SEC adopts amendments to private placement marketing and "bad actor" regimes.

Pursuant to the mandate set out in the Jumpstart Our Business Startups Act, the U.S. Securities and Exchange Commission (the **SEC**) has adopted amendments to Rule 506 of Regulation D and Rule 144A, each under the Securities Act of 1933, as amended (the **Securities Act**) that are expected to become effective in mid-September. The SEC also adopted changes that disqualify certain "bad actors" from participating in securities offerings that rely on the Rule 506 safe harbor and proposed other amendments that may impact the issuer private placement market. Following on from our previous briefings, it is worth examining how these new rules might impact non-U.S., or foreign private issuers (**FPIs**).

Background

Section 5 of the Securities Act prohibits the offer and sale of a security into the United States absent its registration with the SEC, unless both the offer and sale are made in a transaction that is exempt from, or not subject to, such registration requirements. Relatively few FPIs attempt to register their offerings with the SEC; the preferred alternative being to utilize private placement exemptions, primarily the resale exemption provided in Rule 144A and the issuer exemption provided in Rule 506.

Each of these exemptions imposes a variety of restrictions designed to protect U.S. investors, including with respect to the marketing of the transaction in the United States.

Prior to the JOBS Act revisions, offers of securities to investors in the United States made in reliance on Rule 506 have been subject to a requirement that neither the seller, nor anyone acting on its behalf, offers or sells the securities by means of any form of "general solicitation" or "general advertising".[1] Furthermore, although Rule 144A does not expressly prohibit general solicitation or general advertising, such marketing activities are effectively prohibited because offers to participate in a Rule 144A transaction must only be made to qualified institutional buyers (**QIBs**).

As a result, marketing activities in the United States in relation to private placements pursuant to Rule 144A and Rule 506 typically have been directed at a restricted number of sophisticated investors.

The Amendments

Rule 506

The SEC has added Rule 506(c) to Regulation D, which permits an issuer to engage in

[1] General advertising and general solicitation include any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

general solicitation and general advertising when offering and selling securities in or into the United States pursuant to Rule 506(c), provided that all purchasers of the securities are accredited investors ***and*** the issuer takes reasonable steps to verify that such purchasers are accredited investors.[2]

The SEC release states that the determination of whether the steps taken to verify accredited investor status are reasonable is "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". The SEC proposed a number of factors that might be considered in this "principles-based approach":

- 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.[3]

Although verification of certain institutional investors may be fairly straightforward (for example, verifying that the investor is a registered broker-dealer by checking FINRA's BrokerCheck website), the SEC has recognized that verification may be more complicated if the investor is a natural person. Rule 506(c) therefore also includes a non-exclusive list of methods that issuers may use to satisfy the verification requirement for investors who are natural persons:

- receipt of certain documentation of levels of income or net worth of the investors (such as tax returns, bank statements and credit reports)[4];
- verification of accredited investor status from certain third-parties, such as a registered broker-dealer, a registered investment adviser, a licensed attorney or a certified public accountant; or
- for an existing securityholder which previously purchased in a Rule 506 offering by the issuer, the receipt of a certification from the purchaser that it still meets the definition of an accredited investor.

Note that the requirement to take reasonable steps to verify all purchasers are accredited investors is independent of the requirement that sales be made solely to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors. The release states that it will be important for issuers (and any third party verification service providers) "to retain records regarding the steps taken to verify that a purchaser was an accredited investor."

The SEC has left the previous formulation of Rule 506 unchanged in the form of Rule

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[2] Note that the release expressly states that the responsibilities of broker-dealers participating in Rule 506(c) offerings set out in the FINRA rules regarding communications with the public remain unchanged. These rules prohibit broker dealers from making false or misleading statements and, generally, require that all communications "be based on principles of fair dealing and good faith."

[3] According to the release, "[t]hese factors would be 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, which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status."

[4] If the investor's status is to be established by verification of his or her net worth, the release states that the verification requirement will be met if the noted documentation is reviewed ***and*** the investor provides "a written representation that all liabilities necessary to make a determination of net worth have been disclosed".

506(b). Although issuers must still reasonably believe that investors are accredited investors, issuers will not be subject to the verification or related record retention requirements if they do not employ general solicitation or general advertising in reliance upon Rule 506(c). Note also that issuers conducting offerings pursuant to Rule 506(b) may still offer and sell securities to no more than 35 sophisticated non-accredited investors, which is not the case for issuers pursuing Rule 506(c) offerings.

