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# SEC Acts to Help Take the “Private” Out of Private Placements

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## Today's Presenters



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## Today's Topics

- New Rule 506(c)
- “Bad Actors” Disqualification for Use of Rule 506
- State Securities Regulators Possible Reactions to Offerings Conducted Pursuant to Rule 506(c) and to Users of Other Securities Registration Exemptions Mandated Under the JOBS Act
- Best Practices for Compliance Under Rules 506(c) and (d)
- Status of Other Initiatives Mandated Under the JOBS Act

## New Rule 506(c)

## Overview

- The U.S. Congress under the JOBS Act mandated the SEC to lift the ban on general solicitation and advertising for Rule 506 offerings where all of the purchasers in the offering are accredited investors and the issuer had taken reasonable steps to verify each purchaser was accredited, and in Rule 144A offerings where the seller of the securities had taken reasonable steps to verify that each purchaser was a qualified institutional buyer (QIB)
- Effective in about 60 days (or on or about September 9, 2013), issuers may employ general solicitation or advertising in connection with such offerings
- The issuer must take “reasonable” steps to “verify” purchaser’s status
- The SEC has provided within new Rule 506(c) examples of non-exclusive and non-mandatory methods that issuers may use to satisfy the verification requirement

## Non-exclusive and Non-mandatory Methods for Issuers to Satisfy Verification Requirement

- Among the factors that issuers should consider are:
  - 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
  - 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.

## Non-exclusive Methods of Verifying Accredited Investor Status for Natural Persons Under Rule 506(c)

- Annual income verification (copies of certain IRS filings for last two years) with investor's certification
- Net worth verification (dated within prior 3 months, written representations from investor or third party reports)
- Written confirmation from a registered broker-dealer, SEC-registered investment advisor, licensed attorney or certified public accountant

## Other Considerations

- For a natural person that invested in the issuer's offering prior to effective date of Rule 506(c) and remains an investor for Rule 506(c) offering conducted by the same issuer, the issuer may satisfy the verification by obtaining a certificate from such person that he/she qualifies as an accredited investor
- If it is determined at a later date that a purchaser was not an accredited investor at the time of purchase, the exemption under Rule 506(c) will not be lost if the issuer took reasonable steps to verify that the purchaser was accredited and had a reasonable belief that the purchaser was accredited at time of purchase

## Check the Box on Form D for a Rule 506 Offering

- Issuers are required to check the box on revised Form D if they are relying upon the new Rule 506(c) exemption
  - Those issuers relying on the Rule 506 exemption without the use of general solicitation or advertising would check the box for a Rule 506(b) exemption
- Issuers will not be able to check both boxes at the same time for the same offering
- "Private funds" (i.e., funds that are not registered under the Investment Company Act of 1940 based upon reliance of an exclusion from the definition of an investment company under such act) are reminded of their obligations under the Investment Advisers Act of 1940 (Section 206(4)-8) to comply with the anti-fraud provisions (i.e. not make untrue statements of a material fact or omit to state a material fact, in the light of the circumstances made, not misleading to investors and prospective investors of a private fund)
- All issuers of securities are subject to the anti-fraud provisions under the federal and state securities laws with respect to the content of any public ads or notices in connection with a securities offering

## “Bad Actors” Disqualification for Use of Rule 506 Exemption

### Section 926 of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

- Required SEC to adopt rules that disqualify securities offerings involving certain “felons” and other “bad actors” from reliance on Rule 506
- Requires that rules must be substantially similar to disqualification provisions under Rule 262 of Securities Act of 1933 and cover traditional matters including state regulatory orders and bars

## Covered Persons Under Rule 506(d)

- Covered persons include:
  - The issuer and any predecessor or affiliated issuer
  - Any director, executive officer or non-executive officer participating in the offering
  - General partner or managing member of the issuer
  - Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities (calculated on the basis of voting power)
  - Any promoter connected with the issuer in any capacity at the time of the securities offering
  - Any investment manager of an issuer that is a pooled investment fund
  - Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of securities in the offering
  - Any general partner or managing member of any such investment manager or solicitor
  - Any director, executive officer or other officer participating in the offering of such investment manager or solicitor or general partner or managing member of such investment manager or solicitor

## The Disqualifiers

- Effective in approximately 60 days (on or about 9/9/2013), an issuer may not rely on the Rule 506 exemption if a covered person:
  - Has been convicted of certain crimes
  - Is subject to certain court orders
  - Is subject to final order of certain regulators
  - Is subject to certain SEC registration suspensions, revocations or bar orders
  - Is subject to any SEC cease and desist order
  - Is subject to certain Self-Regulatory agency action
  - Is subject to a SEC securities registration stop order or suspension
  - Is subject to a U.S. Postal order

## Disqualifications Under Rule 506

- Do not apply if:
  - The conviction, order, judgment, decree, suspension, expulsion or bar that occurred or was issued before the effective date of this Rule 506(d)
  - Upon showing of good cause, the SEC determines that it is not necessary for the exemption to be denied
  - If before the relevant sale, the court or regulatory authority that entered the relevant order, judgment or decree advised in writing that disqualification under Rule 506 should not arise as a consequence of the order, judgment or decree
  - If the issuer establishes that it did not know and in the exercise of reasonable care, could not have known that a disqualification existed

## Reasonable Care Standard

- The issuer must show it made a reasonable effort to determine if any disqualifications existed at the time
- Nature and scope of effort will vary based “on the facts and circumstances concerning, among other things, the issuer and participants”



## Disclosure of Prior “Bad Actor” Events

- Issuer utilizing Rule 506 is required to provide each purchaser at a reasonable time prior to a sale, a description in writing of any matters that would have triggered disqualification under Rule 506(d) if they had occurred before the effective date of Rule 506(d)
- Failure to furnish this information or on a timely basis shall not prevent an issuer from relying on the Rule 506 exemption if issuer establishes it did not know and, in the exercise of reasonable care, could not have known of the existence of the undisclosed matter(s)

