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Client Alert Commentary

Latham & Watkins Capital Markets Practice Group | Number 1569 | July 25, 2013

"You Talkin' to Me?"

FAQs About the SEC's New General Solicitation, Regulation D and Bad Actor Rules[1]

On July 10, 2013, the SEC:

- adopted final rules to repeal the ban on general solicitation in all Rule 144A offerings and certain Regulation D transactions, as required by Title II of the JOBS Act;[2]
- proposed new Regulation D requirements;[3] and
- adopted final rules to disqualify "bad actors" from participating in Regulation D Rule 506 offerings, as required by Section 926 of the Dodd-Frank Act.[4]

This *Client Alert* briefly summarizes the final rules relating to general solicitation and the proposed rules relating to Regulation D, as well as the final bad actor disqualification rules. We also provide answers to some of the most frequently asked questions about how these changes will affect current offering practices.

Background: General Solicitation and Offerings Under Current Rule 144A and Rule 506

Companies seeking to raise capital through the offer and sale of securities in the United States must either register the securities offering with the SEC under the Securities Act of 1933 or rely on an exemption from Securities Act registration. Rule 144A and Rule 506 are the most commonly used exemptions from this registration requirement. Rule 144A allows for unregistered resales of securities to certain large institutional investors known as qualified institutional buyers, or QIBs. Rule 506 allows offerings to an unlimited number of accredited investors (and up to 35 others) without regard to transaction size. If the conditions of Rule 506 are met, the transaction is deemed not to be a public offering within the meaning of Securities Act Section 4(a)(2) (formerly Section 4(2)).

Since Regulation D was adopted, the availability of the Rule 506 safe harbor has been subject to the condition that neither the issuer nor anyone acting on its behalf uses any form of general solicitation or general advertising to offer or sell the securities. General solicitation is also avoided in Rule 144A offerings in order to preserve the availability of Section 4(a)(2) for the initial private sale by the issuer to the reselling investment banks, who act as initial purchasers from the issuer and resell to QIBs.

Loss of a registration safe harbor is serious business. No one wants to violate Securities Act Section 5, which would give investors a right of rescission or "put" remedy. This harsh possible outcome has led to very restrictive publicity practices in private offerings in order to minimize the risk that the offering would fail to qualify as exempt from registration.

Repealing the Ban on General Solicitation in Rule 144A and Rule 506 Offerings

Section 201(a) of the JOBS Act directed the SEC to eliminate the prohibition on general solicitation in Rule 144A and Rule 506 offerings. The SEC proposed implementing rules in August 2012 and final rules in July 2013.[5] The final rules take effect on Monday, September 23, 2013.

Under the final rules:

- ***General solicitation will be permitted in all Rule 144A transactions.*** Revised Rule 144A(d)(1) requires simply that securities must be sold – not *offered* and sold, as under current Rule 144A – 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, the Rule 144A exemption now will be available even where general solicitation is actively used in the marketing process or has occurred inadvertently.

- ***Rule 506(c) will permit general solicitation in Regulation D private placements under certain conditions.*** New Rule 506(c) permits the use of general solicitation if:

  - the issuer takes "reasonable steps to verify" that purchasers are accredited investors;

  - all purchasers are accredited investors, or the issuer reasonably believes that they are, at the time of the sale; and

  - all requirements of Rules 501 (definitions), 502(a) (integration) and 502(d) (resale restrictions) are met.

- ***The "reasonable steps to verify" determination is left flexible.*** Whether verification steps are reasonable depends on facts and circumstances. The SEC suggested that some relevant factors include:

  - the nature of the purchaser and the type of accredited investor that the purchaser claims to be;

  - the amount and type of information the issuer has about the purchaser; and

  - the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

- ***There is a non-exclusive list of four verification methods***. The new rule includes four specific non-exclusive methods of verifying accredited investor status:

  - when verifying whether an individual meets the accredited investor *income* test, reviewing for the two most recent years any IRS forms that report the individual's income, and obtaining a written representation from the individual with respect to the expectation of income for the current year;

- when verifying whether an individual meets the accredited investor *net worth* test, reviewing certain bank, brokerage and similar documents and obtaining a written representation from the individual with respect to the disclosure of all liabilities;

- obtaining written confirmation from an SEC registered broker-dealer or investment adviser, a licensed attorney or a CPA that has itself taken reasonable steps to verify, and has determined within the prior three months, that the purchaser is an accredited investor; and

- obtaining a certification of accredited investor status at the time of sale from an individual who invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c), for any Rule 506(c) offering conducted by the same issuer.

