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Advertised Private Placements Under Rule 506(c): Status of Proposed Investor Protections and Summary of Comments Received by the SEC

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Background

On July 10, 2013, the SEC proposed significant changes affecting private offerings under Rule 506 of Regulation D, the most frequently used exemption from the registration requirements. If adopted, these proposed changes will impact all offerings made under Rule 506, not just offerings made under the new advertised private placement rule. The proposals would change the filing requirements and content of Form D, provide a one-year disqualification penalty for failure to file a required Form D and require several actions relating to materials used in advertised private placements. This article explains these proposed changes and the comments the SEC has received concerning them.

The proposed rule changes are directly related to very important final rule amendments allowing advertised private placements under Rule 506, which were effective September 23, 2013. In order to use general solicitation, the terms and conditions of Rules 501 and 502(a) and (d) need to be satisfied, all purchasers need to be accredited investors and the issuer needs to take “reasonable steps to verify” that purchasers are accredited investors. Click here for our explanation of the amendments permitting advertised private placements.

The proposed changes primarily result from suggestions regarding investor protection made during the comment process for the rules permitting advertised private offerings. In addition, some changes are driven by the SEC’s desire to collect more data regarding market practices under Rule 506(c). Our summaries of the proposed changes and comments received by the SEC appear below.

The proposed rule changes are extremely controversial. State securities regulators, investor advocates and some members of Congress strongly support them. Industry participants, start-up sponsors, their representatives and other members of Congress vehemently oppose them.

The comment period on the proposed changes ended on November 4, 2013; however, comment letters continue to be posted.

As of October 31, 2014, approximately 960 comment letters had been posted on the SEC’s site for receipt and posting of comments concerning the proposals.

(Since February 2014 virtually all the comment letters have dealt with whether to revise the definition of accredited investor, rather than the issues discussed below.)

Summary of the Proposed Changes

The proposed amendments are intended to address investor protection issues that may arise in connection with advertised private placements under new Rule 506(c) and to enhance the SEC’s ability to evaluate the development of market practices in Rule 506 offerings. However, many of the proposed changes, if adopted, would impact traditional nonadvertised private placements (under Rule 506(b)) as well as advertised offerings (under Rule 506(c)).

Proposed Form D Changes

The proposed amendments would make several changes relating to Form D including requiring:

- the filing of Form D before engaging in advertising,
- more information on Form D about the offering, and
- a closing amendment to Form D after the termination of an offering.

Proposed Penalty For Failure to File Form D

In a very significant difference from current practice, the proposed changes would disqualify future offerings if an issuer (or predecessors or affiliates) had not complied, within the previous five years, with the requirement to file a Form D in a Rule 506 offering. The five-year look-back period would not extend to any period before the effective date of the rule.

Proposed Changes Relating to Advertising Materials

The proposals also contain provisions dealing with materials used in general solicitation and would:

- require written general solicitation materials used in Rule 506(c) offerings to include certain legends and other disclosures; and
- provide for the submission to the SEC, on a temporary basis, of written advertising materials used in Rule 506(c) offerings.

The proposals also extend the antifraud guidance contained in Rule 156 to the sales literature of all private funds.

Practical Considerations

It has been over a year since these changes were proposed. SEC Commissioner Chair Mary Jo White has identified the finalization of these changes as a priority for 2014. However, the timing of a vote on them is unclear.

Also unclear is the extent to which these proposals would receive the support of the majority of the SEC Commissioners. These proposals were adopted in a 3-2 party-line vote. The position of the two SEC Commissioners who voted against these proposals has not changed. In a speech on September 17, 2014, one of them, Commissioner Gallagher, took the view that these proposals would do more harm than good, and should be withdrawn.

Accordingly, Chair White will probably decide which of these proposals will be adopted.

It will also be interesting to see whether the November 4, 2014, elections will have any impact on the ultimate resolution of the issues discussed in this article.

Virtually all these proposals were generated in response to concerns expressed in the wake of the Jumpstart Our Business Startups Act (JOBS Act) provision, which resulted in Rule 506(c), allowing general solicitation in the context of Rule 506. At the time, there was widespread apprehension that this change would fundamentally alter the private placement market, and that additional investor protections were necessary as a result. However, as of this writing in November 2014, Rule 506(c) has not revolutionized the private placement world.

