Burns & Levinson LLP

SECURITIES LAW UPDATE

July 2013

SEC Amends Rules on Advertising, Solicitation and "Bad Actors" for Certain Private Offerings and Proposes Changes to Form D

On July 10, 2013, the Securities and Exchange Commission (SEC) approved new rules that, beginning September 23, 2013, will under specified circumstances eliminate the bans on "general solicitation and general advertising" (hereafter referred to as "general solicitation") in connection with securities offerings made to accredited investors or qualified institutional buyers (QIBs) pursuant to either Rule 506 of Regulation D or Rule 144A of the Securities Act of 1933.

The SEC also approved amendments to the "bad actor" provisions solely for Rule 506 offerings, also beginning September 23, 2013, but left undecided the consideration of whether such provisions should be made uniform and consistent for Regulation A, Regulation D and future "crowd-funding" offerings.

On the same day, in a separate announcement, the SEC asked for public comments on proposed rule changes that would require Rule 506 securities issuers to file significantly more information with the SEC to improve the SEC's ability to evaluate developing market practices and further protect investors.

Because the combined amount of capital raised by operating companies through Rule 506 and Rule 144A offerings was roughly $809 billion in 2012, and the amount of capital raised through these offerings by private investment funds (such as venture capital and hedge funds) was another $729 billion, these new rules and new proposals could have a major impact on the capital strategies of many companies.

Among other things, this Securities Law Update provides a detailed summary of the new regulations for general solicitation offerings. In general, these rules:

- Add a new Rule 506(c) private offering exemption under Section 4(a)(2) of the Securities Act, and make it available to any issuer that wishes to use general solicitation to offer securities only to accredited investors;
- Authorize and permit Rule 144A offerings by means of general solicitation under appropriate conditions;
- Clarify the legal status of such offerings when they are combined with concurrent offerings outside the U.S. pursuant to Regulation S;
- Authorize and permit private investment funds to utilize general solicitation under the conditions specified by the new rules and subject to prohibitions against "fraudulent, deceptive or manipulative" acts; and
- Amend Form D, which must be filed in connection with Regulation D sales, in accordance with the proposals.

This Update also provides a detailed summary of the new rule changes regarding "bad actor" restrictions, which generally define:

- Those entities and individuals who are "covered persons" for whom an unfavorable "disqualifying event" can act as a bar to participation in a private offering under Rule 506 of Regulation D, subjecting the offering exemption to potential nullification;
- The specific "disqualifying events" that would prohibit a person from participating in a Rule 506 offering and prohibit an issuer from making such an offering;
- An exception from disqualification that is available to an issuer that has exercised "reasonable care" to avoid association with any "bad actor;" and
- The availability of waivers from disqualification in limited circumstances.

Finally, this Update also provides a detailed summary of the proposed rule changes pertinent to Rule 506 offerings, which would generally:

- Require issuers to file specified notices both before the commencement of and after the conclusion of a Rule 506 offering;
- Require issuers, especially those using general solicitation, to provide significant additional information similar to some types of information that one might find in a registration statement;
- Require issuers to include certain legends and disclosures in their general solicitation materials;
- Temporarily require issuers to submit the general solicitation materials used in their offering to the SEC; and
- Disqualify issuers who fail to file Form D from using the exemption for future offerings.

The SEC adopted the Rule 506 amendments regarding general solicitation in substantially the same form as they were proposed in August 2012, with some further clarifications, including the addition of a non-exclusive list of methods that issuers may use to verify accredited investor status. The original rule proposals were summarized in our September 2012 Securities Law Update entitled, "SEC Proposes to Lift Bans on General Solicitation and Advertising Pursuant to JOBS Act": http://www.burnslev.com/apps/uploads/publications/BurnsLev_SEC_Proposes_to_Lift_Bans_on_General_Solicitation.pdf.

The rule amendments regarding general solicitation were legislatively mandated by Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"), which was previously described in our April 2012 Securities Law Update entitled, "JOBS Act Makes It Easier to Raise Capital": http://

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www.burnslev.com/apps/uploads/publications/Securities_Law_Update_Apr2012.pdf.

The latest amendments to the "bad actor" rules are generally consistent with the changes proposed by the SEC in May 2011, except that they have:

- Limited the retrospective effect of any "qualifying events" that might have occurred prior to the effective date of the amendments, while making such events still subject to disclosure;
- Enumerated more disqualifying events related to certain actions by the SEC or the Commodity Futures Trading Commission (the CFTC);
- Narrowed the number of "officers" who fall within the definition of "covered persons;"
- Narrowed the number of beneficial owners of an issuer who might fall within the definition of "covered persons;" and
- Expanded the circumstances under which a disqualification from exemption will not apply because of determinations by certain government authorities.