- ***Private investment funds will be able to engage in general solicitation.*** The SEC confirmed that privately offered pooled investment vehicles relying on the qualified purchaser (Section 3(c)(7)) or 100-holder (Section 3(c)(1)) exclusions under the Investment Company Act of 1940 may engage in general solicitation under Rule 506(c).

The SEC's Proposed Regulation D Rules

In a separate release issued on July 10, the SEC also proposed new rules to expand the requirements of Regulation D. In particular, under the proposal:

- ***Failure to file a Form D would disqualify an issuer from relying on Rule 506.*** Revised Rule 507 would significantly change current law by disqualifying an issuer from relying on Rule 506 for one year following a corrective filing if the issuer or its affiliates did not comply, within the prior five years, with all the Form D filing requirements in a Rule 506 offering. The five-year period would not, however, extend to non-compliance that occurred prior to the effective date of the new rule.

- ***Form D information would need to be filed 15 days before engaging in general solicitation under Rule 506(c).*** As proposed, revised Rule 503 would require the filing of Form D information no later than 15 calendar days in advance of the first use of general solicitation in a Rule 506(c) offering.

- ***A "closing amendment" may need to be filed after terminating any Rule 506 offering.*** Revised Rule 503 would require the filing of a closing amendment to Form D under certain circumstances within 30 calendar days after terminating any Rule 506 offering.

- ***Written general solicitation materials would include certain legends and disclosures.*** Proposed Rule 509 would require prescribed legends in any written general solicitation materials used in a Rule 506(c) offering. Private funds under the Investment Company Act would also be required to include an additional legend and certain other disclosures.

- ***For two years after effectiveness of the new rules, written general solicitation materials would need to be submitted to the SEC.*** Proposed Rule 510T would require issuers to submit any written general solicitation materials used in Rule 506(c) offerings to the SEC no later than the date of first use of these materials. These submissions would not be available to the public, and Rule 510T would expire two years after its effective date.

"Bad Actor" Disqualification From Rule 506 Offerings

Section 926 of the Dodd-Frank Act directed the SEC to adopt rules disqualifying an issuer from reliance on the Rule 506 exemption if that issuer committed securities fraud or various other violations of financial regulatory and antifraud laws. The SEC's final rules adopted in July take effect on Monday, September 23, 2013.

Under new Rule 506(d), an issuer will not be able to rely on the Rule 506 exemption if certain "covered persons" have been subject to one or more disqualifying events, such as a conviction for securities fraud. Individuals and entities that are "covered persons" include:

- the issuer;
- a predecessor of the issuer;
- affiliated issuers, unless the event occurred prior to the commencement of the affiliation, and the affiliated issuer is not under the issuer's control and is not "under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events;"
- beneficial owners of 20% or more of the issuer's voting equity securities (calculated on the basis of voting power);
- an issuer's directors, executive officers and other officers, as well as general partners and managing members, who participate in the offering; and
- any person who has received or will receive direct or indirect compensation for solicitation of purchasers in connection with a securities offering.

