506 offering. The one-year period would end one year after all required Form D filings were made or the filing of a closing amendment if the offering has been terminated. The proposed disqualification would apply only to future offerings and would not affect offerings of an issuer or an affiliate that are ongoing at the time of the filing non-compliance, including the offering for which the issuer failed to make a required filing, and these offerings could continue to rely on Rule 506 so long as the conditions of Rule 506 continued to be met. The Proposed Rules include a 30 calendar day cure period for an issuer’s first failure to timely file a Form D or Form D amendment in connection with a particular filing and would permit that disqualification under Rule 507(b) to be waived by the SEC.

**Legend Requirements**

The SEC proposed new Rule 509, which would require all issuers to include legends in any written general solicitation materials used in a Rule 506(c) offering and additional disclosures for private funds if the materials include performance data.

The following legends would be required in all written general solicitation materials under the Proposed Rules:

- 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 and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act;

- 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;

- Investing in securities involves risk, and investors should be able to bear the loss of their investment; and

- With respect to general solicitation materials for a private fund, that the securities offered are not subject to the protections of the Investment Company Act.
Proposed Rule 509(c) also would require the written general solicitation materials of any private funds that include performance data to include a legend disclosing that:

- Performance data represents past performance;
- Past performance does not guarantee future results;
- Current performance may be lower or higher than the performance data presented;
- The private fund is not required by law to follow any standard methodology when calculating and representing performance data; and
- The performance of the fund may not be directly comparable to the performance of other private or registered funds.

All performance data included in written general solicitation materials would be required to be as of the most recent practicable date considering the type of private fund and the media through which the data would be conveyed. The private fund would also need to disclose the period for which performance is presented and, if the performance does not include the deduction of fees and expenses, that the presentation does not reflect the deduction of fees and expenses and that if such fees and expenses had been deducted, performance may be lower than presented.

The failure to include legends or other disclosures required under proposed Rule 509 would not render Rule 506(c) unavailable for the offering. Instead, the Proposed Rules would amend Rule 507(a) so that Rule 506 would be unavailable for an issuer if the issuer, or any of its predecessors or affiliates, has been subject to any order, judgment or court decree enjoining such person for failure to comply with Rule 509.

**Application of Registered Fund Sales Literature Rule to Private Funds**

The SEC proposed to amend Rule 156 under the Securities Act to extend its application to private funds. Currently Rule 156 prohibits the use of misleading sales literature by registered investment funds – including publicly offered mutual funds, closed-end funds and exchange-traded funds – and includes specific factors to consider in determining whether sales literature is materially misleading.

Under Rule 156, “sales literature” explicitly includes any communication used by any person to induce the sale of securities and includes communications between issuers, underwriters and dealers if those communications “can be reasonably expected to be communicated to prospective investors” in either written or oral form. It is not entirely clear how Rule 156 will augment or change the regulatory regime already applicable to private fund advertising under the Advisers Act anti-fraud provisions, Rule 206(4)-1, Rule 206(4)-8 and the SEC staff interpretations addressing marketing and advertising by registered investment advisers.

**Submission of General Solicitation Materials to the SEC**

The Proposed Rules would add new Rule 510T of Regulation D to require an issuer conducing an offering in reliance on Rule 506(c) to submit to the SEC any written general solicitation materials used in connection with the offering. The materials would be required to be submitted no later than the date of first use. As proposed, Rule 510T would expire two years after its effective date. The materials, which would be submitted electronically, but outside the SEC’s EDGAR system, would not be publicly available.

Rule 507(a) would be amended so that Rule 506 would be unavailable for an issuer if such issuer, or any of its predecessors or affiliates, has been subject to any order, judgment or court decree enjoining such person for failure to comply with Rule 510T.
Review of Natural Person Accredited Investor Definition

The SEC is seeking comment as to whether the net worth and income tests are appropriate tests for determining whether a natural person is an accredited investor, if the current financial thresholds in the tests are still appropriate and whether the definition should be expanded to include a financial knowledge or investment experience component.

Rule 506(c) Work Plan

The proposing release notes that the SEC has been directed to execute a comprehensive work plan upon the effectiveness of Rule 506(c) to review and analyze the use of Rule 506(c) (the “Work Plan”), which will involve a coordinated effort of staff from the Division of Corporation Finance, the Division of Economic and Risk Analysis, the Division of Investment Management, the Division of Trading and Markets, the Office of Compliance Inspections and Examinations and the Division of Enforcement. Under the Work Plan, the SEC staff is directed to, among other things:

- Evaluate purchaser verification practices;
- Evaluate whether the absence of the prohibition against general solicitation has been accompanied by an increase in sales to non-accredited investors;
- Assess whether Rule 506(c) has facilitated new capital formation or shifted capital formation from registered to unregistered offerings;
- Examine information provided on Form D and form and content of solicitation materials;
- Monitor for increased incidence of fraud;
- Incorporate evaluation of Rule 506(c) practices into SEC staff examinations of broker-dealers and investment advisers, and
- Coordinate with state regulators.

If you have questions about this Sidley Update, please contact the Sidley Austin LLP lawyer with whom your ordinarily work.

The Investment Funds Practice of Sidley Austin LLP

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