The original "bad actor" rule proposals were summarized in our June 2011 Securities Law Update entitled, "SEC Proposes 'Bad Actor' Bars to Certain Private Securities Offerings": http://www.burnslev.com/apps/uploads/publications/Securities_Law_Bad_Actor_June2011.pdf.

These rule amendments regarding "bad actors" were legislatively mandated by the Dodd-Frank Act, which was previously summarized in our July 2010 Securities Law Update entitled, "Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act": http://www.burnslev.com/apps/uploads/publications/Securities_Update_Dodd-Frank_July2010.pdf.

The full text of the 116-page SEC Release no. 33-9415 regarding relaxation of general solicitation bans (the "Solicitation Release") can be found here: http://www.sec.gov/rules/final/2013/33-9415.pdf.

The full text of the 147-page SEC Release no. 33-9414 regarding "bad actor" disqualifications (the "Bad Actor Release") can be found here: http://www.sec.gov/rules/final/2013/33-9414.pdf.

The proposed rules regarding Rule 506 offerings can be found, along with the full text of the 185-page SEC Release on that subject (the "Proposed Rules Release"), at: http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

The new rules regarding general solicitation offerings and "bad actors" go into effect on September 23, 2013.

RATIONALE FOR NEW RULES ON GENERAL SOLICITATION

Rule 506 has for a long time exempted from public registration requirements any transaction by an issuer "not involving any public offering." Under this rule, an issuer could traditionally offer and sell securities to an unlimited number of "accredited investors" (generally wealthy or institutional investors, as defined by Rule 501(a) of Regulation D) and to no more than 35 non-accredited investors who meet certain "sophistication" requirements.

This offering exemption has proved to be a popular tool for capital raising by issuers, but the availability of this Regulation D exemption has previously been conditioned on the issuer not making use of any form of general solicitation. Although the terms "general solicitation" and "general advertising" are not defined under Regulation D, they do include the use of newspaper and magazine advertisements, television and radio broadcasts, public seminars (where the attendees have been invited by some form of general solicitation or general advertising) and Internet media, according to the SEC.

Issuers have traditionally enjoyed another safe harbor from registration under Rule 144A for the resale of certain "restricted securities" (as defined by Rule 144(a)(3)) to QIBs, which are generally defined by Rule 144A as large institutional purchasers. This rule, as previously formulated, did not expressly prohibit general solicitation, but it did restrict offerings to QIBs only, and thus, was not compatible with the use of general solicitation.

Recognizing that these bans on general solicitation were impeding the ability of issuers to connect with accredited investors and QIBs, Congress passed the JOBS Act, which required the SEC to formulate rules that would:

1. Permit general solicitation in Rule 506 offerings while insuring that sales are made only to accredited investors; and
2. Allow offers of securities under Rule 144A by means of general solicitation, provided that the securities are sold only to persons that the seller or its agents reasonably believe to be QIBs.

NEW GENERAL SOLICITATION OFFERINGS UNDER RULE 506

To implement the rule changes mandated by the JOBS Act, the SEC formulated and approved new Rule 506(c), which will permit the use of general solicitation provided that certain conditions are satisfied. Those conditions are:

- The issuer must comply with all terms and conditions of Rule 501 (which defines "accredited investors" and other key concepts), Rule 502(a) (which prohibits issuers from circumventing the rules by making multiple offerings that should be treated as one offering), and Rule 502(d) (which places certain restrictions on resale of securities);
- All purchasers of the securities offered must qualify as accredited investors by rule, either because they come within one of the enumerated categories of persons that qualify, or because the issuer reasonably believes that they do at the time of sale; and
- The issuer must take reasonable steps to verify that all of the purchasers of the securities are accredited investors, as defined in Rule 501.

The SEC also clarified that new Rule 506(c) will not replace any existing rules, but will give issuers an alternative to complying with the terms of current Rule 506(b), which continues to prohibit general solicitation, but allow for sales to 35 non-accredited investors. Retaining the existing safe harbor should be beneficial to investors and issuers who have positive pre-existing relationships and no need for general solicitation, the Release explained.

As a transitional matter, for ongoing Rule

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506 offerings that commenced prior to the effective date of new Rule 506(c), the issuer may choose to continue the offering consistent with either the requirements of Rule 506(b) or the new rule permitting general solicitation without jeopardizing the exempt status of any offers properly made prior to the effective date of the new rule.

1. "Reasonable Steps" to Verify Accredited Investor Status

As one of the requirements of new Rule 506(c), issuers must take "reasonable steps" to verify the accredited investor status of all investors. The SEC explained that whether such steps have been taken must be determined based on the particular facts and circumstances of each transaction rather than any bright-line test.