Several factors have been discussed as possible explanations for the failure of Rule 506(c) to significantly alter private fundraising. Some people believe that the proposed rule changes have caused many issuers to defer consideration of Rule 506(c) offerings. If an issuer proceeds with an advertised private placement under Rule 506(c), that issuer may not be able to immediately shift back to a traditional private placement if these proposals are adopted. In other words, that issuer may no longer wish to use Rule 506(c) because of these changes, but may not be able to revert to a traditional private

placement until enough time has passed to ensure that the traditional private placement is not "integrated" with the Rule 506(c) offering.

Additionally, some people believe that the need for the issuer to take reasonable steps to verify accredited investor status has been a contributing factor in the failure of Rule 506(c) to significantly alter private placement practices. This factor may be accentuated by the absence of a fallback exemption under Section 4(a)(2) of the Securities Act if the requirements of Rule 506(c) are not satisfied.

(Another factor, which primarily impacted private investment vehicles, was corrected by the CFTC on September 9, 2014. Private investment vehicles which hold commodity interests need to comply with applicable CFTC provisions. The CFTC's action permits issuers who conduct advertised private placements under Rule 506(c) to use two CFTC provisions to either significantly reduce (CFTC Rule 4.7) or substantially eliminate (CFTC 4.13(a)(3)) required CFTC compliance.)

Finally, another factor is that many issuers simply may not need to use Rule 506(c) to raise capital.

In any case, the past year has given the SEC an opportunity to observe the impact of Rule 506(c) and its operation without these investor protections. This experience may impact the decision-making process at the SEC on these proposals.

If adopted, the proposed changes will have a major impact on the day-to-day use of Rule 506.

Click here for a detailed description of the proposed rule changes.

Summary of Comment Letters

The following sections discuss the comment letters that have been received concerning these proposals. Each section explains the main points made in the comment letters relating to that proposal, both in favor of the proposal and opposing it. In addition, in each of these sections you can access a more detailed summary of the relevant comment letters.

Advance Form D in Advertised Offerings – Proposed Amendment to Rule 503

The proposed changes include a new requirement to file a Form D that includes a portion of the information currently required on the Form D at least 15 days before using general solicitation (the "Advance Form D"). This proposal would not impact traditional, nonadvertised private placements (under Rule 506(b)), only offerings using general solicitation under Rule 506(c).

The SEC's proposing release states that the proposed Advance Form D would assist the SEC in its efforts to evaluate the use of Rule 506(c) because it would enhance the information available to the SEC relating to Rule 506(c) offerings, including offerings that were not successful or chose alternative ways of raising capital. The SEC's proposing release also notes that the Advance Form D would be helpful to state securities regulators, as explained below.

There has been a very significant amount of comment on this proposed requirement.

State securities regulators have pushed hard for this type of requirement because they believe that this filing will help them distinguish potentially fraudulent offerings from other offerings. State securities

regulators believe that this type of filing will allow them to conduct limited diligence to try to identify obviously fraudulent offerings and help them to answer questions they receive about advertised offerings. This proposal is also supported by numerous members of Congress, investor advocates, some industry participants and a law professor.

Some commenters have recommended that the SEC go further than the Advance Form D, by, for example, requiring a full Form D in advance, providing for stronger sanctions for failure to file and requiring the Advance Form D for all Rule 506 offerings (including nonadvertised private placements under Rule 506(b)).

Click here for a summary of the comment letters supporting this proposal.

Comment letters opposing this proposal have been posted by several members of Congress, businesses, lawyers, bar associations and trade associations.

Numerous industry participants and their representatives have objected to this proposal, taking the view that it is unnecessary and burdensome and will impede capital formation. Among other recurring arguments, these comment letters in opposition to the proposed Advance Form D for advertised offerings make the following points:

- It will be hard to tell when general solicitation starts and, as a result, difficult as a practical matter to determine when an advance filing is required.
- Advance-filing requirements are not practical for start-ups and small businesses.
- Advance-filing requirements will deter use of general solicitation because issuers will want to go to market immediately.
- Advance-filing requirements will deter use of general solicitation because issuers will not want to signal their capital raising plans to potential competitors.

