

# KIRKLAND ALERT

July 2013

## SEC Allows General Solicitation and General Advertising in Rule 144A and Rule 506 Offerings

On July 10, 2013, the SEC adopted amendments to Rule 144A and Rule 506 of Regulation D under the Securities Act of 1933 (the “Securities Act”). The amendments to Rule 144A allow offers to persons other than qualified institutional buyers (“QIBs”), including through general solicitation, provided that the securities offered are sold only to persons that the seller or its representative reasonably believe are qualified institutional buyers. The SEC also adopted new Rule 506(c) which allows general solicitation and general advertising, provided that all purchasers are accredited investors, the issuer takes reasonable steps to verify that the purchasers are accredited investors, and the satisfaction of certain other terms and conditions of Regulation D.

**Rule 144A can be available even when a general solicitation has occurred.**

### *Current law*

Section 5 of the Securities Act requires that a security being sold must be registered with the SEC or exempt from registration. Section 4(a)(2) of the Securities Act exempts transactions by an issuer “not involving any public offering.

Two types of such transactions are Rule 144A offerings and Rule 506 offerings which play a significant role in capital formation in the United States.

### *Rule 144A*

*Old Rule:* Rule 144A is a non-exclusive safe harbor from the registration requirements of the Securities Act for resales of certain “restricted securities” to QIBs. Old Rule 144A provided that an **offer** of securities is exempt provided the offer is made only to QIBs. While Rule 144A does not expressly prohibit general solicitation, the restriction requirement on offerees has the same effect.

*New Rule:* The amended rule does not prohibit offers to non-QIBs, it simply requires that securities must be sold only to QIBs or to purchasers that the seller and any person acting on behalf of the seller reasonably believe are QIBs. As a result, Rule 144A will be available even where general solicitation has occurred and issuers will no longer have to adhere to the limitations of Rule 135c which, among other things, limited quotes from company management and information about the business. The SEC also clarified in the adopting release that the general solicitation for resales under Rule 144A will not impair the availability of the Section 4(a)(2) private placement exemption for the issuer’s initial sale of the securities to the initial purchasers.

## Rule 506

*Old Rule:* Historically, Rule 506 allowed an issuer to sell securities without any dollar limitation to an unlimited number of accredited investors, but only so long as it did not engage in any general solicitation or general advertising for investors.

**New Rule 506(c) will allow general solicitation so long as certain conditions are met.**

The SEC interpreted this general solicitation and advertising ban in private placements to prohibit any publication, broadcasting or use of other mass media methods to solicit investors, so an issuer was required to restrict public statements on websites, in the general media, and in public presentations by its employees.

In addition, the SEC required the issuer to have a pre-existing substantive relationship with each potential investor solicited (*i.e.*, a relationship that allows the issuer to reasonably conclude the persons being solicited are accredited investors or financially sophisticated), including a prohibition against cold-call solicitations, even to institutional investors generally known to be accredited investors.

*New Rule:* Under newly adopted Rule 506(c), an issuer may engage in general solicitation and advertising in an offering, provided that:

- the issuer takes reasonable steps to verify that each purchaser of its securities is an “accredited investor;”
- either each purchaser of securities is in fact an accredited investor or the issuer reasonably believes, at the time of the sale of the securities, that each purchaser is an accredited investor; and
- the issuer satisfies all of the other requirements of a private placement under Regulation D, such as restrictions on transferability of securities.<sup>1</sup>

However, the SEC preserved the prior Rule 506 exemption (which permits an offering not involving general solicitation or advertising) as new Rule 506(b), which is electively available to an issuer who (a) is selling to non-accredited (as well as accredited) investors and/or (b) does not wish to be subject to Rule 506(c)’s new requirements listed above and is not engaging in general solicitation or advertising.

### *What constitutes “reasonable steps to verify” accredited investor status for Rule 506(c)?*

Whether an issuer took “reasonable steps to verify” the accredited investor status of each purchaser will be judged on the facts and circumstances of each transaction, looking at factors that include, but are not limited to:

- the nature of the purchaser and type of accredited investor the purchaser claims to be (*e.g.*, a registered broker-dealer or large 501(c)(3) organization required to make public filings would require less verification than an individual investor);
- the amount and type of information the issuer has about the purchaser;<sup>2</sup> and

- the nature of the offering, such as the manner of solicitation and the terms of the offering.

New Rule 506(c) preserves reasonable belief standard.

The SEC confirmed that self-certification by an investor without any additional steps is not sufficient to verify such investor's accredited investor status, except in certain limited circumstances where a natural person investor has a pre-existing relationship with the issuer, as discussed below. This stands in contrast to the current treatment under Rule 506(b) where there is no requirement that the issuer take "reasonable steps to verify" accredited investor status. In a Rule 506(b) offering (where general solicitation is prohibited) self-certification by an investor may continue to be used by issuers to establish a reasonable belief that the investor qualifies as an accredited investor.

### *Rule 506(c) safe harbors for verification of natural persons*

The SEC adopted the following non-exclusive safe harbors through which an issuer can demonstrate that it took "reasonable steps to verify" the accredited investor status of a natural person:

- *Tax documents.* Reviewing copies of any IRS form that reports the income of such person (e.g., copies of Forms W-2, 1099 and 1040 and Schedule K-1) plus obtaining a written representation that such person reasonably expects to continue to meet the necessary income threshold during the current year;
- *Bank and other financial statements.* Reviewing documentation<sup>3</sup> of such person's net worth dated within the prior three months plus obtaining a written representation that all liabilities necessary to make a determination of net worth have been disclosed;
- *Third party verification.* Receiving a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, or a licensed attorney or certified public accountant in good standing that such third party has taken reasonable steps to verify such person's status as an accredited investor; and
- *Pre-existing relationship.* With respect to any person who purchased securities in an issuer's private placement as an accredited investor prior to the effective date of the new rules and remains an investor in the issuer, obtaining a certification to the effect that such person remains an accredited investor at the time of any subsequent investment in the issuer under a Rule 506(c) offering.