Impact on Section 4(a)(2) Offerings

Rule 506 has historically functioned as a nonexclusive safe harbour so that, in the event that an offering or sale does not meet the specific requirements of Rule 506, Section 4(a)(2) (previously Section 4(2)) might still be available as an exemption from registration.

The SEC confirmed that Section 4(a)(2)'s prohibition of general solicitation and general advertising has not been effected by the amendments. Therefore, in the event that an issuer does engage in general solicitation or advertising but otherwise does not meet the requirements of Rule 506(c), it appears that the offering will not benefit from the Section 4(a)(2) exemption from registration.

Rule 144A

Rule 144A currently requires that all offerees are QIBs. The amended Rule 144A removes this requirement, which effectively allows general solicitation and general advertising in relation to Rule 144A offerings, so long as all of the purchasers of the securities offered are reasonably believed by the seller to be QIBs.

Implication for Global Offerings

It is often the case that FPIs will conduct "global offerings", whereby they undertake an offering outside of the United States pursuant to Regulation S, alongside a private placement of securities to investors in the United States pursuant to Rule 144A or Rule 506.

Beware of false friends: the distinction between Rule 506(c) and Rule 144A

By its terms, Rule 144A is available solely for resale transactions; however, market participants have used Rule 144A to facilitate capital-raising by issuers in conjunction with a firm underwriting commitment and the term "144A" has often been used as shorthand to connote any offering of securities to investors in the United States, even those offerings that are made by issuers pursuant to Rule 506 (or another issuer exemption). Although both 144A and Rule 506(c) now allow for the use of general solicitation and general advertising, it is important to note that, in addition to the difference between QIBs and "accredited investors" which remains unchanged, Rule 144A does not have either the verification requirements or record retention requirements set out in Rule 506(c). Furthermore, although the SEC has stated that the use of general solicitation for resales under Rule 144A will not affect the availability of the Section 4(a)(2) private placement exemption for the sale by the issuer to the initial purchasers, it is unclear if this is also true with respect to an offering made pursuant to Rule 506(b).

Regulation S prohibits any "directed selling efforts" in the United States by or on behalf of an issuer in relation to an offering of securities to investors outside of the United States. Directed selling efforts include any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for the securities that are being offered outside of the United States.

Although there are no statutory examples provided in relation to the term "directed selling efforts", there is significant overlap between this concept and the activities deemed

to be general solicitation and general advertising. Directed selling efforts would include general and targeted marketing activities in the United States intended to raise awareness of the Regulation S offering but would not include appropriate marketing activities done in relation to the U.S. tranche of the offering.

The SEC has confirmed that offshore offerings under Regulation S will not be integrated with concurrent Rule 506(c) or Rule 144A transactions. General solicitation and general advertising therefore will not constitute directed selling efforts for purposes of the Regulation S offering.

Despite this, questions have been raised as to how the amendments might impact the marketing efforts in relation to global offerings, as the prohibition on directed selling efforts set out in Regulation S has not been amended. Marketing activities that utilize general solicitation and advertising in the context of a global offering will almost inevitably generate broader market interest in ***both*** the onshore Rule 506(c) or Rule 144A tranche and in the offshore Regulation S tranche, from U.S. persons that are neither accredited investors nor QIBs. It could reasonably be argued that the amendments to Rule 506 and Rule 144A, in part, appear to be in conflict with the legislative intent of Regulation S as it pertains to the prohibition of directed selling efforts.

Blue Sky Laws

U.S. state securities laws ("blue sky laws") apply to the offer of sale of securities to investors in the relevant state, unless the securities are "covered securities" and therefore exempted by federal securities laws. Securities offered pursuant to Rule 506 had been considered to be "covered securities" prior to these amendments and the SEC has confirmed that securities offered pursuant to either Rule 506(b) or Rule 506(c) will be "covered securities".

Impact on Private Funds

Hedge funds, venture capital funds, private equity funds and other private funds usually rely on Section 4(a)(2) and Rule 506 for their fundraisings. In addition, such funds usually rely on either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the **ICA**) in order to avoid having to register as an "investment company". Sections 3(c)(1) and 3(c)(7) of the ICA are not available, however, to a private fund making a "public offer" of its securities.