Under this approach, the determination of whether an issuer has taken the required "reasonable steps" will depend on a number of factors, including:

- The "nature of the purchaser" and the type of accredited investor that the purchaser claims to be;
- The amount and type of "information about the purchaser" that the issuer has; and
- The "nature of the offering," such as the manner in which the purchaser was solicited to participate in the offering, as well as the "terms of the offering," such as any required minimum investment amount.

1a. "Nature of the Purchaser"

Currently, Rule 501(a) defines an "accredited investor" to include both natural persons and entities that fall within one of eight enumerated categories based on:

- Their sophisticated financial status (such as a broker-dealer or investment company);
- Their combination of status and total assets (such as a state retirement plan with assets in excess of $5 million); or
- Their net worth or annual income (for individuals whose individual worth or joint net worth with a spouse exceeds $1 million, excluding any primary residence, or whose individual annual income has exceeded $200,000 in each of the two most recent years or $300,000 together with a spouse's income, and who has a reasonable expectation of reaching the same level in the current year).

The SEC stated that the "reasonable steps" an issuer must take to verify a purchaser's status will vary based on the type of accredited investor that the purchaser claims to be. For example, the steps to verify that an entity is a registered broker-dealer will necessarily be simpler and more defined than the steps necessary to verify whether a natural person meets certain net worth or income tests.

The SEC also emphasized that "the verification of natural persons as accredited investors may pose greater practical difficulties as compared to other categories of investors, particularly [if they claim to be] accredited investors based on the net worth test."

1b. "Information about the Purchaser"

The more information that an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps the issuer should have to take to verify the purchaser's proclaimed status, the SEC stated in the Solicitation Release.

Examples of information that an issuer might reasonably rely upon, depending on facts and circumstances, could include:

- Publicly available information gleaned from filings with governmental bodies;
- Third-party information that provides reasonably reliable evidence, such as copies of W-2 Forms or data tables published in trade journals about average income earned in the workplace, trade or profession in an investor's geographic locale; and
- Third party verifications if the issuer has a reasonable basis to rely on them.

1c. "Nature of the Offering" and "Terms of the Offering"

The nature of the offering, such as the means by which the issuer solicits its purchasers, may be relevant in determining the reasonableness of any steps that must be taken to verify investor status, the SEC added, noting for example, that an issuer which solicits investors through a public Website or social media portal should take greater measures to verify status than an issuer who solicits only from a database of investors pre-screened by a reliable third party, such as a registered broker-dealer.

The terms of the offering could also be relevant to determining what steps are reasonable for ascertaining accredited investor status. For instance, the SEC noted that the ability of a purchaser to pay cash for a sufficiently high minimum investment could provide reasonable evidence of an investor's required net worth, provided that the issuer also ascertained that the purchaser's cash investment was not financed through borrowing or pledges.

Again, in discussing the relevance of the nature and terms of an offering, the SEC reiterated that uniform verification methods would likely be ill-suited, inadequate or even unnecessary to a particular offering or purchaser, depending on the facts and circumstances. But in any event, the SEC warned that it will likely be insufficient for issuers to merely require that investors check boxes on a form and sign it, which is one method that historically has often been used by issuers.

1d. SEC List of Non-Exclusive Methods for Verifying Accredited Investor Status

In response to public comments on the originally proposed rules, the SEC also issued a list of four non-exclusive methods that will be deemed to satisfy the accredited investor verification requirements for natural persons under Rule 506(c). These methods provide that an issuer will be deemed to satisfy the accredited investor income verification requirements of Rule 506(c):

1. By reviewing sufficient copies of Internal Revenue Service forms that have reported the investor's income for the last two years, including Form W-2, Form 1099, Schedule K-1 of Form 1065, and a copy of the filed Form 1040, provided that the issuer also obtains a written representation that the investor has a reasonable expectation of reaching the necessary income level for the current year as well.
2. By reviewing one or more of the following types of documentation related to an investor (or a couple) dated within the prior three months, and by obtaining a written representation from the investor (or couple) that all liabilities have been fully disclosed: For

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assets, an issuer should review, as necessary, relevant bank statements, brokerage statements and other statements of securities holdings, as well as certificates of deposit, tax assessments and appraisal reports issued by independent third parties. For liabilities, an issuer should consider, as necessary, review of consumer credit reports from at least one nationwide consumer reporting agency.

3. By obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that they have taken reasonable steps to verify that a purchaser is, in fact, an accredited investor within the prior three months. An issuer may also rely on the verification of another type of third party, provided that such party has taken reasonable steps to verify a purchaser's status, has determined that the purchaser is accredited, and has given the issuer a reasonable basis to rely upon such verification.
4. For "existing investors in an issuer who were accredited investors in a Rule 506(b) offering of an issuer prior to the effective date of Rule 506(c), a self-certification at the time of sale that he or she is an accredited investor will be deemed to satisfy the verification requirement in Rule 506(c)." The SEC did not specify whether this applies to all subsequent offerings by an issuer or only those reasonably proximate in time.

