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CAPITAL FORMATION

# JOBS Act: SEC Proposal Would Dramatically Expand Marketing Options in Regulation D and Rule 144A Private Placements

BY NATHAN GREENE AND ROBERT TREUHOLD

When the JOBS Act (formally the Jumpstart Our Business Startups Act) was signed by President Obama in April, it directed that one of its signature provisions – the relaxation of decades-long limits on general solicitation and advertising in connection with unregistered securities – not go into effect until the Securities and Exchange Commission (''SEC'') set rules to implement the changes. Though the SEC was given 90 days to act, the rule proposal was released on August 29, 2012 almost two months after that statutory deadline. The agency's proposal would:

- Eliminate the prohibition on ''general solicitation''[1] in Rule 506 private placements so long as the only purchasers are accredited investors or the issuer reasonably believes they are accredited investors at the time of sale;

- Require issuers that use general solicitation in Rule 506 offerings to take reasonable steps to verify that the purchasers are accredited investors; and

- Eliminate the restriction in Rule 144A on *offers* to persons other than qualified institutional buyers (QIBs) so long as *sales* in the offering are only made to QIBs or persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

The proposed rules have not yet taken effect, and the SEC is taking comments on the proposal from the public until October 5, 2012.[2]

## Background

Rule 506 is among the most widely relied upon exemptions from the registration of securities offerings under the Securities Act of 1933. The rule provides a non-exclusive safe harbor exemption for offers and sales of securities by issuers to an unlimited number of accredited investors[3] and sales to no more than 35 non-accredited investors. Offers and sales made pursuant to existing Rule 506 have long had to satisfy, among other things, the requirements of Rule 502(c) of Regulation D, which prohibits any offer or sale of securities by any form of ''general solicitation or general advertising,'' including newspaper, magazine, television and internet advertisements.

Rule 144A likewise provides an exemption from the registration requirements of the Securities Act for offers and sales of securities by persons other than the is-

[1] As used in this article, the term ''general solicitation'' means both general solicitation and general advertising.

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[2] The JOBS Act is available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf. The SEC's proposing release, SEC Release No. 33-9354, is available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf. There is also already a rich trove of comment letters on file with the SEC that preceded its rulemaking. Those letters are available at http://www.sec.gov/comments/jobs-title-ii/jobs-title-ii.shtml.

[3] The accreditation thresholds are defined in Rule 501 of Regulation D. Different standards apply for individuals versus institutions.

suer to QIBs or persons reasonably believed to be QIBs. Although existing Rule 144A does not explicitly prohibit general solicitation, offers may be made only to QIBs or persons reasonably believed to be QIBs.

## Proposed Rules

**General Solicitation in Rule 506 Offerings**

The proposed rules would amend Rule 506 to provide for a new Rule 506(c) that would permit the use of general solicitation in securities offerings under Rule 506 so long as the following conditions are satisfied:

- The issuer takes ''reasonable steps to verify'' that the purchasers are accredited investors;
- All purchasers are accredited investors or the issuer reasonably believes that the purchasers are accredited investors at the time of sale; and
- The issuer meets all terms and conditions of Rule 501 (which provides the definitions used in Regulation D, including the multiple categories of accredited investors), Rule 502(a) (which outlines the factors to be considered when determining whether an offering under Rule 506 should be integrated with another offering), and Rule 502(d) (which provides that securities sold under Regulation D are restricted securities under the Securities Act and cannot be resold without registration under the Securities Act or an exemption from registration[4]).

The end effect is that proposed new Rule 506(c) should operate like existing Rule 506 except for the flexibility to engage in general solicitation, the requirement to take reasonable steps to verify that purchasers are accredited investors and the inability to sell to non-accredited investors. These last two requirements (*i.e.*, ''reasonable steps to verify'' and the blocking of non-accredited investors) should not be a surprise; both were mandated by the JOBS Act.

In addition, the proposed rules would amend Form D, which is a notice filed by issuers claiming a Regulation D exemption, to add a box to check for issuers who are relying on the new rule. This would allow regulators to readily confirm whether a given offering is being conducted with or without general solicitation and, looking ahead, would facilitate tracking the adoption of general solicitation activity over time.

**'Reasonable Steps to Verify' Accredited Investor Status**

Faced with a direction from Congress to ''determine'' reasonable verification methods, and the reality that there can be no one-size-fits-all approach, the SEC was intentionally fuzzy in its guidance. It stated that the reasonableness of the steps an issuer takes to identify a purchaser's accredited investor status would be subject to ''an objective determination, based on the particular facts and circumstances of the transaction.''