The disqualifying events include:

- criminal convictions in connection with the purchase or sale of a security or involving the making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within five years of the proposed sale of securities in the case of the issuer and its predecessors and affiliated issuer, or within 10 years for other covered persons;
- court injunctions and restraining orders in connection with the purchase or sale of a security, or involving the making of a false filing with the SEC, or arising out of the conduct of the business of an underwriter, an SEC-regulated entity such as a broker-dealer. The injunction or restraining order must have occurred within five years of the proposed sale of securities;
- final orders from certain federal or state regulators that bar the issuer from associating with a regulated entity, or engaging in the business of securities, insurance or banking or in savings association or credit union activities or that are based on fraudulent, manipulative, or deceptive conduct and issued within ten years of the proposed sale of securities;
- certain unexpired SEC disciplinary orders relating to regulated entities in the securities industry and their associated persons;
- unexpired SEC cease-and-desist orders related to violations of *scienter*-based antifraud provisions of the federal securities laws or the Securities Act Section 5 registration requirements that were entered within five years before the proposed sale of securities;

- previously filing or being named as an underwriter in a registration statement that, within five years before such sale, was the subject of a refusal order, stop order, or suspension order, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether issuance of such an order is appropriate;

- suspension or expulsion from membership in a self-regulatory organization (SRO) or association with an SRO member for violating just and equitable principles of trade; and

- US Postal Service false representation orders issued within five years of the proposed sale of securities.

Any disqualifying events that occurred *prior* to the effectiveness of the new rules will not prevent an issuer from relying on Rule 506, though they will be subject to mandatory disclosure requirements. For disqualifying events occurring *after* the effectiveness of the new rules, an issuer may nevertheless rely on Rule 506 if the SEC determines upon a showing of good cause that denial of an exemption is not necessary under the circumstances, the court or regulator that issued the disqualifying order advises the SEC in writing that the exemption should not be denied, or the issuer can demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event existed.

FAQs

General Solicitation in Rule 144A Offerings

1) Q: The typical structure of a Rule 144A offering is a private sale under Section 4(a)(2) to one or more investment banks acting as initial purchasers followed by immediate resales by the initial purchasers to QIBs under Rule 144A. Is general solicitation in the Rule 144A offering permitted even though the first step in the transaction is a Section 4(a)(2) private placement?

A: Yes. The adopting release makes clear that general solicitation in a Rule 144A offering will not compromise the private sale under Section 4(a)(2) from the issuer to the initial purchasers.[6] It is possible that market participants will choose to include representations and warranties in initial purchase agreements to cover the unlikely possibility that an issuer engaged in general solicitation in the course of identifying investment banks to act as initial purchasers for a Rule 144A transaction.

2) Q: Would general solicitation in connection with a Rule 144A offering require an issuer to comply with the proposed Regulation D requirements for general solicitation in Rule 506(c) transactions?

A: No. The adopting release recognizes that the first step in a Rule 144A transaction is a private sale under Section 4(a)(2).[7] As a result, the proposed notice, legending and other requirements for Rule 506(c) general solicitation will not apply to Rule 144A general solicitations. Similarly, issuers will not need to file a Form D or otherwise comply with Regulation D in a Rule 144A offering.

3) Q: What happens if I add a concurrent offering to accredited investors under Rule 506 to my Rule 144A transaction. Can I still generally solicit?

A: Yes, so long as the requirements of Regulation D that apply to Rule 506(c) offerings are met. In other words, we expect that general solicitation practices in "side-by-side" QIB/accredited investor offerings will default to Regulation D requirements for Rule 506(c) offerings. If the SEC's proposal to require advance filing of Form D is adopted, however, it may be impossible as a practical matter to add a Rule 506(c) offering while general solicitation is underway in a Rule 144A transaction. As noted below, we believe market participants will be cautious about engaging in Rule 506(c) general solicitation until the status of the SEC's proposed notice and legending requirements is clarified.

4) Q: Regulation M contains exceptions for Rule 144A offerings. Are these available for a Rule 144A offering using general solicitation?

A: Yes. The SEC made conforming amendments to Regulation M to make the exceptions available in all Rule 144A transactions, including those using general solicitation.

5) Q: Can I name the initial purchasers in a press release announcing a Rule 144A offering?

A: In our view, yes. Doing so takes the press release outside the Rule 135c safe harbor from the definition of "offer," because the Rule requires that the press release not mention the names of the initial purchasers. However, because Rule 144A no longer limits offerees, it follows that issuing a press release otherwise within Rule 135c but naming the initial purchasers should not undermine the status of the transaction as a good Rule 144A offering. Nonetheless, deal teams will want to look carefully at any additional information added to the press release – for example, if the announcement of the deal were combined with a more comprehensive press release covering concurrent corporate developments.