Some commenters recommended that any advance-filing requirement be simplified so that small businesses do not need to use a lawyer to complete it.

Several commenters who oppose the Advance Form D as proposed have recommended instead the filing of a Form D at the time general solicitation is first used. Even some state securities regulators have indicated that a filing at the time of the first use of advertising would work for them. This approach would deal with some of the objections to the Advance Form D proposal. However, it would not address the practical problem of determining when general solicitation has begun or the cost and resource issues faced by start-ups and small businesses in complying with the requirement if adopted.

Click here for a summary of the comments opposed to the Advance Form D filing requirement.

Closing Form D – Proposed Amendment to Rule 503

The proposals include a new requirement to file a Form D amendment within 30 calendar days after termination of a Rule 506 offering (the “closing Form D”). This new requirement would apply to all Rule 506 offerings, both traditional nonadvertised Rule 506(b) private placements and Rule 506(c) offerings that use general solicitation.

Regulation D does not currently require a final amendment to Form D. When Regulation D was originally adopted, issuers were required to amend Form D every six months during an ongoing

offering and to file a final Form D within 30 days after the last sale in the offering. These requirements were removed in 1986.

The proposing release states that the purpose of this new closing Form D requirement is to provide the SEC with more complete information about the size and characteristics of the Rule 506 offering market.

Comment letters supporting the proposed closing Form D have been posted by members of Congress, investor advocates, state securities regulators, lawyers and trade associations.

A few commenters have supported the new requirement as proposed. Some commenters have supported it, but only for Rule 506(c) advertised offerings, not for traditional Rule 506(b) private placements. A few have supported the concept of a closing Form D, but suggested different ways of applying the concept.

Several commenters have recommended that the closing Form D be allowed to be submitted on a confidential basis.

Click here for a summary of the comment letters supporting the proposed closing Form D.

Comment letters opposing this proposal have been posted from trade associations, lawyers, law firms, bar associations and industry participants.

Many commenters oppose this proposal on the grounds that it will be difficult to determine when an offering terminates. Commenters have also objected to this proposal on the grounds of cost and because they do not believe it serves an investor protection purpose. In addition, many comment letters take the view that if the proposal is adopted, the information in a closing Form D should remain confidential. A few comment letters take the view that the closing Form D should be optional.

Click here for a summary of the comment letters opposing the proposed closing Form D.

Disqualification – Proposed Amendment to Rule 507

The SEC proposes to amend Regulation D so that an issuer would be disqualified from using Rule 506 in any new offering for one (1) year if the issuer (or any predecessor or affiliate of the issuer) did not comply with Form D filing requirements of Rule 503 for a Rule 506 offering within the previous five (5) years. The one-year disqualification period would not begin until after all of the required Form D filings had been made or, if the offering has been terminated, after the filing of a closing amendment.

The five-year look-back period would not extend to any period before the effective date of the amendment.

The disqualification provisions would not impact offerings that are ongoing at the time of noncompliance, including the offering for which the issuer failed to file the required Form D.

Filings made during a 30-day cure period do not trigger disqualification.

The extent of compliance with the Form D filing requirement, and whether there should be penalties for failure to file, became issues during the consideration of Rule 506(c), which permits advertised private placements. (The question of the extent of compliance with existing Form D filing

requirements is also a point of contention in many of the comment letters.) As discussed above, state securities law regulators have requested an advance Form D filing requirement to allow them to identify and track Rule 506(c) offerings made in their states. There is concern that these filings would not be made even if required, if there is no penalty attached to the failure to file.

The proposing release states that the SEC believes it is appropriate to strengthen the incentives for issuers to comply with the Form D filing requirements. These filings would also provide a more complete perspective on Rule 506(c) offerings and the Rule 506 market as a whole, and facilitate analysis of market developments by the SEC and state securities regulators. Incentives for issuers' compliance with Form D filing requirements would make it more likely that these required Form D filings would be made, and, as a result, that the SEC would obtain the information called for by these Form D filings. The proposing release also is clear that in order to be an effective incentive, the provision needs to have meaningful consequences for failure to file, but that the consequences should not give rise to disproportionate consequences.

