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JOBS Act: SEC Proposes Rules Allowing General Solicitation and Advertising in Private Placements Under Rule 506 of Regulation D and Rule 144A

On August 29, 2012, the Securities and Exchange Commission proposed rule changes allowing general solicitation and advertising that the Jumpstart Our Business Startups Act (the "JOBS Act") requires it to adopt.[1] The proposed rule changes would: (1) eliminate the prohibition on general solicitation[2] 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; (2) require issuers that use general solicitation in Rule 506 offerings to take reasonable steps to verify that the purchasers are accredited investors; and (3) eliminate the restriction in Rule 144A on offers to persons other than qualified institutional buyers ("QIBs") so long as sales 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 do not affect traditional "quiet" Rule 506 offerings. In addition, the proposed rules would continue to permit concurrent offshore offerings conducted in reliance on Regulation S under the Securities Act. The proposed rules have not yet taken effect and the SEC is taking comments from the public until 30 days after publication in the Federal Register. Until final rules are adopted, there will be no change to the prohibition on general solicitation.

[1] The JOBS Act is available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf. Section 201 of the JOBS Act requires the SEC to adopt rules removing general solicitation prohibitions not later than 90 days after the Act's enactment. The SEC's proposing release, SEC Release No. 33-9354, is available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

[2] As used herein, the term "general solicitation" means both general solicitation and general advertising.

Background

Existing Rule 506 is a non-exclusive safe harbor that provides an exemption from the registration requirements of the Securities Act 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.

Existing Rule 144A provides an exemption from the registration requirements of the Securities Act for offers and sales of securities by persons other than the issuer 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.

Section 201(a) of the JOBS Act directed the SEC to revise the SEC's rules to allow for general solicitation in the context of Rule 506 and Rule 144A offerings. As a condition to the use of general solicitation in Rule 506 offerings, the JOBS Act requires the SEC rule revision to provide for all purchasers of such securities to be accredited investors. In addition, Congress mandated that the SEC adopt rules requiring the issuer to "take reasonable steps to verify" that such purchasers are accredited investors, using methods to be determined by the SEC. Similarly, the JOBS Act requires the SEC to amend Rule 144A to permit offers to persons other than QIBs so long as such securities are sold only to persons that are QIBs or the seller and any person acting on its behalf reasonably believe are 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 therefrom. 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.

[3] As defined in Rule 501 of Regulation D.

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. In addition, the proposed rules would amend Form D[4] to add a box to check for issuers who are relying on the new rule.

Section 201(b) of the JOBS Act provides that a general solicitation under Rule 506 would not be considered a public offering under any of the federal securities laws. For this reason, the SEC noted its view that a private fund, despite making a general solicitation under new Rule 506, may continue to rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (which are exclusions from the definition of "investment company" but by their terms are unavailable in the event of a public offering). The Commodity Exchange Act, however, 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 any exemptions from CFTC registration that are conditioned on the absence of a public offering may still be unable to make general solicitations.

"Reasonable Steps to Verify" Accredited Investor Status

The SEC did not propose a uniform or standard verification process. Rather, 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 a number of factors that may be relevant when determining whether an issuer's verification was "reasonable", including:

- the nature of 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); and
- 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 screened invite list), and the existence of a minimum investment amount.

The proposing release notes that if a solicitation was made through a generally accessible website, through a widely disseminated e-mail or through social media, simply having investors check a box as to their accredited status would not constitute reasonable verification, absent other information. A third party's verification of a person's accredited investor status may be a part of a reasonable determination. Additionally, 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.

[4] Form D is a notice filed by issuers claiming a Regulation D exemption.

Two items of note. First, the new verification requirements will not apply to Rule 506 offerings where there is no general solicitation (so-called "quiet" Rule 506 offerings). Second, it will be important for issuers to maintain records that document the steps they have taken to verify that a purchaser was an accredited investor. Any 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 could offer such securities to non-QIBs, including by means of general solicitation, so long as the securities are only sold to QIBs or persons reasonably believed to be QIBs.

Integration with Offshore Offerings

The proposing rule release provides that unregistered domestic offerings that satisfy the new Rule 506 or Rule 144A registration exemptions will not be integrated with offshore offerings made in compliance with Regulation S. Therefore, assuming the proposed rules are adopted without changes and the conditions to the proposed rules are otherwise satisfied, market participants would be able to conduct concurrent Rule 144A (or Rule 506) and Regulation S offerings and generally solicit investors in the United States without violating the prohibition in Regulation S with respect to "directed selling efforts" in the United States.

Looking Ahead

The amendments to Rule 506 and Rule 144A are not yet effective. After the comment period ends, the SEC will consider the comments received and would then be expected to issue final rules, which could vary from the proposed rules, and provide the effective date for the rule changes. Until adopted, market participants should continue to follow the customary procedures with respect to Rule 506 and Rule 144A offerings. The deadline for commenting is 30 days after publication in the Federal Register.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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