General Solicitation in Rule 506(c) Offerings

6) Q: Will issuers be willing to conduct Rule 506(c) offerings with general solicitation after the rule takes effect on September 23, given the additional requirements that the SEC has proposed but not yet adopted?

A: The SEC did not express a view on how it anticipates market participants would conduct Rule 506(c) offerings while the proposed additional Regulation D requirements were still being considered. We think market participants will be cautious in pursuing Rule 506(c) offerings until the status of the SEC's additional Regulation D proposals has been clarified.

7) Q: How will we determine if an issuer has taken reasonable steps to verify that all of the purchasers are accredited investors?

A: The adopting release states that "whether the steps taken are 'reasonable' would be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction."[8] However, an issuer will not have taken reasonable steps "if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status."[9]

The SEC suggested some relevant factors to consider would include:

- *The nature of the purchaser and the type of accredited investor that the purchaser claims to be*. The status of certain investors as accredited will be easier to verify than others, with natural persons being more difficult than institutions.

- *The amount and type of information that the issuer has about the purchaser*. According to the adopting release, 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."[10]

- *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*. Fewer verification steps would be required for purchasers solicited from pre-screened accredited investors as compared to those solicited from the general public. The terms of the offering could also serve as a screening method (*e.g.*, a high minimum investment requirement that only accredited investors could reasonably be expected to meet).[11]

We expect that market participants will develop standard representations and warranties to serve as a foundation for this determination and to support typical third-party legal opinions that the transaction is not subject to registration under the Securities Act.

8) Q: Will it be reasonable to rely on a third-party service to screen potential investors for accredited investor status?

A: Yes, if there is a reasonable basis for believing that the service is reliable. As the adopting release puts it, an issuer "will be entitled to rely on a third party that has verified a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on such third-party verification." We think it's only a matter of time until independent verification services emerge to verify accredited investor status. Certain third-party services already provide a list of QIBs, which many market participants use to establish the required reasonable belief for Rule 144A offerings.[12]

9) Q: Will we be able to engage in general solicitation if we wish to preserve the flexibility to sell to some non-accredited investors in our Rule 506 offering?

A: No. Rule 506(c) does not modify the Rule 506 requirements relating to private placements to non-accredited investors. As a result, an issuer wishing to sell to non-accredited investors in its offering would not be able to engage in general solicitation.

Ongoing Investor Communication Issues in Rule 144A or Rule 506(c) Offerings

10) Q: Will a public company that is planning to offer convertible bonds or high yield notes in a Rule 144A or Rule 506(c) offering be able to discuss the upcoming offering on an earnings call?

A: Yes. Assuming Rule 144A securities are resold only to QIBs or Rule 506(c) securities are sold only to accredited investors (and the other applicable requirements of Rule 506(c) and Regulation D are met), any general solicitation concerns related to mentioning the upcoming offering will

disappear. However, we don't expect the earnings call playbook to change, because deal teams will continue to want to preserve the separation between the earnings call and a pending offering to avoid making the transcript part of the offering materials.

11) Q: Will a company be able to conduct a non-deal road show and shortly thereafter engage in a Rule 144A or Rule 506(c) offering?

A: Yes. Again assuming only QIBs purchase securities in the Rule 144A offering or only accredited investors purchase in the Rule 506(c) offering (and the other applicable requirements of Rule 506(c) and Regulation D are met), any lingering general solicitation concerns associated with non-deal road shows will fall away under the new regime. However, we don't expect the non-deal road show playbook to change. We will still be recommending careful vetting of the contents of any non-deal road show presentations that occur in proximity to a planned offering to address antifraud and Regulation FD concerns.

12) Q: Will a company be able to discuss an upcoming Rule 144A or Rule 506(c) offering with prospective investors at an industry conference?