The SEC also made clear that "none of these methods will be deemed to satisfy the verification requirement if the issuer or its agent had knowledge that the purchaser is not an accredited investor."

2. "Reasonable Belief" That All Purchasers Are Accredited Investors

Many public comments on the originally proposed amendments objected to the continuation of a "reasonable belief" standard, calling for an absolute requirement that all investors be accredited in fact under Rule 506(c). Nonetheless, the SEC did not eliminate the opportunity for issuers to rely on representations related to accredited investor status, provided that they have a basis for "reasonable belief" in those representations.

Thus, both Rule 506 and Rule 144A, requiring an issuer to have a "reasonable belief" regarding the eligibility of investors to participate in an offering, still permit an issuer to rely on that actual belief so long as the issuer took "reasonable steps" to verify that its purchasers were accredited investors. The SEC cited several federal court cases that were unsympathetic to investors who misrepresented their status to support this position.

NEW GENERAL SOLICITATION OFFERINGS UNDER RULE 144A

The SEC also approved new Rule 144A(d)(1), which eliminates references to "offer" and "offeree" (the prior rule restricted the persons to whom offers could be made), thereby requiring "only that securities be sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believes is a QIB."

Rule 144A already provides a list of non-exclusive methods of establishing a prospective purchaser's ownership and investments of securities for purposes of determining whether the purchaser is a QIB.

TREATMENT OF CONCURRENT OFFSHORE OFFERINGS

Rule 902(c)(1) currently provides that "directed selling efforts" in a Regulation S offshore offering, which might be used to "condition" U.S. markets, could defeat a Regulation S exemption. Some commentators expressed concerns about the effect of utilizing a public solicitation with a concurrent offshore offering.

To which, the SEC replied in the Solicitation Release: "Concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, as amended."

TREATMENT OF PRIVATE INVESTMENT FUNDS WITH RESPECT TO GENERAL SOLICITATION

The JOBS Act directed the SEC to eliminate the prohibition against general solicitation for a subset of offerings, but it made no specific reference to what impact a general solicitation would have on private investment funds, such as hedge funds and venture capital funds.

The SEC noted that these funds can legally avoid registration requirements of the Investment Company Act of 1940 (the "1940 Act") if their securities are owned exclusively by "qualified purchasers," or if their securities (other than short-term paper) are beneficially owned by not more than 100 owners, and they are not making or proposing to make a "public offering" of their securities.

Because the SEC has historically regarded Rule 506 transactions as "non-public" offerings for purposes of the 1940 Act, it concluded that "the effect of Section 201(b) is to permit private funds to engage in general solicitation in compliance with new Rule 506(c) without losing either of the exclusions under the [1940 Act]."

AMENDMENTS TO FORM D

The SEC noted in the Solicitation Release that "issuers conducting Rule 506(c) offerings must indicate that they are relying on the Rule 506(c) exemption by marking the new check box in Item 6 of Form D." The current check box for Rule 506 will be relabeled as a check box for Rule 506(b). The SEC added that "an issuer will not be permitted to check both boxes at the same time for the same offering."

NEW RULE 506 BAD ACTOR PROVISIONS

The SEC also adopted amendments to Rules 501 and 506, as well as Regulation D, in order to implement Section 926 of the Dodd-Frank Act pertinent to the SEC's "bad actor" disqualification requirements, sometimes called "bad boy" provisions. These provisions disqualify securities offerings from reliance on exemptions if the issuer or other "covered persons" (such as underwriters, placement agents and other key people associated with the issuer) have been convicted of, or are subject to certain sanctions for past instances of securities fraud or other violations of specified laws.

With regard to these "bad actor" amendments, it is important to note that the SEC decided to limit their applicability to Rule 506 offerings. Thus, the new provisions – pending further consideration – will not apply to offerings under Regulation A or to

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future "crowd-funding" offerings, according to the SEC's Bad Actor Release.

1. Covered Persons

As adopted, the new disqualification provisions pertinent to Rule 506 will cover the following persons:

- The issuer, any predecessor of the issuer, or any affiliated issuer (except that events relating to certain affiliated issuers are not disqualifying if they pre-date the affiliate relationship under Rule 506(d)(3));
- Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- Any beneficial owner of 20 percent or more of any class of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- Any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of any such investment manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member;
- Any promoter (as defined in Rule 405) connected with the issuer in any capacity at the time of the sale;
- 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 (called a "compensated solicitor"); and
- Any director, executive officer, general partner or managing member of any such compensated solicitor.

This new rule is similar, but not identical to the definition of "covered persons" found in Rule 262 pertinent to Regulation A private offerings.