Regardless of the verification methods employed by an issuer, the issuer is required to make and preserve adequate records of the steps taken to verify that all purchasers were accredited investors.

### *Reasonable belief standard preserved for Rule 506(c)*

Recognizing that prospective investors could provide false information to an issuer or a third party claiming to be an accredited investor, the SEC stated that an issuer that took "reasonable steps to verify" the status of each purchaser would not lose the

private placement exemption as long as the issuer had a reasonable belief that such purchaser was an accredited investor at the time of sale.

### *New Rule 506(b) preserves traditional private placement option*

Amended Rule 506 preserves the option of a private placement under the traditional rules — renamed Rule 506(b) — with no general solicitation or advertising, but without the enhanced verification requirements.

### *Form D revisions*

The SEC also adopted modifications to Form D, which an issuer must file with the SEC, so that an issuer must indicate whether it is relying on (x) the new Rule 506(c) exemption allowing general solicitation or advertising but no non-accredited purchasers or (y) the existing private placement exemption now embodied in Rule 506(b) (with no general solicitation or advertising but with up to 35 non-accredited purchasers).

### *Practical implications*

Despite the availability of this more flexible approach to marketing, issuers must carefully consider the burdens and costs that the heightened investor verification procedures and proposed additional investor protection measures would impose. In particular, issuers must evaluate the risk that the intrusiveness of certain verification methods under Rule 506(c) could discourage high net worth individuals from investing in companies that are required to utilize them.

Once there is general solicitation or advertising under Rule 506(c), it is not possible to change course and instead rely on Rule 506(b) (with its less intrusive investor qualification requirements) or the general private placement exemption under Section 4(a)(2) without a sufficient cooling-off period. Similarly, an issuer that initially markets an offering under Rule 506(b) and subsequently transitions to a Rule 506(c) offering involving general solicitation or advertising must employ the heightened verification standards for all investors, not just those obtained through the later Rule 506(c) offering.

In addition, an issuer (1) must still be mindful of securities law and general anti-fraud prohibitions against making misleading statements or failing to disclose material information to investors and (2) should consider amending its marketing policy to ensure that it remains appropriate in light of any general solicitation or advertising it conducts.

### *Proposed Changes*

The SEC also proposed changes to track the Rule 506 market after the general solicitation ban is lifted which include:

- expanding the information that issuers must include on Form D, a filing that has

Old Rule 506(b) is preserved for offerings subject to prohibition on general solicitation.

always been required for every Rule 506 offering, so that the SEC has more information about the issuers and the offerings in this market;

The SEC proposed new Regulation D requirements.

- ***requiring issuers to file a Form D before the general solicitation begins;***
- requiring issuers to file a Form D when an offering is completed;
- putting in place an effective mechanism for enforcing compliance with Form D filing requirements;
- requiring legends in general solicitation materials that would inform potential investors of risks as well as the statutory mandate that sales are limited to accredited investors; and
- requiring, on a temporary basis, that issuers submit their written general solicitation materials to the SEC so it can monitor the solicitation practices that issuers employ.

### *Other Notes*

*Integration:* The SEC confirmed that 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.

*Private Funds:* The rule changes also impact private investment funds which we address in a separate *Kirkland Private Equity Newsletter* titled "[SEC Adopts JOBS Act Rules Allowing Public Marketing of Private Fund Securities.](#)"

*Other requirements:* In order to perfect the safe harbors of Rule 144A and Rule 506 the other existing conditions must be satisfied.

*Bad Actors:* In a separate release, in order to implement Section 926 of the Dodd-Frank Wall Street Reform Act and Consumer Protection Act, the SEC adopted amendments to Rule 506 to disqualify issuers and other market participants from relying on Rule 506 if "felons and other 'bad actors'" are participating in the Rule 506 offering. Please see our separate *Kirkland Private Equity Newsletter* titled "[SEC Adopts New Rules for 'Bad Boy' Disqualifications for Regulation D Offerings](#)" (See page 5).

### *Effective date*

The new rules are not effective until 60 days from the date of publication in the Federal Register and no general solicitation or advertising is permitted before such date, expected to be in mid-September.

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<sup>1</sup> The public offering restriction, including through general solicitation or advertising, will, how-

ever, remain in effect for other private placement exemptions, such as Section 4(a)(2), Rule 505 or new Rule 506(c).

- <sup>2</sup> According to the SEC, “the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it may have to take, and vice versa,” and “if an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer will not have to take any steps at all.” For a prospective investor who is a natural person that cannot be verified under one of the four safe harbor methods, the SEC has suggested that it might suffice to (a) obtain copies of such person’s pay stubs for the two most recent years and the current year, (b) review public filings (*e.g.*, under the Exchange Act) disclosing such person’s compensation, or (c) review specific publicly available information about the average compensation earned at such person’s workplace by persons at the level of such person’s seniority.
- <sup>3</sup> For example, to verify a person’s assets, an issuer may obtain redacted copies of such person’s bank, brokerage and other statements of securities holdings, certificates of deposit, tax assessments and third-party appraisals. To verify a person’s liabilities, an issuer may obtain a credit report from at least one of the nationwide consumer reporting agencies.

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