A: We look at an industry conference as if it were a non-deal road show. So long as all of the actual sales are made to QIBs in the Rule 144A offering or to accredited investors in the Rule 506(c) offering (and the other applicable requirements of Rule 506(c) and Regulation D are met), mentioning an upcoming offering at an industry conference will no longer trigger general solicitation concerns. However, the company will still need to keep antifraud and Regulation FD concerns firmly in mind, particularly if a securities offering is being contemplated in the near term.

13) Q: Will a company be able to conduct a Rule 144A or Rule 506(c) offering using general solicitation and concurrently offer securities to the public in a registered transaction?

A: In our view, yes. In 2007, the SEC clarified that the filing of a registration statement is not *per se* general solicitation and that companies should analyze whether a concurrent private placement is itself a valid private transaction:

> "This analysis should not focus exclusively on the nature of the investors, such as whether they are 'qualified institutional buyers' as defined in Securities Act Rule 144A or institutional accredited investors, or the number of such investors participating in the offering; instead, companies and their counsel should analyze whether the offering is exempt under Section 4(2) on its own, including whether securities were offered and sold to the private placement investors through the means of a general solicitation in the form of the registration statement."[13]

As a result of the revisions to Rule 144A and the addition of Rule 506(c), the absence of general solicitation will no longer be a feature of the private placement analysis in the case of a Rule 144A or Rule 506(c) offering. It follows that a company should be able to conduct a public offering and concurrently conduct an otherwise valid Rule 144A or Rule 506(c) offering, without losing the applicable Section 4(a)(2) exemption even if the securities were offered to the private investors by means of general solicitation. The playbook for concurrent public and private offerings should otherwise remain largely unchanged.

14) Q: What about gun-jumping concerns in the concurrent public/private scenario discussed above?

A: Recall that Securities Act Section 4(a) provides an exemption from Section 5's various restrictions, and that Rule 144A and Rule 506(c) transactions are exempt under Section 4(a). As a result, general solicitation in connection with a Rule 144A or Rule 506(c) private offering should not be considered gun jumping for a concurrent public offering, so long as there is an appropriate separation between the two sets of offerees. We expect that issuers will want to take care to segregate offerees to avoid the claim that the purported general solicitation for the private offering was in fact being used to solicit investors in the public offering.[14]

15) Q: And what about integration concerns in the concurrent public/private scenario?

A: In the *Black Box* and *Squadron Ellenoff* no-action letters,[15] the SEC Staff reasoned that offerings to QIBs and up to three large institutional accredited investors would not be integrated with a concurrent public offering. In 2007, the SEC provided additional guidance on integration of concurrent public and private offerings that focused on *how* the private placement investors were solicited rather than *who* they are, taking a "how, not who" approach to this issue.[16] Since general solicitation will no longer be part of the "how" equation for a Rule 144A or Rule 506(c) offering, we believe an otherwise-valid Rule 144A or Rule 506(c) offering can occur concurrently with a registered offering.

However, many of the procedures currently employed to maintain the separateness of concurrent public and Rule 144A or Rule 506(c) offerings will likely remain in place. For example, we expect issuers to segregate the private-side offerees to ensure that any marketing materials used in the Rule 144A or Rule 506(c) offering will not be considered free writing prospectuses in the concurrent public offering.

General Solicitation in Global Offerings

16) Q: Is general solicitation permissible in a global offering in which offshore sales will be made under Regulation S and US sales will be made under Rule 144A or Rule 506(c)?

A: Yes. The adopting release confirms that offshore offerings under Regulation S will not be integrated with concurrent Rule 144A or Rule 506(c) transactions.[17] In other words, general solicitation will not constitute directed selling efforts that would jeopardize a concurrent Regulation S offering.

17) Q: Does the repeal of the general solicitation ban mean that participating broker-dealers may now distribute research generally in the United States in advance of, or concurrently with, a Rule 144A or Rule 506(c) offering?

A: Yes, although we think this is unlikely to become commonplace. Existing SEC and FINRA rules regarding research (including the interaction between investment banking and research personnel and the content and approval requirements relating to the preparation and issuance of research reports) will continue to apply.

General Solicitation in Other Private Placements

18) Q: Can I generally solicit in a traditional Section 4(a)(2) private placement?