This disqualification proposal is supported by consumer advocates, several U.S. Senators and state securities law regulators.

Some of these comment letters recommend that the SEC go further and condition the availability of Rule 506 on compliance with the Form D filing requirements, so that failure to file would result in loss of the exemption relating to the missed filing.

Click here for a summary of the comment letters supporting the proposed disqualification provisions.

There have been a very large number of comment letters posted that oppose the proposed disqualification provision. The comment letters opposing the proposed disqualification provision have been posted by businesses, trade associations, bar associations, lawyers, law firms, members of Congress and various individuals.

These comment letters make a number of points, including, among others, the following:

- The penalty is disproportionately severe, too harsh, draconian, etc.
- The cure period should be extended/broadened.
- The penalty should apply only to willful failure to file or repeat offenders, and should not apply to immaterial matters.
- The penalty period should be reduced, or replaced with a monetary penalty.

A recurring theme in these comment letters is that the disqualification provisions would have a negative impact on capital formation and could discourage the use of Rule 506(c). Some commenters have recommended that the proposal be replaced by a "three strikes" policy, starting with a warning and having gradually increasing penalties.

A difficult issue discussed in these comment letters is whether the disqualification should apply to failures by affiliates. Several comment letters oppose this aspect of the proposal. The practical impact of this provision would be significant, because the definition of affiliate may include portfolio companies of a private equity fund as well as other funds and fund managers in a fund complex.

Another interesting question is whether, and how, the disqualification provision should work in the case of start-ups and small businesses. Several comment letters recommend that the disqualification provision should not apply to start-ups and small businesses, and advance good practical considerations supporting this recommendation. (In this regard see the discussion under "Angel Letters" below.)

Click here for a summary of the comment letters opposing the proposed disqualification provisions.

Mandatory Legends – Proposed New Rule 509

The SEC has proposed that written general solicitation materials used in Rule 506(c) offerings would be required to include specified legends and disclosures. The proposal would require legends in written general solicitation materials to the effect that:

- only accredited investors are eligible to invest,
- the securities have not been registered or approved by the SEC,
- transfer of the securities is restricted, and
- investing involves risk that the purchaser needs to be prepared to bear.

The rationale for this proposal is that the legends would better inform potential investors as to whether they are eligible as well as certain risks of investing.

Additional legends and disclosures are proposed for written general solicitation materials used by private funds. These additional legends would make it clear that the private fund is not registered as a mutual fund and would require certain disclosures if the issuer provides performance data. Also, if a private fund's written general solicitation materials include performance data, that data needs to be as of the most recent practicable date.

Comment letters supporting this proposal have been posted from members of Congress, businesses, trade associations, state securities regulators and consumer advocates. Some comment letters recommend the use of model legends. Several comment letters take the view that the proposals do not go far enough, or that the required disclosure should be as prescriptive as those that are required for mutual funds.

Click here for a summary of the comment letters supporting this proposal.

Comment letters in opposition to this proposal have been posted from lawyers and bar associations, trade associations, businesses, individuals and members of Congress.

The comment letters opposing the proposal to require legends on solicitation materials make the following points:

- The SEC needs to provide clear guidance on when legends would be required.
- The legends are burdensome and unnecessary.
- The SEC needs to provide alternatives to legends for various types of electronic communications.
- Legends should be required only when financing terms are discussed.
- Legends should be required only when the securities are documented.
- Legends should be allowed to be provided in a separate notice rather than in general solicitation materials.

Click here for access to a summary of the comment letters opposing this proposal.

Proposed Amendments to Rule 156 to Apply Antifraud Guidance to Private Funds

The SEC is proposing to require the offering materials of private funds using Rule 506 to comply with a general advertising rule applicable to mutual funds. This rule, Rule 156, provides guidance about circumstances that might result in misleading advertising material. These circumstances include certain general factors that could cause a statement to be misleading, as well as situations in which representations about past performance and statements involving a material fact about the characteristics or attributes of an investment company would be misleading. Rule 156 does not mandate any particular type of presentation. The SEC proposal would apply the provisions of Rule 156 to all Rule 506 offerings by private funds, both advertised Rule 506(c) offerings and traditional private placements pursuant to Rule 506(b).

