PRYOR CASHMAN LLP

LEGAL UPDATE

July 2013

By: Bertrand C. Fry, Stephen M. Goodman and Michael T. Campoli

SEC ADOPTS SIGNIFICANT CHANGES TO RULE 506 TO PERMIT GENERAL SOLICITATION AND TO DISQUALIFY "BAD ACTORS"

At its open meeting held on July 10, 2013, the U.S. Securities and Exchange Commission (the "SEC") approved final rules that, among other things, lift the ban on the use of general solicitation or general advertising (collectively, "general solicitation") in offerings of securities that are exempt from registration under Rule 506 of Regulation D of the Securities Act of 1933, as amended (the "Securities Act"), and restrict the use of the Rule 506 exemption with respect to offerings in which "bad actors" and certain other felons are involved. The final rules will become effective 60 days after publication in the Federal Register.

In addition, the SEC proposed new rules and rule amendments that would allow it to better assess developments of market practices in Rule 506 offerings now that the restriction on general solicitation has been eliminated. The proposal is subject to a 60-day public comment period.

We plan to update this Legal Update to set forth a more comprehensive analysis of the recently adopted and proposed rules shortly.

AMENDMENTS TO PERMIT GENERAL SOLICITATION IN OFFERINGS UNDER RULE 506 AND RULE 144A

The most significant action that the SEC took at the open meeting was its long-awaited decision to adopt amendments to Rule 506 to implement Section 201(a)(1) of the Jumpstart Our Business Startups Act of 2012. The final rule creates a new subsection (c) to existing Rule 506 that permits issuers to use general solicitation to offer their securities provided that:

- the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors; and
- all purchasers of the securities are either accredited investors or persons who the issuer reasonably believes are accredited investors at the time of the sale of the securities.

The determination of the reasonableness of the steps taken to verify a prospective purchaser's status as an accredited investor is an objective assessment by an issuer, in which the issuer considers the facts and circumstances of each purchaser and the transaction. To provide issuers with guidance in making this assessment, the final rule sets forth a non-exclusive, non-mandatory list of methods that may be used to satisfy the verification requirement for investors who are natural persons.

The methods described in the final rule include: (i) reviewing copies of any IRS form that reports the purchaser's income and obtaining a written representation from the purchaser that he or she will likely continue to earn the necessary income to qualify as an accredited investor in the current year; and (ii) receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that such entity or person has taken

reasonable steps to verify that the purchaser is an accredited investor.

The final rule also amends Form D to add a separate box for issuers to check if they are claiming the new Rule 506(c) exemption.

In addition to the amendments to Rule 506, the final rules permit securities sold pursuant to Rule 144A to be offered to persons who are not qualified institutional buyers (QIBs) by means of general solicitation provided that the securities are sold only to persons who are, or whom the seller reasonably believes to be, QIBs.

Overall, the final rules regarding general solicitation do not vary significantly from the rules that the SEC proposed on August 29, 2012, other than to provide additional details on the methods that an issuer can use to verify the accredited status of an individual purchaser.[1]

Issuers should keep in mind that although general solicitation is permitted in connection with offerings conducted pursuant to new Rule 506(c), general solicitation will not be permitted in connection with private offerings conducted in reliance upon Section 4(a)(2) of the Securities Act or the existing Rule 506 safe harbor exemption.

Restrictions on the use of Rule 506 by "Bad Actors"

The SEC at its open meeting approved final rules that prohibit reliance on the Rule 506 safe harbor for securities offerings in which certain felons and other "bad actors" are involved, as mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Under the rule, "bad actors" are those with respect to whom a "disqualifying event" has occurred. "Disqualifying events" include, among other things, criminal convictions, court injunctions and restraining orders in connection with the offering and sale of securities, making false filings with the SEC, and being the subject of certain SEC disciplinary, cease-and-desist and stop orders.

The final disqualification rule covers the issuer, including its predecessors and affiliated issuers, as well as directors and executive officers of the issuer, holders of 20% of an issuer's voting power, promoters, investment managers and principals of pooled investment funds, and persons compensated for soliciting investors.

The Rule 506 disqualification applies only for disqualifying events that occur after the effective date of the rule. However, matters that existed before the effective date of the rule and would otherwise be disqualifying are subject to a mandatory disclosure requirement to investors.

Proposed Amendments to Regulation D, Form D and Rule 156

In connection with the adoption of final rules to permit general solicitation in Rule 506 offerings, the SEC also proposed rule amendments that are intended to assist the SEC in its efforts to assess developments of market practices in Rule 506(c) offerings and to address certain concerns raised by investors related to issuers engaging in general solicitation.

