Rule 506: Too Cumbersome for Private Offerings?

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The SEC has been pursuing several initiatives that, taken together, would significantly increase the difficulties and uncertainties presented by the securities registration exemption found in Rule 506 of Regulation D. Some of these complications (see "Advertising Under Rule 506: A Two Edged Sword," *Expect Focus*, Vol. II, Fall 2013) would arise only in connection with offerings that take advantage of last year's amendment by which the SEC permitted general solicitation (including advertising) in connection with Rule 506 offerings. Others would arise independent of any general solicitation, either from changes recently adopted by the SEC (see, e.g., "'Bad Actors' Barred from Rule 506 Private Placements," *Expect Focus*, Vol. II, Fall 2013) or from changes merely proposed. **Proposed Form D Changes** Proposed changes pending would, for example, amend the Form D filing requirements in Rule 506 offerings to require issuers to:

- File a final amendment to the Form D within 30 days after termination of the offering.
- Provide extensive information about the number of (and amounts raised from) different categories of investors in the offering and how many investors have qualified as "accredited": (a) by income, (b) by net worth, (c) by status as director, executive officer of the issuer (or of the issuer's general partner),
or (d) by "other" factors.
- Provide identifying information for each adviser that functions directly or indirectly as a promoter, if the issuer is a pooled investment fund; or if the issuer is not a pooled investment fund, information about the percentage
(if any) of the offering's proceeds that has been or will be used for each
of six purposes the form prescribes.

Thus, issuers would be required to make sometimes difficult judgments about such matters as when an offering must be deemed "terminated," who falls within the applicable definition of a "promoter," and how certain investors or uses of proceeds should be categorized for purposes of the proposed new Form D requirements. **Increasing Chance of Form D Deficiencies** Even without the currently proposed changes, numerous uncertainties exist about the required content and timing of Form D filings and amendments. For example, difficult questions can arise about what transactions must be "integrated" (and thus deemed part of the same "offering" for Form D purposes). Regarding certain non-traditional types of securities, there may be significant doubt about even such basic matters as what entity should be reported on Form D as the "issuer." The currently proposed changes would, of course, further increase the likelihood of inadvertent errors in Forms D or amendments thereto, particularly regarding information that may change over time and must be monitored for the duration of an offering. **Penalty for Form D Deficiencies** The SEC is proposing that an issuer be disqualified from using Rule 506 for five years if it (or any of its predecessors or affiliates) has failed to comply with the Form D filing requirements. There would be various exceptions and limitations, including that any disqualification would end one year after any necessary corrections have been made in all Forms D (and amendments thereto) filed or required to be filed for the past five years. Nevertheless, **it is worrisome that the proposed disqualification is worded broadly enough to be triggered by *any* Form D deficiency** – including not only failure to make a required filing but also, perhaps, any omission or mistake in completing the form or amendment thereto. Moreover, assuming that any Form D filing deficiency is inadvertent, the issuer could very possibly make subsequent offerings in reliance on Rule 506 without knowing that it had become disqualified from such reliance. Clearly, any disqualification from reliance on Rule 506 could impose significant liabilities and other adverse business and legal consequences on the issuer; and private litigants (and even, occasionally, the SEC) may be tempted to "second guess" the sometimes difficult judgments that issuers may have to make in complying with some Form D requirements. **Increasing Regulatory Scrutiny** FINRA Rule 5123, adopted last year, requires member firms to submit to FINRA copies of private placement memoranda and other offering documents in connection with non-public offerings, with exceptions for insurance products and various other types of offerings. FINRA's published regulatory and examination priorities for 2014 state that it will use such filed materials to identify high risk offerings and will verify that firms' submissions pursuant to Rule 5123 are timely and accurate. Moreover, such published priorities of both FINRA and the SEC's Office of Compliance Inspections and Examinations (OCIE) indicate that, in 2014, they will devote particular attention to marketing materials used in connection with Rule 506 offerings where general solicitation is used. FINRA, for example, wants to assure that the marketing materials "are based on principles of fair dealing and good faith, are fair and balanced, and provide a sound basis to evaluate the facts about [the] securities acquired." FINRA and OCIE are also pressing for broker-dealer firms and investment advisers to perform adequate due diligence on private offerings in which they recommend or cause their customers to invest. See "More Due Diligence for Investments in Private Funds" on page 14. In sum, the regulators are, in various ways, trying to provide more protections to investors in Rule 506 offerings, in response to developments such as the use of general solicitation, private fund losses (including those resulting from the Madoff fraud), and the complexity and opacity of many of the investments that are offered in reliance on the rule. Although this significantly increases the cost and legal uncertainties involved with many such offerings, the trend seems unlikely to soon reverse.

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