The SEC has confirmed that, subject to the requirements set out in Rule 506(c), the use of general solicitation and advertising will not violate the prohibition against "public offers" and private funds may pursue Rule 506(c) offerings for fundraising purposes while maintaining their exemptions under the ICA.

Please note, however, that private funds may be subject to non-U.S. regulatory frameworks, many of which strictly restrict or prohibit fund advertising. Therefore, such private funds should seek specific legal advice before proceeding with a Rule 506(c) offering.

Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings

The SEC has also implemented Section 926 of the Dodd-Frank Act which banned participation by certain "bad actors" in offers and sales of securities pursuant to Rule 506. Under the new rules, certain offering participants (including issuers, underwriters, placement agents, directors, executive officers, and certain shareholders of the issuer) are prohibited from participating in Rule 506

offerings if they have been convicted of or are subject to court or administrative sanctions for violations of specified laws (including securities fraud). Disqualifying events that occurred prior to the effectiveness of the new rules will not count, though such events must be disclosed, and an issuer may be able to rely on Rule 506 if it can demonstrate that it did not know and, in the exercise of reasonable care could not have known, that a disqualifying event existed.

Proposed Changes to Form D and Other Filing Requirements

The following proposed changes are currently open for comment to the SEC:

Timing of Form D Filings

The SEC also proposed amendments to Regulation D and Form D that are intended to augment the SEC's ability to assess the use of general solicitation and general advertising in Rule 506(c) offerings and the impact that these marketing efforts have on investors and the market. The proposed rules would require the filing of an advance Form D 15 calendar days before the first use of general solicitation in a Rule 506(c) offering and the filing of a closing Form D amendment within 30 calendar days after the termination of any Rule 506 offering.

Content Requirements of Form D

Currently, Form D requires relatively limited identifying information about the issuer, any related persons, the exemption the issuer is relying on to conduct the offering and certain other factual information about the issuer and the offering.

Under the proposal, issuers also will be required provide additional information to enable the SEC to gather more information on the changes to the Rule 506 market that could occur now that the general solicitation ban has been lifted.

The additional information would include:

- identification of the issuer's website;
- expanded information on the issuer and the securities offered;
- the types of investors in the offering;
- the use of proceeds from the offering;
- information on the types of general solicitation used; and
- the methods used to verify the accredited investor status of investors.

Consequences of Failing to File Form D

The proposed revisions to Rule 507 would disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer or its affiliates did not comply, within the prior five years, with all the Form D filing requirements in a Rule 506 offering. The five-year period would not, however, extend to non-compliance that occurred prior to the effective date of the new rule.

Additional Filing Requirements under Proposed Rule 510T

Under the proposed Rule 510T, issuers making offers and sales pursuant to Rule 506(c) would also be required to submit any written general solicitation materials to the SEC no later than the date of first use of these materials. These submissions would not be available to the public and Rule 510T, if adopted, would expire two years after its effective date.

Conclusion

The amendments that were adopted by the SEC are very much in line with those proposed earlier this year. However, current market practice with respect to the avoidance of general solicitation and advertising is well

accepted; it remains to be seen whether Rule 506(c) will be attractive to sophisticated domestic issuers or FPIs, given the additional filing and record keeping requirements.

With respect to the proposed amendments, the SEC acknowledged that filing Form D is not currently a condition to claiming the safe harbor[5] and indeed that many issuers in Rule 506 transactions today do not file a Form D. This is likely the result of several factors, including, in addition to the provision of certain issuer and offering-specific information, the fact that Form D requires (and will continue to require) an issuer to appoint an agent for service of process in the United States and effectively confirms that the issuer submits to U.S. jurisdiction. Although it can be argued that an issuer that offers and sells securities into the United States would have implicitly submitted itself to U.S. jurisdiction, FPIs in particular often have been reluctant to do so explicitly by filing a Form D.

Given that the proposed changes to Form D expands the information that would be required in the filing and the reluctance that many issuers, particularly FPIs, have had in filing Form D to date, some commentators have questioned whether issuers will be more reluctant to pursue Rule 506 offerings. Furthermore, although the proposed new Rule 510T is intended to be temporary and the submissions will not be public, it remains to be seen whether these two changes would, if adopted, have a chilling effect on the otherwise active Rule 506 private placement market.

[5] See question 257.07 ("Section 257. Rules 503 and 503T– Filing of Notice of Sales") of the Compliance and Disclosure Interpretations last updated on May 16, 2013.

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