A: No. The adopting release makes clear that the rule changes affect only the Rule 506 safe harbor, not other private offerings under Section 4(a)(2).[18]

19) Q: Can I generally solicit in connection with "Section 4(1½)" private resales?

A: The SEC Staff has previously indicated that so-called Section 4(1½) private resales are not affected by new Rule 506(c). We nonetheless believe that permitting general solicitation in Section 4(1½) private resales in situations where all the purchasers are accredited investors and the requirements of Rule 506(c) are met (other than its limitation to transactions by issuers) is consistent with the legal theory that gave rise to the secondary market in private offerings. As noted above, however, we believe market participants will be cautious about engaging in Rule 506(c) general solicitation until the status of the SEC's proposed notice and legending requirements is clarified.

The Section 4(1½) exemption relies on the interplay between Section 4(a)(2) on the one hand, and Sections 4(a)(1) and 4(a)(3) on the other. It is based on the notion that if the requirements of Section 4(a)(2) are otherwise met with respect to a private secondary market resale of a restricted security, the fact that a resale transaction occurs further down the chain of title (*i.e.*, does not involve the issuer as a counterparty) is not a reason to deny it the exempt status that would have been available had the issuer been the seller in the transaction. What's good enough for the issuer, in our view, should be good enough for subsequent holders in the chain of title.

We believe this logic should apply with equal force to Rule 506(c), which, after all, is a safe harbor under Section 4(a)(2). In other words, in an otherwise Rule 506(c)-compliant transaction, a secondary market reseller should enjoy an exemption from registration notwithstanding the occurrence of general solicitation. If this is not permitted, the only channel available for resales of a restricted security originally sold under Rule 506(c) would seem to be Rule 144A. We see no policy basis for such a limitation.

Investment Company Act Issues in General Solicitation

20) Q: Will general solicitation be permissible in connection with an unregistered offering for a private investment fund under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940?

A: Yes, so long as the offering also meets the requirements of Rule 506(c). The adopting release confirms that Rule 506 transactions have historically been regarded as non-public offerings for purposes of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act and that a private fund may engage in general solicitation in compliance with Rule 506(c) without losing either of those exclusions.[19]

21) Q: Will a Section 3(c)(1) or 3(c)(7) fund be able to sponsor a golf tournament or similar publicity-generating event?

A: Yes. Consistent with the answer above, general solicitation in connection with branding initiatives by these types of private funds should not cause concern.

Broker-Dealer Issues in General Solicitation

22) Q: If there is no prohibition on general solicitation in Rule 144A or Rule 506(c) offerings, can anyone now solicit potential purchasers in connection with private placements?

A: No. Persons who solicit or find potential purchasers in securities offerings will still need to be registered as broker-dealers under the Securities Exchange Act of 1934 (and applicable state blue sky laws) or comply with an appropriate exemption from such registration requirements.[20]

Blue Sky Issues in General Solicitation

23) Q: How will Rule 144A or Rule 506(c) offerings be treated under state blue sky laws?

A: Section 18 of the Securities Act broadly preempts state securities law registration requirements for certain exempt transactions in covered securities, including Rule 506 offerings for all issuers and Rule 144A offerings by SEC reporting issuers. The use of general solicitation should not affect the preemption of state securities registration requirements provided under Section 18 for these offerings. However, Rule 144A offerings for *non-reporting* issuers are not federally preempted pursuant to Section 18. Fortunately, each state provides an exemption from state securities registration requirements for offers and sales of securities made solely to QIBs, but those exemptions do not extend to offers made to non-QIBs. It remains an open question whether written offering materials used to offer (or deemed to be used to offer) securities to non-QIBs would be subject to a filing requirement in some states. We nonetheless do not expect most market participants to consider this technical point to be a concern in practice.

The Proposed Revised Regulation D Rules

24) Q: What effect would the proposed advance filing and legending requirements have on market participants' willingness to engage in general solicitation in Rule 506(c) offerings?

A: We think that the new advance filing and legending requirements would have a substantial chilling effect. We do not believe that deal teams will find the ability to generally solicit under Rule 506(c) attractive if these proposed new requirements are adopted.