The proposing release states that the SEC believes it is important to provide interpretive guidance to private funds regarding the types of information in sales literature that could be fraudulent or misleading. The proposing release notes that the SEC has brought enforcement actions against private fund advisers in a number of situations. The enforcement actions have included instances in which defendants were charged with misrepresenting a private fund's prior investment performance, exaggerating their personal employment history and qualifications, omitting information regarding their disciplinary history, misrepresenting information about the holdings of the fund's investment portfolio, making fraudulent claims that the fund was performing better than the major stock indexes and falsely valuing the fund's investments. The proposing release also notes that the SEC is particularly concerned about the use of performance data.

This proposal has not gotten as much attention in the comment letters as the other proposals. A trade association that represents the mutual fund industry, two members of Congress and two state securities regulators have filed comment letters supporting this proposal.

Click here for a summary of the comment letters supporting this proposal.

Comment letters opposing this proposal have been posted by businesses, trade associations, lawyers and bar associations. These comment letters make the following points:

- Rule 156 should apply only in the context of advertised Rule 506(c) offerings by private funds.
- The extension of Rule 156 to Rule 506 offerings by private funds is neither needed nor warranted.
- If adopted, the proposal should not apply to SBIC funds.
- Changes would be required in Rule 156 to make it fit in the context of private funds.

Click here for a summary of the comment letters opposing this proposal.

Proposed New Temporary Rule 510T for Mandatory Submission of Written General Solicitation Materials

The SEC is proposing to require that an issuer conducting an advertised private placement under Rule 506(c) provide written advertising/solicitation materials to the SEC. The proposed submission requirement would not apply to oral communications. The materials would need to be submitted on the

day of first use, would be submitted through an intake page on the SEC's website (not filed) and would not be publicly available. The SEC's EDGAR filing system would not be used for the submission of these solicitation materials.

This requirement is proposed to last for two (2) years. Compliance with the proposed submission requirement would not be a condition of the use of Rule 506(c) and no new penalty is proposed for failure to comply.

During the comment process relating to Rule 506(c), a variety of recommendations were made to require materials used in general solicitations under Rule 506(c) to be filed with, or furnished to, the SEC or FINRA, as a "safeguard for investor protection." The rationale for the proposed submission requirement is to provide the SEC with information on market practices, in particular the types of materials used in general solicitations.

Comment letters supporting this proposal have been posted from members of Congress, consumer and investor representatives, trade associations and a few industry participants. Among other things, these letters recommend the following:

- The SEC should develop a program to review the submitted materials.
- The materials submitted to the SEC should be made public.
- The requirement to submit the materials to the SEC should be made permanent.
- The submission requirement should apply to video, audio and oral, as well as written, communications.

One industry trade association supported the proposal so long as no penalty was imposed for noncompliance but recommended that soliciting material be required to be submitted within a specified time after the completion of the offering.

Click here for a summary of the comment letters supporting this proposal.

Comment letters opposing this proposal have come from trade associations, businesses, lawyers, bar associations, individuals and members of Congress. Among other arguments, these comment letters in opposition make the following points:

- The SEC should clarify what constitutes general solicitation.
- The requirement is unnecessary for registered investment advisers because they are subject to SEC compliance examinations.
- Soliciting material should be required to be submitted only upon specific SEC request.
- The requirement would be burdensome on issuers, without any corresponding benefit to investors.
- The proposal is probably unworkable as a practical matter and will result in the SEC receiving a "deluge of unnecessary information."

In addition, several comment letters take the position that this proposal should not apply to start-ups and small businesses. On this point, see also the discussion under the caption "Angel Letters" below.

A few letters suggest requiring that solicitation materials to be submitted at regular intervals (such as annually) or within a specified time after termination of an offering.

The president of NASAA suggested that instead of submission, the SEC require that general solicitation materials contain a searchable identifier, which would allow the SEC to locate and view these materials online.

Click here for a summary of the comment letters opposing the proposal.