2. Disqualifying Events

Under new Rule 506(d), a Rule 506 private offering exemption will not be available to issuers associated with a "covered person" who is the subject of any of the following types of "disqualifying events":

- Certain criminal convictions;
- Certain court injunctions and restraining orders;
- Final orders of certain state or federal regulatory authorities;
- Certain SEC disciplinary orders;
- Certain cease and desist orders;
- Suspension or expulsion from membership in, or suspension or bar from associating with a member of a securities self-regulatory organization;
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S Postal Service false representation orders.

2.1. Criminal Convictions

Under new Rule 506(d), it will be a "disqualifying event" if any "covered person" associated with a Rule 506 offering for sale has been convicted within 10 years before such sale (or 5 years, in the case of issuers, their predecessors and affiliated issuers) of any felony or misdemeanor:

- "In connection with the purchase or sale of any security;
- Involving the making of any false filing with the SEC; or
- Arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities."

2.2. Court Injunctions and Restraining Orders

Under new Rule 506(d), an offering will also be disqualified from exemption if any "covered person" associated with the offering "is subject to any order, judgment or decree of any court of competent jurisdiction, entered within 5 years before such sale, which at the time of such sale restrains or enjoins [that] person from engaging or continuing to engage in any conduct or practice:

- In connection with the purchase or sale of any security;
- Involving the making of any false filing with the [SEC]; or
- Arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities."

2.3. Final Orders of Certain Regulators

New Rule 506(d) will additionally make it a "disqualifying event" for any "covered person" associated with a Rule 506 offering for sale to be subject to: (i) a final order of a state securities commission (or of an agency or officer of a state performing like functions); (ii) a final order of a state authority that supervises or examines banks, savings associations or credit unions; or (iii) a final order of a state insurance commission (or of an agency or officer of a state performing like functions) or of an appropriate federal banking agency, the U.S. Commodity Futures Trading Commission or the National Credit Union Administration if that order:

- "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 the savings association or credit union activities; or
- Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct, which was entered within 10 years before such sale."

Because there could be confusion over what constitutes the "final order" of a regulator, the SEC also adopted new Rule 501(g), which provides that a "final order" shall mean "a written directive or declaratory statement issued by an appropriate federal or state agency… 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."

The SEC declined to provide a regulatory definition of "fraudulent, manipulative or deceptive conduct" as cited in this rule, but it did explicitly state that such conduct is not limited to matters involving scienter (a specific type of knowledge or intent of wrongdoing).

2.4. SEC Disciplinary Orders

Rule 506(d) now also makes it a "disqualifying event" for any "covered person" associated with a Rule 506 offering to be subject to an order of the SEC entered pursuant to certain rules pertinent to brokers, dealers and investment advisers (as codified in section 15(b) or 15B(c) of the Exchange Act, or

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section 203(e) or (f) of the Investment Advisers Act of 1940) which at the time of such sale:

- "Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;
- Places limitations on the activities, functions or operations of such person; or
- Bars such person from being associated with any entity or from participating in the offering of any penny stock."

2.5. Cease and Desist Orders

The SEC also added a disqualification to Rule 506(d) that was not in its original rule proposals in 2011. As adopted, Rule 506(d)(1)(v) imposes disqualification if any "covered person" is "subject to any order of the SEC entered within five years before such sale that, at the time of sale, orders the person to cease and desist from committing or causing a violation or future violation of:

- Any scienter-based anti-fraud provision of the federal securities laws…; or
- Section 5 of the Securities Act of 1933 [covering prohibitions related to interstate commerce and the mail]."

2.6. Suspensions or Expulsions

As adopted, Rule 506(d) will also impose disqualification on any offering involving a "covered person" that 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."

2.7. Stop Orders and Orders Suspending Exemptions

New Rule 506(d) additionally imposes disqualification on any offering for sale involving a "covered person" who has filed (as a registrant or issuer) or was an underwriter or was named as an underwriter in any registration statement or Regulation A offering statement filed with the SEC that:

- "Within 5 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."

2.8. U.S. Postal Service False Representation Orders

Finally, Rule 506(d), as approved, will disqualify from exemption any offering for sale that involves a "covered person" who is:

- "Subject to a U.S. Postal Service false representation order entered within 5 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 U.S. Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations."

3. "Reasonable Care" Exception to Disqualification

The SEC acknowledged that it is possible issuers will fail to uncover certain "disqualifying events," despite acting with due diligence and good faith in checking the backgrounds of "covered persons" involved in an offering.

Thus, new Rule 506(d)(2)(iv) provides that disqualification shall not apply to an offering "if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under paragraph (d)(1) of [Rule 506]."