25) Q: How might the proposed revised rules affect Form D filing practices?

A: Issuers in many Rule 506 transactions today do not file a Form D, and filing it is not currently a condition to claiming the safe harbor. Revised Rule 507 could change that practice, since failure to file a Form D would disqualify the issuer from relying on Rule 506 in future offerings for a period of time.

Bad Actor Disqualification Rules

26) Q: Do the bad actor provisions of new Rule 506(d) contain a materiality qualifier?

A: No. If a director, officer or director nominee of an issuer was involved in a potential disqualifying event that the issuer has determined would not need to be disclosed in a periodic report under Regulation S-K Item 404(f), that event could nonetheless result in disqualification from reliance on Rule 506. If the event occurred prior to the effective date of the new rules, it may be required to be disclosed pursuant to new Rule 506(d).

27) Q: What steps must an issuer take to satisfy the "reasonable care" standard for the purpose of relying on the exemption from disqualification under new Rule 506(d)(2)(iv)?

A: This is a facts-and-circumstances test, and we accordingly expect that market participants will develop standard representations and warranties confirming the absence of bad actor disqualification.

The adopting release suggests the steps an issuer should take will vary according to the relevant facts, and the overall objective "should be for the issuer to gather information that is complete and accurate as of the time of the relevant transactions, without imposing an unreasonable burden on the issuer or the other participants in the offering."[21] In this regard, the adopting release provides that:[22]

- issuers would be expected to have an in-depth knowledge of their own executive officers and other officers participating in securities offerings gained through the hiring process and in the course of the employment relationship, "and in such circumstances, further steps may not be required in connection with a particular offering;"

- factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, "may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement;" and

- the timeframe for inquiry should also be "reasonable in relation to the circumstances of the offering and the participants."

28) Q: May an issuer rely on statements made in a beneficial owner's Schedule 13D for the purposes of determining whether that 20% beneficial owner has been subject to certain triggering events during the applicable look-back period?

A: In our view, yes. We expect market participants will be comfortable relying on Schedule 13D disclosures.

29) Q: What should an issuer look out for in settling SEC cases to avoid being disqualified under Rule 506(d)?

A: Whether the SEC brings the settled enforcement action in federal court or in its own administrative process, and the specific charges the issuer settles to, can determine whether a bad actor disqualification under Rule 506(d) is triggered. For example:

- If the SEC agrees to bring an administrative cease-and-desist proceeding finding violations of the non-*scienter*-based Securities Act antifraud provisions (Sections 17(a)(2) and (3)), that would not lead to a disqualifying event.

- By contrast, a settled federal court injunctive action for the same non-*scienter*-based violations would be a disqualifying event.

- Similarly, an SEC cease-and-desist order finding violations of the *scienter*-based antifraud provisions of the Securities Act (Section 17(a)(1)) or the Exchange Act (Section 10(b) and Rule 10b-5 thereunder) would be a disqualifying event.

If disqualifying events cannot be avoided, the issuer can seek a waiver from the SEC Staff during settlement negotiations. The SEC has delegated authority to the Director of the Division of Corporation Finance to grant a waiver from a Rule 506 disqualification upon a showing of good cause that the disqualification is not necessary under the circumstances.

The SEC has declined to articulate standards for granting Rule 506 waivers but has stated that it might consider doing so after the SEC and its Staff have developed experience in handling waiver requests under the new rules.[23] The SEC listed a number of circumstances (including a change of control, change of supervisory personnel, and absence of notice and opportunity for hearing) that could, depending on the specific facts, be relevant to the evaluation of a waiver request.[24]

30) Q: Could FCPA violations give rise to disqualification under Rule 506(d)?