The proposing release suggests factors that may be relevant when determining whether an issuer's verification was ''reasonable,'' including:

- The nature of the purchaser (*e.g.*, fewer or different steps might be required to verify the status of a broker-dealer or investment company as opposed to a natural person);
- Information about the purchaser (*e.g.*, if the issuer has existing information about the purchaser, fewer verification steps might be necessary);
- The nature and terms of the offering, in particular the type of general solicitation used (*e.g.*, purchasers solicited through a billboard in Times Square would presumably require more verification than those solicited through a narrow invite list);
- The existence of a minimum investment amount (*e.g.*, a high minimum purchase requirement would allow for less verification than a lower requirement); and
- The use of pre-screening (*e.g.*, no additional verification may be required when a purchaser has been pre-screened for accredited investor qualification by a third party, so long as there is a reasonable basis to trust the third party's process).

**The proposal confirms that unregistered U.S. offerings that satisfy the new Rule 506 or Rule 144A exemptions will not be "integrated" with non-U.S. offerings under Regulation S, so that activity under one regulation will not taint the ability to rely on the other.**

The proposing release notes that if a solicitation is made through a generally accessible website, widely disseminated e-mail or social media, then simply having investors ''check a box'' as to their accredited status would not constitute reasonable verification, absent other information. This can be read to question the ability of an issuer to rely solely on self-certification by an investor about whom the issuer or its agents has no other information.

A few items of note:

- The unintentional sale of securities to a non-accredited investor would not violate the new rules if the issuer and those acting on its behalf can establish they took reasonable verification steps and reasonably believed the person to be an accredited investor at the time of the sale;
- The new verification requirements will not apply to Rule 506 offerings when there is no general solicitation (so-called ''quiet'' Rule 506 offerings), though it seems likely that any new verification practices that develop in the market will inform dealings with investors in private offerings more generally; and
- It will be important for issuers to maintain records that document the steps they or their agents take to verify that a purchaser is an accredited investor. An issuer claiming an exemption from the registration requirements will have the burden of showing that it is entitled to that exemption.

**General Solicitation in Rule 144A Offerings**

The proposed rules would amend Rule 144A to eliminate the references to ''offer'' and ''offeree'' in Rule 144A(d)(1). As a result, sellers or persons acting on their behalf selling securities pursuant to Rule 144A

[4] Rule 502(d) further requires that an issuer use reasonable care to ensure that purchasers are not ''underwriters'' for purposes of the Securities Act and provides examples of such reasonable care including the use of certain legends on securities certificates.

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could offer such securities to nonQIBs, including by means of general solicitation, so long as the securities are only sold to QIBs or persons reasonably believed to be QIBs. This change is not conditioned on the new ''reasonable steps to verify'' requirement.

**Integration with Offshore Regulation S Offerings**

Many issuers carry on parallel U.S. and non-U.S. offerings, with the U.S. offering typically made pursuant to Regulation D or Rule 144A and the non-U.S. offering typically made pursuant to Regulation S. Regulation S prohibits ''directed selling efforts'' in the United States, and there had been concern that this prohibition might conflict with the proposed ability to carry on U.S. general solicitation activities under revised Regulation D and Rule 144A. The proposal, however, confirms that unregistered U.S. offerings that satisfy the new Rule 506 or Rule 144A exemptions will not be ''integrated'' with non-U.S. offerings under Regulation S, so that activity under one regulation will not taint the ability to rely on the other. Assuming the proposed rules are adopted without changes and that the conditions to the proposed rules are otherwise satisfied, issuers therefore should be able to conduct Rule 506 or Rule 144A offerings and generally solicit investors in the United States without concern that U.S. activity will limit their ability to also sell securities pursuant to Regulation S.

**Special Considerations for Investment Funds**

The JOBS Act and the Congressional debate that accompanied it are almost completely silent on the question of whether private investment funds like hedge or private equity funds should be able to rely on the new general solicitation rules. Yet much of the media interest in the law focused on the fact that hedge funds will, for the first time, be able to engage in general advertising.

Meanwhile, interest within the private funds community has been more muted, with many insiders predicting – at least initially – only incremental changes in current practices. This is in part attributable to a culture that stresses exclusivity and consciously seeks to distinguish hedge and private equity fund managers from mass-market financial services providers.

For many years, however, private funds also have been explicitly limited in their ability to use general solicitation techniques by a string of interrelated statutory requirements. For example, many fund managers historically were not registered with the SEC as investment advisers and were subject to Investment Advisers Act of 1940 rules that limited their ability to ''hold themselves out'' to the public as offering fund management or other advisory services. Following Dodd-Frank Act rule changes, most fund managers marketing funds in the United States today are either registered as investment advisers with the SEC or have filed notices to be treated as ''exempt reporting advisers.'' Neither SEC registered advisers nor exempt reporting advisers are subject to Investment Advisers Act prohibitions on marketing their services, so they need not be concerned that the Investment Advisers Act will be a source of restrictions on their ability to rely on new Rule 506(c). The Investment Advisers Act can, however, restrict the actual content of public statements. For example, registered advisers are subject to SEC staff positions on how to present track record information, and all advisers are subject to the Investment Advisers Act's general antifraud provisions.

