New Reg D: Implications for Offering Publicly-Traded Securities as Consideration in Private Acquisitions

By Robert Little, Jim Moloney & Anthony Shoemaker of Gibson, Dunn & Crutcher LLP

Two sets of final rules adopted by the SEC in July will impact public companies seeking to use their equity securities as consideration in an M&A transaction. The new rules (i) eliminate the absolute prohibition against "general solicitation" in securities offerings conducted pursuant to Rule 506 of Regulation D under the Securities Act of 1933[1] and (ii) disqualify certain "bad actors" from participating in Rule 506 offerings.[2]

When a target business is privately held and the consideration for the acquisition consists wholly or partially of equity securities of a public acquirer, such acquirer may seek to privately place its equity securities with the owners of the target rather than registering the securities due to the long lead-time that is often associated with the registration process or for other reasons. Such public acquirers generally will desire to comply with a safe harbor from the securities registration requirements under the Securities Act in conducting the offer and sale of its securities to the target's owners. Under the former version of Rule 506, which historically provided a commonly relied-upon safe harbor from the registration requirements, an issuer could sell an unlimited amount of its securities in a private placement to an unlimited number of "accredited investors"[3] and up to 35 non-accredited investors.

Under this rule, each investor that is not an accredited investor, either alone or with his purchaser representative(s), must have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment. As a result, to confirm satisfaction of the investor suitability standards of Regulation D, the acquirer must determine whether the sellers are accredited investors or meet the financial and business sophistication requirements. The acquirer can make this determination by contacting each seller and requesting that each seller complete and return an investment questionnaire, but such contact must not constitute a general solicitation. If any seller is not an accredited investor and does not meet the sophistication requirements, the acquirer can arrange for the appointment of a purchaser representative for such seller.

Under this Rule 506 regime, an issuer-acquirer that reached out to potential sellers to determine their status as "accredited investors" or as otherwise suitable to evaluate the potential investment risked violating the prohibition against general solicitation, unless the issuer or its agent had a pre-existing substantive relationship with the offerees.[4] It was therefore often difficult for issuers to comply with the rule's investor verification requirements while being restricted from directly contacting certain offerees for fear of violating the ban on general solicitation.

Under the new rules, the traditional Rule 506 safe harbor described above has been preserved intact as Rule 506(b), and issuers may continue to comply with its conditions, including the prohibition on the use of any form of general solicitation in the offering or sale of securities. The new rules create a new subsection (c) of Rule 506, which permits Rule 506 offerings that employ general solicitation methods if: (i) each purchaser in the offering is an accredited investor, or the issuer reasonably believes that each purchaser is an accredited investor at the time of the sale of the securities, and (ii) the issuer takes reasonable steps to verify that each purchaser is an accredited investor. Rule 506(c) represents a seismic shift in the nature of allowable advertising and outreach in private offerings—including transactions in which unregistered equity securities may be offered as consideration in an acquisition—but the usefulness of new Rule 506(c) will likely be constrained by the requirement that each offeree receiving unregistered equity securities must be an accredited investor.

---

[1] See *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9415 (July 10, 2013) (the "General Solicitation Adopting Release"). These rules were mandated by Title II of the Jumpstart Our Business Startups Act and became effective on September 23, 2013.

[2] See *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings*, Release No. 33-9414 (July 10, 2013) (the "Bad Actor Adopting Release"). These rules implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and also became effective on September 23, 2013.

[3] Under Rule 501 of Regulation D, "accredited investor" is defined to include, among others, individuals with a net worth that exceeds $1 million (excluding the value of the person's primary residence); individuals with income exceeding $200,000 (or $300,000 joint income with a spouse); certain businesses or entities with assets exceeding $5 million; and banks, insurance companies and other investment companies.

[4] SEC guidance recognizes the existence of a substantive pre-existing relationship by the issuer or its agent with a prospective investor as evidence that general solicitation was not used to attract such investor to the offering. See, e.g., *Use of Electronic Media*, Release No. 33-7856 (April 28, 2000) (noting that "one method of ensuring that general solicitation is not involved is to establish the existence of a 'pre-existing, substantive relationship'").

