SEC Proposes to Eliminate General Solicitation and General Advertising Prohibitions from Certain Private Placements

On August 29, 2012, the US Securities and Exchange Commission proposed eliminating the prohibition against general solicitation and general advertising in offerings of securities pursuant to Rule 506 of Regulation D and Rule 144A. See Release No. 33-9354.[1] The rule proposals were mandated by Title II of the Jumpstart Our Business Startups Act (the "JOBS Act") enacted on April 5, 2012.

As a general matter, the Securities Act of 1933 (the "Securities Act") requires registration of all securities offerings in the United States unless conducted pursuant to an available exemption from registration. Regulation D is a safe harbor promulgated under Section 4(a)(2)[2] of the Securities Act, and provides one exemption from registration for primary offerings of securities by companies. Similarly, Rule 144A, also promulgated under the Securities Act, provides an exemption from registration for certain for certain resales of securities to qualified institutional buyers ("QIBs"). The proposed rules would amend certain aspects of these exemptions to allow for general solicitation and general advertising without compromising reliance on the exemptions from registration.

In particular, the rule proposals would:

- Add new Rule 506(c) to Regulation D to provide that the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D would not apply to offers and sales of securities made pursuant to Rule 506(c), provided that all purchasers of the securities are accredited investors, and that the issuer take reasonable steps to verify that purchasers of the securities are accredited investors;
- Amend Rule 144A to provide that securities may be offered to persons other than QIBs, including by means of a general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs; and
- Amend Form D to add a separate check box for issuers to indicate whether they are using general solicitation or general advertising in a Rule 506 offering.

The rules as proposed do not mandate any specific procedures that issuers of offerings made in reliance on new Rule 506(c) must follow to be assured that the steps they have taken to verify that the purchasers of its securities are accredited investors are reasonable. In the proposing release, the SEC said that "[w]hether the steps taken are 'reasonable' would be an objective determination, based on the particular facts and circumstances." But regardless of the steps taken, issuers must retain adequate records that document the steps taken to verify that a purchaser was an accredited investor. The SEC went further by highlighting the following factors to be considered when determining the reasonableness of the steps to verify that a purchaser is an accredited investor:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- The amount and type of information that the issuer has about the purchaser; and
- The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

While the SEC did not make specific verification standards part of the proposed rule, the proposing release did provide some specific guidance on the appropriateness of certain verification measures. For example, sources of verification of accredited investor status could include publicly available information contained in regulatory filings, such as the compensation tables of a proxy statement for an executive officer of a public company or a Form 990 for a purchaser that is a 501(c) organization. Reasonably reliable information prepared by a third party, such as a Form W-2 or a trade publication disclosing average annual compensation for certain levels of employees, could also be taken into account. Assuming an issuer has a reasonable basis to rely on such information, it could consider verification of accredited investor status from a broker-dealer, attorney or accountant. In addition, the fact that an offering has a sufficiently high minimum-investment requirement could be a factor in verifying accredited investor status.

The SEC pointed out in the proposing release that an issuer soliciting new investors through a website that is accessible to the general public, or through a widely disseminated email or social media solicitation, would *not* have taken reasonable steps to verify accredited investor status if it only requires a person to check a box in a questionnaire or sign a form. For such a solicitation, the issuer would need to have other information indicating the purchaser's accredited investor status in order to satisfy the verification requirement.

The key to the exemption would be whether the reasonableness requirement of the verification standard is satisfied. The SEC stated in the proposing release that it believes that an issuer would *not* lose the ability to rely on the proposed Rule 506(c) exemption if it ultimately turned out that a purchaser did not meet the criteria for any category of accredited investor status, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that the purchaser was an accredited investor.

In the proposing release, the SEC also provided its views regarding the application of these changes to Regulation D to privately offered funds, such as hedge funds, venture capital funds and private equity funds. These funds, in addition to relying on an exemption from the registration requirements of the Securities Act (e.g., Regulation D), also typically rely on one of two exclusions from the definition of investment company, set forth in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act"), to avoid being subject to the regulatory provisions of the Investment Company Act. Many types of securitizations and structured finance transactions utilize special purpose entities that also rely on these exclusions. However privately offered funds or special purpose issuers are precluded from relying on either exclusion if they are making a public offering of their securities. Consistent with the provisions in Title II of the JOBS Act, the SEC confirmed that such entities will be able to engage in a general solicitation or general advertising pursuant to the revisions to Rule 506 without losing the availability of either of the exclusions under the Investment Company Act.

The SEC addressed the interplay between concurrent offerings made outside the United States in reliance on Regulation S and inside the United States made in reliance on either Rule 506 or Rule 144A, where there is a general solicitation or general advertising. Of particular

concern is the requirement in Regulation S that there be no directed selling efforts in the United States. In the proposing release, the SEC took the position that concurrent offshore offerings that are conducted in compliance with Regulation S would not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, even if there is a general solicitation or general advertising. This position is consistent with the SEC's views regarding integration of concurrent offshore offerings made in compliance with Regulation S and registered domestic offerings. However, issuers in such offerings must be cognizant of applicable foreign requirements also to make sure that general solicitation or general advertising in the United States does not impact the ability to do an offering in one or more jurisdictions outside the United States.

Practical Considerations

Notably, neither the JOBS Act nor the SEC addressed the relationship between general solicitation or general advertising and the statutory exemption from registration set forth in Section 4(a)(2) of the Securities Act. Section 4(a)(2) exempts "[t]ransactions by an issuer not involving any public offering." This has typically been interpreted by the courts and practitioners to preclude general solicitation and general advertising in offerings relying on the Section 4(a)(2) exemption. Because it was not addressed by either the JOBS Act or the SEC, there remains uncertainty about the ability to engage in general solicitation or general advertising for offerings being made solely in reliance on Section 4(a)(2), notwithstanding the changes being proposed to Regulation D, which is a safe harbor under that section. Absent further guidance, it appears that under the proposal general solicitation and general advertising may be used for offerings being made in reliance on the safe harbor provided by Rule 506(c) of Regulation D but not for offerings being made solely in reliance on Section 4(a)(2).

If the rules are adopted as proposed, Rule 506 will contain two alternative methods of compliance. The first is that which exists today, prohibiting general solicitation and general advertising but allowing offers and sales to accredited investors and up to 35 non-accredited investors or persons who the issuer reasonably believes are not accredited investors who meet certain sophistication requirements (which would include employees that are not accredited). The second , which is now under consideration, permitting general solicitation and general advertising, but not allowing sales to any non-accredited investors, including employees that are not accredited investors, and would require an issuer to take reasonable steps to verify the accredited investor status of purchasers. As a result, if the rules are adopted as proposed, if an issuer wishes to engage in general solicitation and/or general advertising, it may not make sales to non-accredited investors (including employees) pursuant to the offering. Any sales to non-accredited investors would have to be made in a separate non-integrated offering pursuant to an available exemption from the registration requirements.

The comment period for the rule proposals runs for 30 days from the date of their publication in the *Federal Register*. As a result, it is possible that the SEC could act to adopt final rules as early as October 2012.

If you have any questions regarding the proposed elimination of the general solicitation and general advertising prohibitions from certain private placements, please contact the author of this Legal Update, ***Michael L. Hermsen, at +1 312 701 7960****, any of the lawyers listed below, or any other member of our Corporate & Securities group.*

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Endnotes

[1] Available at http://www.sec.gov/rules/proposed/shtml.

[1] Originally Section 4(2) until it was renumbered as part of the JOBS Act.