Also, many private funds would be subject to regulation like that applied to public mutual funds but for two exclusions from the Investment Company Act of 1940 definition of an ''investment company,'' and those exclusions are by their terms unavailable in the event of a public offering. Section 201(b) of the JOBS Act, however, provides that a general solicitation under Rule 506 will not be considered a public offering under any of ''the federal securities laws.'' That this JOBS Act text effectively trumps the traditional no public offering limits under the Investment Company Act was acknowledged by the SEC in the proposed rulemaking, so that those Investment Company Act requirements should not be a constraint going forward.

**Some fund firms may find themselves free to engage in general solicitation as to some funds while being constrained by CFTC no-public-offering rules as to others.**

The Commodity Exchange Act, on the other hand, is generally viewed as not being a ''securities'' law, which means that, absent action by the Commodity Futures Trading Commission (''CFTC''), issuers that rely on certain exemptions from CFTC registration that are conditioned on the absence of a public offering may still be unable to make general solicitations. Accordingly, many fund firms will need to review their approach on a fund-by-fund basis. Some may find themselves free to engage in general solicitation as to some funds while being constrained by CFTC no-public-offering rules as to others.

**The Political Debate**

Advocates of a more flexible approach to the general solicitation rules can breathe a sigh of relief that the SEC proposal sticks so closely to the relatively narrow script suggested by Congress. Given the vigor of the opposition that showed in a spate of hostile comment letters in August, that outcome was not foregone. Yet JOBS Act opponents faced an uphill battle, given that the rulemaking is basically directed by law. The opposition was thus left primarily with two tools: (1) calling for delay and (2) advocating various kinds of ''friction'' that would make the rules less attractive for many issuers.

With regard to delay, much of the heat in the debate was directed at the prospect of the SEC adopting an ''interim final rule'' with immediate effect, which would have allowed general solicitation activity to commence right away. This is in contrast to the default approach to rulemaking that requires a reasonable public notice period before a rule can take effect. JOBS Act opponents called for an extended notice period; studies before certain kinds of advertising would be permitted; and other types of ''go slow'' approaches.

With regard to friction, JOBS Act opponents called for a far-ranging approach to reconsider the regulation of private offerings in light of what some baldly characterized as a mistake by Congress in adopting the JOBS Act in the first place. Letters to the SEC from consumer and labor organizations (including the Consumer Fed-

eration of America, AFSCME, the AFL-CIO and the Teamsters), from the Investment Company Institute, which is the main trade group for the mutual fund industry, and from various state regulators offered every imaginable variation on limits to the general solicitation rule, notably including repeated suggestions that hedge and private equity funds not be allowed to rely on the rule at all. Their arguments apparently did not sway the SEC, though the agency did ask for comment as to whether certain issuers (*e.g.*, blank check companies) should be carved out of the final rule. Another outpouring of suggestions to block funds or other kinds of perceived high risk issuers from engaging in general solicitation should be expected.

Meanwhile, several letters from members of Congress in support of the JOBS Act were also filed with the SEC. The tone of one of these – an open letter from the Chairman of one of the subcommittees of the House Committee on Oversight and Government Reform – spoke to the question of timing and was positively inflammatory, accusing SEC Chairman Mary Schapiro of ''delaying tactics'' motivated by her ''ideological opposition'' to the JOBS Act.

## Looking Ahead

Perhaps in response to the highly politicized environment, an SEC press release hints that the agency will move quickly through the remainder of the rulemaking process, saying that, ''[t]he Commission will seek public comment on the proposed rules for 30 days. *Shortly thereafter*, the Commission will review the comments and determine whether to adopt the proposed rules.'' (emphasis added)

But for now, the amendments to Rule 506 and Rule 144A remain proposals and are not yet effective. Until adopted, market participants should continue to follow their customary procedures with respect to Rule 506 and Rule 144A offerings.

In the interim, those considering how they might adapt their formerly private marketing efforts to a more public model should identify and weigh the various practical implications of doing so, which clearly involves consideration of new compliance structures. The SEC's proposal, however, is uncharacteristically silent as to suggestions for compliance officers.

This assuredly temporary silence aside, for firms that embrace newly available offering options – such as open websites, social media campaigns, press releases and the like – the SEC, FINRA, states attorneys general and other interested regulators undoubtedly expect appropriate systems and controls. New controls might include enhanced internal review of newly public advertising or offering content, more training of staff, especially in the front-line departments involved (*e.g.*, marketing, media relations and investor servicing), and generally greater attention to calibrating one's offering message to reflect its broader reach.

Compliance and legal staff also should attend closely to new accredited investor verification guidance. Both issuers and marketers can be expected to critically evaluate their current sales processes to determine what kinds of information they obtain about purchasers in unregistered securities offerings. The goals in doing so will be to two-fold: first, to understand how that information, together with any supplemental background that might be appropriate, lines up with the new guidance and with potentially shifting market practice; and second, to consider how these verification processes will be documented over time.

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