Angel Letters

Angel Network Response

There has been a concerted push by various people associated with angel networks to make sure that their perspective on the proposals is included in the comment file and considered by the SEC Commissioners. These particular comment letters are focused almost entirely on the impact of the proposals on start-ups. The comment letters highlight a number of issues that start-ups face in trying to raise funds and they pose an important policy issue for the SEC: whether there should be a separate or simplified set of requirements for start-ups where the amount of capital sought is below a specified amount (perhaps $1 million to $5 million). However, the SEC had a bad experience with fraud in the small offering space when it first adopted Rule 504, and as a result had to revise its approach on small offerings. Fraud and abusive pump-and-dump schemes continued to plague the Rule 504 space, even after the SEC revised its provisions. As a result, the SEC may wish to exercise care in applying these proposals — and the comments to the proposals — to start-ups. A number of alternative approaches could be used. In any case, the impact of these proposals on start-ups may not drive the SEC's analysis of these proposals insofar as they would deal with other types of issuers and offerings.

AngelList Letter

In March 2013, AngelList LLC obtained a no-action letter from the SEC, allowing AngelList and certain affiliates to operate a website that permits companies seeking financing and accredited investors to meet and communicate with each other, without broker-dealer registration. An affiliate, AngelList Advisors, LLC, has registered as an investment adviser.

On August 12, 2013, Naval Ravikant, CEO of AngelList, submitted a comment letter on these proposals. This letter explains some of the features of angel networks and their approach to fundraising for start-ups. The letter recommends the following changes in the proposals:

- Allow third parties to do the filing on the issuer's behalf through an application programming interface.
- Allow the company (or a third party like AngelList) to hold the financing materials so that the SEC can access them rather than requiring that they be provided to the SEC as solicitation material.
- Require legends and disclosures only when terms are communicated.
- Drop the 15-day advance filing requirement.
- Do not impose penalties for noncompliance.

A very large number of comment letters followed, supporting the points contained in the AngelList letter.

Type A Angel Letter

According to the SEC's site for receipt and posting of comments concerning these proposals, the SEC has received 49 copies of a letter that the SEC describes as Letter Type A. Letter Type A is four

paragraphs long, takes the view that the proposals will put a number of start-ups out of business and concludes with three requests, which are also contained in the AngelList Letter described above (see the first, third and fifth bullet points under the caption "AngelList Letter" above).

Type B Angel Letter

According to the SEC's site for receipt and posting of comments concerning the proposals, the SEC has received 160 signatures on a letter/petition that the SEC identifies as Letter Type B. This letter requests that the SEC:

- withdraw its proposed amendments to Regulation D and Form D,
- clarify that limited "Friends and Family" participation by non-accredited investors in Rule 506(c) offerings is allowed, and
- provide that membership in an established angel group would establish that an investor is accredited under Rule 506(c).

SEC Advisory Committee on Small and Emerging Companies

Representatives of angel investors made a presentation at an open meeting of the SEC Advisory Committee on Small and Emerging Companies on September 17, 2013. This presentation included many of the recommendations contained in the angel letters described above, that the proposals be withdrawn and that the SEC provide guidance on what constitutes general solicitation. Part of this effort by angel groups was designed to have general solicitation defined in a manner that did not pick up customary angel activities, like "demo" days and other types of events that may be deemed to involve general solicitation. In response to this effort, an official from the SEC stated that the SEC would provide a better definition of general solicitation, right after it finishes drafting the definition of insider trading.

The Advisory Committee recommended to the SEC that it extend the comment period on the proposed rules and the SEC did so. However, the Advisory Committee did not endorse the recommendations of the angel group representatives.

Individual Emails

The SEC comment file contains an extremely large number of short emails from persons associated with start-ups objecting generally to the changes. The authors of these comments include angel investors, persons associated with start-ups and others. While most of these letters appear to have been composed one at a time, several consist entirely or in large part of paragraphs from other comment letters. Many of these letters make recommendations contained in the AngelList Letter.

It remains to be seen whether, and the extent to which, the very large number of angel comment letters impact the SEC. In a few instances, the SEC staff has provided interpretations of the verification procedures, in part to accommodate issues raised in comment letters. However, the framework for these interpretations is the verification procedure adopted by the SEC, rather than the framework proposed by angel groups.