In order to establish the exercise of "reasonable care," an issuer will have to demonstrate a reasonable factual inquiry into whether any disqualifications exist based on the "particular facts and circumstances" of each offering, according to the Bad Actor Release and a new instruction appended to Rule 506(d)(2). The SEC specifically declined to prescribe specific steps as necessary or sufficient to establish reasonable care.

For continuous and long-lived offerings, reasonable care should include "updating the factual inquiry on a reasonable basis," the SEC added, noting that "the frequency and degree of [required] updating will depend on the circumstances of the issuer, the offering and the participants involved."

4. Waivers

The SEC also provided for two kinds of waivers of disqualification, expanding the availability of waivers as originally proposed.

A waiver may be granted by the SEC under Rule 506(d)(2)(ii) "upon a showing of good cause and without prejudice to any other action by the SEC, if the SEC determines that it is not necessary under the circumstances that an exemption be denied." The SEC added that "it would be premature to attempt to articulate standards for granting waivers," but described in the Bad Actor Release a number of circumstances that could, depending on the facts, be relevant, including: change of control; change of supervisory personnel; and absence of notice and opportunity to be heard prior to the issuance of an adverse order.

Supplementing the original waiver proposal, final Rule 506 (d)(2)(iii) also provides that disqualification shall not apply "if before the relevant sale, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing (whether contained in the relevant judgment, order or decree, or separately to the SEC or its staff) that disqualification under [Rule 506(d)(1)] should not arise as a consequence of such order, judgment or decree."

This latter provision is self-executing (requires no SEC approval) and was modeled on a waiver of "bad actor" disqualification articulated in the Model Accredited Investor Exemption (MAIE). But the SEC specifically refused to adopt a companion provision of the MAIE that also prevents disqualification if the triggering event occurs with respect to a regulated person, such as a broker-dealer.

5. Transition Issues

Under the SEC's original "bad actor" proposals, the new disqualification provisions would have applied to all relevant ales made after the effective date of the new rules, regardless of whether disqualifying triggering events occurred prior to the effective date.

But after consideration of public comments, the SEC decided to adopt Rule 506(d)(2)(i), which provides that disqualification shall not apply with respect to any "conviction, order, judgment, decree, suspension,

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expulsion or bar" that occurred before the effective date of the new rules.

However, the SEC also added Rule 506(e), which requires issuers to furnish each purchaser at a reasonable time prior to sale, "a description in writing of any matters that would have triggered disqualification" but for the timing of when those matters occurred (prior to the effective date of the new rules).

The SEC added that it expects issuers to "give reasonable prominence" to these disclosures to insure that material information about preexisting "bad actor" events is appropriately presented.

PROPOSED CHANGES RELATING TO FORM D

In the Proposed Rules Release, the SEC proposed to expand upon the current requirements that relate to the prescribed content of Form D, while adding a requirement to file a closing summary on Form D after the termination of sales. The SEC also proposed mandatory disclosure legends to be included in general solicitation materials, as well as temporary requirements to file those materials.

1. Required Timing of Form D Filings

Rule 503 currently requires issuers to file a Form D not later than 15 calendar days after the first sale of securities in any Regulation D offering, but the SEC has proposed that issuers be required to file Form D at least 15 calendar days before commencing general solicitation for an offering under new Rule 506(c).

The SEC has also proposed to expand the types of information required on this new Form D, to be known as "Advance Form D." The information to be filed would be defined under current Regulation D, and would include:

- Regulatory disclosure Item 1, basic identifying information;
- Item 2, information on the issuer's principal place of business and contact information;
- Item 3, information on related persons;
- Item 4, information on the issuer's industry group;
- Item 6, identification of the exemption(s) being claimed for the offering;
- Item 7, indication of whether the filing is new or amended;
- Item 9, information on the types of securities to be offered;
- Item 10, indication of whether the offering is related to a business combination;
- Item 12, information on persons receiving sales compensation; and
- Item 16, information on the use of proceeds from the offering.

After the filing of Advance Form D, an issuer would also be required to file an amendment providing the remaining information required by Form D within 15 calendar days after the date of the first sale of securities in the offering, as is currently required by Rule 503. An issuer that wishes to provide all of the information required by Form D in the Advance Form D could do so, if possible, thereby eliminating the need to file an additional amendment unless otherwise required to do so.

2. Form D Closing Amendment for All Rule 506 Offerings

The SEC also proposed to amend Rule 503 to require the filing of a final amendment to Form D within 30 calendar days after the termination of any offering conducted in reliance on Rule 506, including offerings under Rule 506(b) and Rule 506(c).

As proposed, the closing amendment would have to be filed soon after termination of the offering, whether that is after the final anticipated sale or upon the issuer's decision to abandon the offering. Until a closing amendment is filed, the offering would be deemed as "ongoing," subjecting the issuer to the current Rule 503 requirement to file annual amendments as needed.