Therefore, while an issuer-acquirer may now choose to engage freely in any "solicitation" or other efforts directed toward potential sellers to determine investor suitability, once the issuer has engaged in general solicitation, it may not then rely on Rule 506(c) to issue the equity securities to sellers that are not verified accredited investors. Furthermore, once a general solicitation has commenced, the issuer will no longer have the flexibility to go back and rely on Rule 506(b) or the traditional Securities Act Section 4(a)(2) private placement exemption as an alternative to the Regulation D safe harbor.[5]

As a practical matter, if an acquirer chooses to engage in a general solicitation and cannot verify that each seller is accredited, then the acquirer should be prepared to pay cash consideration to any non-accredited investors. If so desired, the acquirer could also attempt to register the entire issuance of equity securities with the SEC, though the SEC may view the prior general solicitation as an "offer" in violation of the gun-jumping provisions of Section 5 of the Securities Act. A further alternative to registration may be to pursue a fairness hearing under Section 3(a)(10) of the Securities Act, though this option is available only in a handful of states.[6]

If the acquirer suspects that some of the sellers may not be accredited, but it still wants to use its privately-placed equity securities as acquisition currency and is not prepared to cash-out any non-accredited sellers, then it will need to follow the traditional model for engaging in such private placements—under Rule 506(b)—and avoid any type of general solicitation. This means that the issuer or its agent will need to have a pre-existing substantive relationship with each seller, and the offering can include no more than 35 non-accredited investors.

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 convictions or sanctions for securities fraud.[7] In addition to the issuer and its predecessors or affiliated issuers, the list of covered persons includes any director, executive officer, other officer participating in the offering, general partner, or managing member of the issuer, as well as beneficial owners of 20% or more of the issuer's voting equity securities.[8] The new rule also provides for an exception from disqualification for offerings where the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed.[9] In order to satisfy the "reasonable care" standard, issuers conducting a private placement under Rule 506 will need to make "a factual inquiry into whether any disqualifications exist."[10]

These new "bad actor" rules should be added to the list of issues that a public acquirer must consider when it seeks to use its equity as acquisition currency under either Rule 506(b) or Rule 506(c). The acquirer should consider whether it has conducted the appropriate inquiry (whether through the use of questionnaires, certifications and/or undertakings from its directors, officers and large shareholders) to reasonably assure itself of the absence of any disqualifying events or other disclosure obligations in connection with the acquisition transaction.

---

[5] See General Solicitation Adopting Release at 12-13 ("This mandate affects only Rule 506, and not Section 4(a)(2) offerings in general, which means that even after the effective date of Rule 506(c), an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering because public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2).").

[6] California, Idaho, North Carolina, Ohio, Oregon and Utah are the only states that currently offer a "fairness hearing" review and approval process.

[7] The disqualifying events detailed in Rule 506(d)(1) include various categories of criminal convictions, court injunctions and orders, final orders of certain regulators, certain SEC disciplinary, cease-and-desist and stop orders, and U.S. Postal Service false representation orders. If the event occurred prior to September 23, 2013, the issuer will not be prevented from relying on Rule 506, but new Rule 506(e) requires disclosure of the information to each purchaser. Because there is no materiality qualifier in the new rules, any violation by a covered person would result in disqualification or mandatory disclosure, as applicable.

[8] See Rule 506(d)(1) for the complete list of covered persons.

[9] Rule 506(d)(2)(iv).

[10] Id.

A sister publication of the popular newsletter, *The Corporate Counsel*, *Deal Lawyers* is a bi-monthly newsletter for M&A practitioners to keep them abreast of the latest developments and analyze deal practices.

Publisher: **Jesse M. Brill.** Formerly an attorney with the Securities and Exchange Commission and a leading authority on executive compensation practices, Mr. Brill is the Publisher/Editor of *The Corporate Counsel*, Chair of the National Association of Stock Plan Professionals, CompensationStandards.com and DealLawyers.com.

Editor: **Broc Romanek**, former SEC attorney and Editor of DealLawyers.com and TheCorporateCounsel.net. Broc can be reached at broc@naspp.com.