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The SEC's Proposed Rule Changes under the JOBS Act

Edward T. Dartley | dartleye@pepperlaw.com
Gregory J. Nowak | nowakg@pepperlaw.com

As much as the elimination of the ban on general solicitation of private placements through the passage of Rule 506(c) creates significant opportunities for private issuers, the U.S. Securities and Exchange Commission (SEC) has also proposed a series of rule changes that will, if passed, increase disclosure requirements and impose new consequences for failure to follow the new rules. While these proposals, if adopted, should not dampen your enthusiasm over the doors that new Rule 506(c) will open, you just need to look carefully as you cross the threshold.

One of the SEC's most significant rule changes is an effort to give teeth to the Form D filing requirements. Currently, firms that issue securities pursuant to Rule 506 must file a Form D with the SEC, disclosing certain categories of information about the issuer, the offering, and the potential investors. Under Rule 507 as currently in force, a firm may be disqualified from using Regulation D if it fails to comply with Form D filing requirements, but only if a court has first entered an injunction for violating the filing requirements.

The SEC's proposal would increase the stakes dramatically. The SEC is proposing that a failure to comply with your Form D filing requirements at any time within a five-year period will result in an automatic one-year disqualification from using Rule 506. While issuers will get a pass on the first violation, a subsequent failure to comply with Form D filing requirements will sideline you from future Rule 506 offerings for a full year from the date when all required Form D filings were made.

The severity of the SEC's proposal may be driven in part by the fact that, historically, some issuers have been able to skirt Form D filing requirements and not suffer any real consequences, because given the size of the offerings and their systemic impact, the SEC traditionally has not expended resources on obtaining court injunctions for Form D filing deficiencies. The SEC's proposal, however, swings well in the other direction, and imposes a draconian consequence for failing to follow non-substantive filing requirements.

Another component of the SEC's proposed rules that has sparked an unusual governmental debate is the requirement to file an "Advance Form D" at least 15 days ahead of the commencement of a Rule 506(c) offering. That proposal sparked an incendiary letter from Congressmen Patrick T. McHenry (R-N.C.) and Scott Garrett (R-N.J.) of the House Financial Services Committee, arguing that the 15-day waiting period re-introduces a ban on general solicitation that the JOBS Act has lifted. While SEC Chair Mary Jo White was somewhat dismissive of the congressmen's pointed comments on this and other proposed changes (treating the letter as a comment letter to be considered with dozens of other such letters from industry participants), the fact remains that the proposed requirements for an Advance Form D, as well as for a "Closing Form D" means that there will be up to three Form D filings that will need to be made by Rule 506(c) issuers. That in turn means potentially three times as many opportunities to trip the one-year disqualification rule if a filing requirement is missed.

Another objective of the SEC's proposed rules is increased disclosure and transparency. For instance, the proposed rule changes would require issuers to include in their Form D filings a substantial amount of information that is not required under the current rule, such as the number and types of accredited investors that were purchasers, and information about investment

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advisers that directly or indirectly act as promoters of a pooled investment fund issuer. For Rule 506(c) offerings, issuers under the new rules will be required to disclose the types of general solicitations to be used and the verification methods for confirming the accredited investor status of purchasers (for further information on the new accredited investor verification requirements, click here for our August 14, 2013 *JOBS Act Alert* on that topic, "Practical Considerations for a Rule 506(c) General Solicitation"). http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2719

Another proposed rule aimed at transparency is proposed Rule 510T, a temporary rule that would require issuers engaging in Rule 506(c) offerings to submit to the SEC any marketing materials used in a general solicitation, no later than the date of first use. Submissions would not be available to the public, and the requirement would expire after two years. While the SEC's stated purpose in proposing these new disclosure requirements is to gather information on Rule 506 and the impact of new Rule 506(c), one cannot ignore the fact that this will provide the SEC with a wealth of information about your Rule 506 offerings, and accordingly greater opportunity to spot deficiencies and make determinations about whether to initiate examinations of particular asset managers. Even if Rule 510T is not adopted, however, issuers must still make sure that their materials are correct in all material respects, as the anti-fraud rules still apply and the SEC has a myriad of very powerful tools at their disposal to police advertising and marketing.

Rule 510T's submission requirement takes on heightened importance, given another rule change proposed by the SEC—applying the standards of Rule 156 of the Securities Act of 1933 to private funds that engage in Rule 506(c) offerings. Rule 156 presently provides guidance on the manner in which registered investment company (*i.e.*, mutual funds) sales literature may be deemed to be misleading under the federal anti-fraud securities laws. Rule 156 contains numerous specific examples of how performance representations and statements about the attributes of registered funds can be misleading. This guidance, however, was designed to address issues that pertain to registered investment companies, not hedge funds or private equity funds. If the SEC's proposal is adopted, private fund managers will be tested in their ability to conform their new Rule 506(c) marketing materials to Rule 156 strictures that were not designed for their industry. The fact that these marketing materials will also be submitted to the SEC raises the challenge of compliance with Rule 156 to an even higher level.

These proposals are the most controversial among the changes that were proposed by the SEC on July 10, 2013. There are others, such as a request for comment on whether the accredited investor standards should be changed or indexed for inflation, that will draw comments from all industry participants. We at Pepper Hamilton question whether all of the proposed changes are necessary or even advisable, and whether they will survive the comment period and become finalized. There is no question, however, that when we hear, we will make sure that you hear. Stay tuned.

More Resources on the JOBS Act

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