Specifically, under the proposals, issuers that utilize Rule 506 would be required to:

- file a Form D at least 15 calendar days before engaging in general solicitation for an offering pursuant to Rule 506(c);

[1] For a summary of the proposed rules, please see the Pryor Cashman Legal Update entitled "*The Path Opens for Advertising in Rule 506 and Rule 144A Offerings: SEC Proposes Rules Effecting the JOBS Act's Elimination of the General Solicitation Ban in Private Offerings*", available here: http://www.pryorcashman.com/assets/attachments/854.pdf

- file an amended Form D within 30 days after completing or terminating an offering to indicate that the offering has ended;
- provide additional disclosure 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, such as information on the types of general solicitation used and the methods used to verify the accredited status of investors;
- include certain legends or cautionary statements in any written general solicitation materials used in a Rule 506(c) offering; and
- for a two-year period following the effective date of the new rules, submit written general solicitation materials to the SEC.

Issuers would be disqualified from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the prior five years, with the Form D filing requirements in a Rule 506 offering. As proposed, the disqualification would end one year after the required Form D filings are made or, if the offering has been terminated, one year after a closing amendment is made.

The proposed rules provide that private funds that include information about past performance in written general solicitation materials must provide additional information to highlight the limitation on the usefulness of this type of information, and they must highlight the difficulty of comparing this information with past performance information of other funds.

Finally, the proposals would extend the guidance contained in Rule 156 of the Securities Act on when information in sales literature by an investment company registered with the SEC could be fraudulent or misleading for purposes of federal securities laws to the sales literature of private funds.

***

If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Bertrand C. Fry at bfry@pryorcashman.com, Stephen M. Goodman at sgoodman@pryorcashman.com or Michael T. Campoli at mcampoli@pryorcashman.com.

About the Authors

Bertrand C. Fry
Partner

Direct Tel: 212-326-0134
Direct Fax: 212-710-6320
bfry@pryorcashman.com

Bertrand Fry is a partner in Pryor Cashman's Corporate Group and is co-head of the firm's Investment Management Group. Bert has nearly twenty years of general corporate and transactional experience that includes extensive experience with alternative investment vehicles. In addition to having launched and advised a diverse array of U.S. and non-U.S. investment products, including vehicles engaged in macro, distressed, private equity, venture capital, and real estate investing, debt origination, and quantitative trading of securities and futures, his practice has included, among other things, structuring and advising investment managers and advisers, private company mergers & acquisitions, and joint ventures.

Bert is particularly well attuned to the business needs of his clients, based on more than a decade of in-house experience at the D. E. Shaw group, where Bert was a Senior Vice President and served for a period as Acting General Counsel. During his tenure there, the D. E. Shaw group included several SEC-registered investment advisers and, at its apex, managed approximately $40 billion across various strategies and multiple funds. Bert also launched and advised a wide range of hedge funds, funds of funds, and their managers as a member of the London office of Dechert LLP.

Bert earned his A.B., with honors, from the University of Chicago and his J.D., with honors, from The University of Texas at Austin School of Law, where he was also an articles editor for the Texas Law Review and received the Outstanding Second-Year Member Award from the Texas Law Review, the Gilbert I. Low Endowed Presidential Scholarship in Law, and Highest Achievement in Contracts.

Stephen M. Goodman
Partner

Direct Tel: 212-326-0146
Direct Fax: 212-798-6340
sgoodman@pryorcashman.com

Stephen M. Goodman is co-head of the Mergers and Acquisitions Practice at Pryor Cashman LLP. He has extensive experience representing technology-based companies in public offerings; private placements; limited liability company, partnership and joint venture agreements; and complex arrangements for the acquisition, sale, development and commercialization of patents, copyrights and trademarks, in particular for drug compounds and formulations, software and other technology.

Mr. Goodman has also written on topics ranging from export controls relating to biotechnology research to raising seed capital for entrepreneurial companies and has lectured on various aspects of pharmaceutical/biotech collaboration agreements. He is frequently called upon by the press to comment upon corporate, life science and other newsworthy matters.

Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.

MICHAEL T. CAMPOLI
Of Counsel

Direct Tel: 212-326-0468
Direct Fax: 212-798-6361
mcampoli@pryorcashman.com

Michael Campoli devotes his practice to counseling public and private companies of all sizes and at all stages of development on a broad range of corporate matters, including securities law compliance, Securities Exchange Act reporting, corporate formation and governance, mergers and acquisitions, public and private financing transactions (including early-stage financing initiatives), joint ventures, and limited liability company and partnership counseling.

Mr. Campoli is a 2000 graduate of New York University School of Law, and a 1997 Phi Beta Kappa graduate of Columbia College.