A: The Foreign Corrupt Practices Act (FCPA) has both anti-bribery provisions under Exchange Act Section 30A and accounting (books-and-records and internal controls) provisions under Exchange Act Section 13(b). It is unlikely that Section 30A violations standing alone, whether prosecuted criminally by the US Department of Justice (DOJ) or civilly by the SEC, would give rise to a disqualifying event under Rule 506, because bribery violations in themselves generally do not involve the making of a false filing with the SEC and are not in connection with the purchase or sale of securities. However, if a criminal conviction or injunctive order in an FCPA case includes violations of the books-and-records or internal controls provisions of Section 13(b), it is possible that the SEC would take the position that there is a disqualifying event under Rule 506 because the conduct either involved the making of false SEC filings or was in connection with the purchase or sale of securities. Moreover, the facts underlying an FCPA violation might also support a court order or SEC cease-and-desist order for violating the reporting or antifraud provisions of the federal securities laws more broadly. Because those violations could involve false SEC filings or be in connection with the purchase or sale of securities or both, they could give rise to disqualification under Rule 506.

31) Q: Could OFAC violations give rise to disqualification under Rule 506(d)?

A: The Office of Foreign Assets Control (OFAC) is a division of the US Department of the Treasury that administers and enforces economic and trade sanctions based on US foreign policy and national security goals. Commonly called "embargoes," these sanctions programs target certain foreign countries and their governments (*e.g.*, Cuba, Iran, Sudan and Syria) as well as a number of specially designated parties, such as terrorist organizations, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction (WMD). An OFAC violation in and of itself would not give rise to disqualification. However, Exchange Act 13(r) (codifying Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012) requires SEC registered issuers to disclose in their periodic reports filed under Section 13, among other things, any "transaction or dealing" by the issuer or its affiliates: (i) with the "Government of Iran" as broadly defined by OFAC; (ii) with parties designated by OFAC for supporting global terrorism or WMD activities; or (iii) relating to certain activities in Iran's energy sector, Iran's development of WMDs or other military capabilities, and human right abuses. A violation of that provision could be prosecuted criminally by the DOJ or civilly by the SEC, and a criminal conviction or civil injunction could be in connection with the purchase or sale of a security and so a disqualifying event under Rule 506.

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Endnotes

[1] With apologies to Robert De Niro – he may have played bad guys on screen but *IMDB* says he is "thought of as one of the greatest actors of his time." We agree.

[2] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9415 (July 10, 2013) (*General Solicitation Adopting Release*).

[3] *Amendments to Regulation D, Form D and Rule 156*, Release No. 33-9416 (July 10, 2013).

[4] *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings*, Release No. 33-9414 (July 10, 2013) (*Bad Actor Adopting Release*).

[5] *See* Latham & Watkins *Client Alert* "The JOBS Act, Part Deux: Frequently Asked Questions about Title II of the JOBS Act," available at www.lw.com/thoughtLeadership/faq-jobs-act-title-II.

[6] *See General Solicitation Adopting Release*, at 55 n.172.

[7] *Id.* at 8.

[8] *Id.* at 27.

[9] *Id.* at 34.

[10] *Id.* at 32.

[11] *Id.* at 34.

[12] *See, e.g.* SEC Division of Corporation Finance Staff no-action letters to *Communicator Inc.* (Sept. 20, 2002) and *CommScan LLC* (Feb. 3, 1999).

[13] *Revisions of Limited Offering Exemptions in Regulation D*, Release No. 33-8828 (Aug. 3, 2007) at 55-56 (*2007 Regulation D Release*).

[14] In an offering involving an emerging growth company, these concerns might be mitigated to the extent that only institutional accredited investors were solicited.

[15] SEC Division of Corporation Finance Staff no-action letters to *Black Box Incorporated* (June 26, 1990) and *Squadron Ellenoff, Pleasant & Lehrer* (Feb. 28, 1992).

[16] *See 2007 Regulation D Release,* at 55-56.

[17] *See General Solicitation Adopting Release*, at 58.

[18] *Id.* at 12-13.

[19] *Id.* at 49.

[20] *See* Latham & Watkins *Client Alert* "'Finders' and the 'Issuer Exemption': The SEC Sheds New Light on an Old Subject," available at www.lw.com/thoughtLeadership/sec-finders-issuers-exemption.

[21] *Bad Actor Adopting Release*, at 66-67.

[22] *Id.*at 66.

[23] *Id.* at 71.

[24] *Id.*