3. Proposed Amendments to the Required Content of Form D

To further the purpose of evaluating the impact of Rule 506(c) on the market and to facilitate its enforcement efforts, the SEC proposed to require additional information in Form D for all Rule 506 offerings. The additional information to be provided would include the following:

- For Item 2, an identification of the issuer's Website address;
- For Item 3, the name and address of any person who directly or indirectly controls the issuer in addition to the information currently required for "related persons;"
- For Item 4, a written "clarification" by the issuer if it checks the box marked "other" for its industry group;
- For Item 5, a check box for "not available to the public" in relation to information requested about the size of an issuer, replacing the "decline to disclose" box, thereby compelling issuers to disclose such information if it is generally available to the public;
- For Item 7, a statement whether a Form D filing is an Advance Form D filing or a Closing Form D amendment;
- For Item 9, information on any trading symbol or generally available security identifier related to the offered securities;
- For Item 14, a table with information about the number of accredited and non-accredited investors that have purchased shares in the offering, whether they are natural persons or legal entities, and the amount raised from each category of investor; and
- For Item 16, as to issuers that are not pooled investment funds, information on the percentage of the offering proceeds that was or will be used: (i) to repurchase or retire existing securities; (ii) to repay offering expenses; (iii) to acquire assets outside of the ordinary course of business; (iv) to finance acquisitions of other businesses; (v) for working capital; and (vi) to discharge indebtedness.

The SEC also proposed to add new Items 17 through 22 to Form D, which would require issuers to provide the following information pertinent to any Rule 506 offerings:

- 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 exchange or other organized trading venue, and/or is registered under the Securities Exchange Act of 1934, the name of the exchange or trading venue and/or the Exchange Act file number, and whether the securities being offered under Rule 506 are of the

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same class or are convertible into or exchangeable for such class;

- If the issuer used a registered broker-dealer for the offering, whether any general solicitation materials were filed with the Financial Industry Regulatory Authority (FINRA);
- In the case of a pooled investment fund advised by investment advisers registered with, or reporting as exempt reporting advisers to the SEC, the name and SEC file number for each investment adviser who 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.

With respect to these added disclosure requirements, the SEC stated that Items 2, 4, 5 and 9 would also require additional information on offerings made under Rule 504, Rule 505 and Securities Act Section 4(a)(5).

4. Proposed Amendment to Rule 507

Rule 507 currently only disqualifies an issuer from comprehensively using Rules 504, 505 or 506 for a Regulation D offering if the issuer, or one of its predecessors or affiliates, has been enjoined by a court for violating the filing requirements in Rule 503.

The SEC has proposed to add another disqualification from using Rule 506 in any new offering for a period of one year "if the issuer, or any predecessor or affiliate of the issuer, did not comply within the past five years with Form D filing requirements in a [prior] Rule 506 offering, provided that such one-year period would commence following the filing of all required Form D filings or, if the [offending] offering has been terminated, following the filing of a closing amendment."

Of some comfort to issuers is the fact that the SEC decided not to propose making Form D filing a condition of any Rule 506 exemption in a current offering where the issuer has no record of any past offense, despite being urged by some commenters to do so.

The SEC also proposed a cure period of 30 days for an issuer's first failure to timely file a Form D, and it noted that Rule 507 already provides for a waiver "upon a showing of good cause, that it is not necessary under the circumstances that exemption be denied."

PROPOSED CHANGES RELATING TO GENERAL SOLICITATION MATERIALS

The Proposed Rules Release also introduced a proposal for new Rule 509 relating to general solicitation materials, and an amendment to Rule 156 that would pertain to any general solicitation sales literature used by private funds.

1. Mandated Legends and Disclosures for General Solicitation Materials

The SEC proposed that new Rule 509 would require issuers to include the following prominent legends in all written general solicitation materials:

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

For private fund written general solicitation materials, the SEC also proposed the requirement of an additional legend stating that the securities offered are not subject to the protections of the Investment Company Act of 1940.

Furthermore, the SEC proposed that Rule 509 would require any private fund written general solicitation materials 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.

The proposed rule would also require the performance-related legend to identify either a telephone number or a Website where an investor may obtain current performance data.

The SEC proposed as well that any performance data presented must be as of the most recent possible date considering the type of private fund and the media through which the data will be conveyed. Private funds that include performance data that does not account for fees and expenses would also be required to show what their performance would have been like if fees and expenses had been deducted.

Adding some teeth to its proposed amendments, the SEC also suggested that Rule 507(a) should be modified to state that Rule 506 will be unavailable for use by 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 the proposed legend and disclosure requirements of Rule 509.