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## Form D Check the Box

- Issuer will be required to check the box on revised Form D, if relying on Rule 506 (or Rule 505) that it is not disqualified from using the exemption

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**State Securities Regulators Possible Reactions to Offerings Conducted Pursuant to Rule 506(c) and to Users of Other Securities Registration Exemptions Mandated Under the JOBS Act**

## Considerations

- Will state regulators target users of new Rule 506(c)?
- Will state securities regulators review “reasonableness” of verification process utilized by issuers?
- What about use of portals that are not registered as brokers, will there be enhanced scrutiny of their activities?
- Will there be a grace period in which issuers will be advised by state regulators that verification process utilized did not meet the reasonableness test?
- Crowdfunding exemption and state regulators’ concerns.
- Regulation A registration requirements under state securities laws and possible actions by state regulators to make the process more streamlined

## Best Practices for Compliance Under Rules 506(c) and (d)

### Verification Procedures – Best Practices

- Utilize the SEC recommended verification procedures, when possible; if not practical or deemed not necessary, be prepared to defend what process was implemented being reasonable under the circumstances;
- Keep written records of the verification process utilized. If the issuer utilizes third parties verification, maintain a record of the third parties written statement as to its verification process and determination;
- Remember that although the securities issued under the Rule 506(c) exemption can be publicly advertised and solicited, they remain “restricted securities” under the Securities Act, and restrictions on resale still need to be in place – legends, etc.;
- Still can use 506(b) and not go through the time and expense of verification, an offering that would not require the benefits of Rule 506(c) (i.e., an offering solely to existing securities holders).

## General Solicitation and Advertising – Best Practices

- Any form of general solicitation or advertising is fair game; billboards, newspaper, TV or radio, internet, social media, email, etc. All statements made in such public announcements, ads, etc., are subject to the “anti-fraud” provisions under state and federal securities laws. Regulators will be looking carefully for ads that appear to be fraudulent or “too good to be true;”
- Avoid projected performance numbers or other forward looking statements or, if used, include appropriate legends. They will attract attention and could come back to haunt the issuer;
- Consider appropriate legends, such as: securities may only be purchased by accredited investors; these securities are being sold upon reliance of an exemption from the securities registration requirements under federal and state securities laws; neither the SEC nor any state securities regulator has passed upon the merits of or given approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials; and investing in securities involves risk, and investors should be able to bear the loss of their investment.
- Use of Rule 506(c) could eliminate the use of certain fall back limited offering exemptions under state securities laws;
- Current CFTC exemptions for commodity pools offerings do not allow public solicitations or advertising.

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## Bad actor Disqualification – Best Practices

- The Issuer should obtain a signed certificate from each covered person including covenants and undertakings to report all such events. Registered broker-dealers could be checked out through FINRA Broker-Check.
- If a covered person turns out to be a bad actor in a Rule 506 offering that was either not disclosed to prospective investors (for events that occurred prior to the effective date of Rule 506(d) or not allowed to be a covered person in connection with an offering (for events that occurred subsequent to the effective date of Rule 506(d)), the issuer may rely on the Rule 506 exemption if it can show that it did not know and in the exercise of reasonable care, could not have known that a disqualification existed. That evidence of reasonable care is established by the issuer’s exercise of reasonable care through a factual inquiry based on the circumstances of the issuer and the other offering participants or covered persons.
- For those bad acts that occurred prior to the effective date of Rule 506(d), written disclosure to prospective investors prior to the purchase date about such events needs to be provided;
- Issuer should implement a system for offerings that continue for an extended period of time so that covered persons periodically execute the bad actor certificate.
- The certification made by the issuer on Form D requires the issuer to state that is not disqualified from reliance on Rule 506 for one of the reasons under Rule 506(d). Checking the box when the issuer knows it was incorrect to so state could subject the issuer to penalties for making a false filing with a securities regulator.

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## Update of Status of Other Initiatives Mandated Under the JOBS Act

### Update

- Crowd Funding. (The SEC was required to issue rules with 270 days of enactment of the JOBS Act). That date has come and gone with no proposed rules in place.
  - This exemption is for offerings of not more than \$1 million during a 12-month period;
  - There are certain investment amount limitations based on the investors annual income or net worth;
  - The offering must be included through a SEC registered broker dealer or funding portal;
  - State securities registration requirements are pre-empted but state securities regulators still have enforcement authority over such offerings;
  - Bad actor disqualifications will apply and there will be certain disclosure and reporting requirements by such issuers.
  - SEC is expected to release proposed implementing rules later this year with probable effectiveness of exemption in Spring 2014.

## Update (continued)

- Reg A + (no deadline currently in place for the SEC to promulgate rules for this exemption and none have been released)
  - Allows increase in offering to \$50 million from current \$5 million cap.
  - Issuers required to file audited financial statements annually with SEC.
  - The offering may utilize general solicitation and advertising, and there are no restrictions on the resale of the securities.
  - The securities are pre-empted from state securities registration requirements if offered or sold on a national securities exchange or offered and sold to registered broker-dealers exclusively to QIBs.
  - State securities regulators are taking steps to make uniform registration requirements and other initiatives to streamline the state requirements.
  - No projections for when SEC enacts rules for Reg A+ offerings. Best guess is later this year with effectiveness of exemption in mid 2014.

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## Questions & Answers

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## Mark Your Calendar

- **2013 NDI Checkpoint Sessions**
  - August 21, 2013
  - December 4, 2013
- **Save the Date! NDI Executive Exchange**
  - November 13, 2013 – Chicago, IL – Invitation-only
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