The SEC further stated that while it has not yet proposed a prohibition on the inclusion of past performance information in general solicitation materials, it is seeking further comment and input from the public on that issue.

2. Proposed Amendments to Rule 156

Rule 156 currently provides guidance on the types of information in investment company sales literature that could be misleading for purposes of the federal securities laws, and the SEC has proposed that this guidance be

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applied to the sales literature of unregulated private funds.

Under the provisions of Rule 156, no specific representations are permitted or prohibited, and whether a statement involving a material fact is misleading depends on an evaluation of the context in which it is made. Statements can be misleading under this rule because of the absence of information as well, including the absence of explanations, data or other information necessary to provide a full and accurate picture of the issuer and the investment being offered.

3. Requests for Comment on Potential Restrictions on Sales Content

The SEC also specifically solicited public comments as to "whether other manner and content restrictions related to the removal of the prohibition against general solicitation are necessary or appropriate for Rule 506(c) offerings by private funds or other issuers."

PROPOSED MANDATORY FILING OF GENERAL SOLICITATION MATERIALS

New Rule 510T of Regulation D was proposed by the SEC to require that an issuer conducting an offering under Rule 506(c) must submit any written general solicitation materials to the SEC that are to be used in connection with the offering. Under the proposed rule, the materials would have to be submitted no later than the date of first use of such materials in the offering.

As of now, this would only be a temporary rule that would expire two years after its effective date. But the SEC has also proposed a penalty for failure to follow the rule, suggesting that Rule 507(a) should make Rule 506 unavailable for use by any 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 file general solicitation materials as required.

The SEC did not propose that issuers be required to file their general solicitation materials through the EDGAR system, but they explicitly invited comment on that issue.

REQUEST FOR COMMENT ON "ACCREDITED INVESTOR" DEFINITIONS

At this time, the SEC is not proposing any specific amendments to the accredited investor definition, but it clearly expressed that it would review the definition in the near future, especially as it relates to natural persons, and it asked for public input on this issue.

Any reworking of the accredited investor definition would take into account, at a minimum, whether net worth and annual income should be used as the tests for determining whether a natural person is accredited, as well as the question of what the thresholds for those tests and other potential tests should be, the SEC concluded.

Explanatory Notes:

This update is intended to call your attention to various new rules and proposed rule changes of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all changes and information that could be material to you.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes and proposals, or if you want to learn more about our expertise in this area.

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Burns & Levinson's Securities Law Group represents public and private companies, underwriters and investment banks, venture capital and investment funds, real estate investment funds, investment advisors, broker-dealers, stockholder groups and individuals in public and private securities offerings and transactions, SEC, FINRA and stock exchange compliance, corporate governance, fund formation and offerings, SEC enforcement and securities litigation.

THE SECURITIES LAW GROUP

Josef Volman - Co-Chair
617.345.3895 | jvolman@burnslev.com

Andrew Merken - Co-Chair
617.345.3740 | amerken@burnslev.com

If you have any questions regarding this Burns & Levinson Securities Law Update, please contact one of the individuals named above.

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About Burns & Levinson's Securities Law Group

Burns & Levinson's attorneys have extensive experience representing public and private issuers, stockholder groups and individual investors. Our attorney team counsels clients on IPOs and follow-on offerings of equity, debt and other securities (including shelf registration takedowns), corporate acquisitions involving registered and restricted stock, mergers and acquisitions where one or both parties are publicly traded, private investment in public equity (PIPE) transactions, private placements, venture capital financings, and complex securities law transactions and issues, including corporate governance/ Sarbanes-Oxley and SEC and stock exchange reporting and compliance.

In the securities compliance area, we advise our clients on corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance. Specifically, we assist our clients in fulfilling their ongoing SEC and stock exchange reporting obligations, managing sensitive disclosure issues internally and with industry analysts, preparing proxy statements and handling stockholder meetings, structuring employee benefit plans and executive compensation packages under the SEC's "short-swing profit" reporting and liability rules, effecting re-sales of securities in the public trading markets under the SEC's Rule 144, and advising boards of directors and board committees concerning the requirements and restrictions imposed on their actions by the securities laws and corporate governance laws such as Sarbanes-Oxley. We have served as special securities counsel to the Boards and Audit Committees of publicly traded companies looking for opinions or advice of counsel other than their regular outside counsel.

We have counseled clients both domestic and international, from emerging growth companies to large public companies, and are positioned to provide clients with timely, expert, efficient and cost effective advice that they need to meet their business objectives. We take a practical and proactive approach to the rapidly changing securities disclosure and corporate governance laws, providing our clients with timely updates, identifying specific situations in which the new laws will impact particular clients either operationally or structurally, and working with clients to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

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Our attorneys also represent underwriters in initial and follow-on public offerings and investment banks in private placements and mergers and acquisitions.

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