SEC Proposes Rules Eliminating Prohibition Against General Solicitation and General Advertising in Certain Private Placements

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On April 5, 2012, the Jumpstart Our Business Startups Act (the JOBS Act) was signed into law by President Obama with strong bipartisan support. The JOBS Act directed the Securities and Exchange Commission (SEC) to amend Rule 506 of Regulation D under the Securities Act of 1933 to permit general solicitation or general advertising in unregistered offerings made under Rule 506, provided that all purchasers of the securities are accredited investors. The SEC proposed rules on August 29, 2012 to implement that requirement.

Proposed Amendments to Rule 506 and Form D

Section 4(a)(2) of the Securities Act creates the private placement offering exemption by exempting from registration the offer and sale of securities by an issuer in a transaction “not involving any public offering.” This exemption has been interpreted to restrict an issuer from using public announcements, advertising or general solicitations when offering and selling securities. Rule 506, which creates a “safe harbor” for issuers seeking to use the Section 4(a)(2) exemption, expressly prohibits the issuer, or any person acting on its behalf, from offering or selling securities through any form of general solicitation. The JOBS Act requires the SEC to amend Rule 506 to eliminate the prohibition on general solicitation and general advertising. However, this mandate does not affect Section 4(a)(2) offerings in general.

In order to comply with the JOBS Act mandate, the SEC proposed new Rule 506(c), which would permit the use of general solicitation to offer and sell securities under Rule 506 if the following conditions are satisfied:

- the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;

- all purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they do, at the time of the sale of securities; and

- all terms and conditions of Rule 501 and 502(c) and 502(d) must be satisfied.

Any offerings conducted by an issuer under proposed Rule 506(c) would not be subject to Rule 502(c), which contains the prohibition against general solicitation.

The proposed rule preserves an issuer's ability to undertake a Rule 506 offering without any general solicitation or advertising. In that case, issuers need not take "reasonable steps" to verify a purchaser's accredited investor status (i.e., they can rely on an investor's self-certification) and they may still sell privately to up to 35 non-accredited investors who meet Rule 506(b)'s sophistication requirements.

Unlike in past releases, the SEC did not propose any special rules for certain categories of issuers that might present heightened investor protection concerns such as shell companies, blank check companies and issuers of penny stock.

Reasonable Steps to Verify Accredited Investor Status

The SEC noted that the purpose of the verification mandate is to address concerns, and reduce the risk, that the use of general solicitation under Rule 506 may result in sales to non-accredited investors. The SEC also noted that amendments to Rule 506 must be flexible to accommodate different types of issuers and different types of accredited investors (natural persons, public and private for profit and not-for-profit corporations, general and limited partnerships, business and other types of trusts and funds and other types of collective investment vehicles) that may purchase securities in these offerings. The SEC also made it clear that the determination of whether the steps taken by an issuer to verify the accredited status of an investor are reasonable is an objective determination based on the particular facts and circumstances of each transaction.

The SEC provided a non-exclusive list of factors that an issuer would consider when determining the reasonableness of the steps taken to verify that a purchaser is an accredited investor, including, the nature of the purchaser, the amount and type of information that the issuer has about the purchaser and the nature of the offering (including the manner in which the issuer was solicited and the terms of the offering, such as minimum investment amount).

Nature of the Purchaser

The definition of accredited investor in Rule 501(a) of Regulation D identifies several different types of accredited investors. The SEC noted that some investors are accredited because of their status, e.g., a registered broker or dealer or a registered investment company. Other investors are accredited because of a combination of their status and economic wherewithal, such as a state pension plan that has total assets in excess of $5 million, or a corporation with total assets in excess of $5 million. Finally, natural persons are accredited because of their net worth or total income.

According to the SEC, the steps taken to verify whether a purchaser is an accredited investor will vary depending on the type of accredited investor. For example, the SEC noted that to verify that a broker dealer is an accredited investor an issuer need not go further than FINRA's BrokerCheck Website. Verifying the accredited investor status of natural persons can be a more difficult undertaking. These

difficulties are compounded by privacy concerns about the disclosure of personal financial information and the integrity of information provided. As a result, the issuer may need to rely more heavily on other factors such as the type of information that the issuer has about the purchaser and the nature of the offering to determine exactly how to best verify that a natural person is accredited.

Information about the Purchaser

In many cases, an issuer may have substantial information about a potential investor. The amount and type of information that an issuer has about a purchaser would be a significant factor in determining what additional steps would be reasonable to verify that the purchaser is an accredited investor. The SEC provided examples of the types of information that issuers could review or rely upon to verify a purchaser's accredited investor status, including publicly available governmental filings, third party information such as a Form W-2 prepared by an investor's employer, a trade publication that discloses average income earned at the investor's workplace by persons at the level of the investor's seniority and verification of a person's status as an accredited investor by a third party, such as a broker-dealer, attorney or accountant, provided that the issuer has a reasonable basis to rely on such third-party verification.

Nature and Terms of the Offering

Another factor that the SEC instructs issuers to consider when verifying the accredited status of investors is the nature and the terms of the offering. The issuer should consider the means through which the issuer publicly solicits purchasers. According to the SEC, an issuer that solicits new investors through a website accessible to the general public or through a widely disseminated email or social media solicitation would likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party such as a registered broker dealer. As a result, issuers may begin to utilize the services of broker-dealers who have amassed a large pool of pre-screened accredited investors. In such case, the issuer could presumably rely upon the broker-dealer to verify the accredited status as long as the issuer understands the methods used by the broker-dealer to undertake the pre-screening and the issuer reasonably believes that the broker-dealer is conducting such pre-screening effectively.

Form D Check Box for Rule 506(c)

The SEC proposed a revision to Form D to add a separate field or check box for issuers to indicate whether they are claiming an exemption under Rule 506(c) which will allow general solicitation or general advertising. The SEC stated that the additional information will assist its efforts to monitor the use of general solicitation under Rule 506(c) offerings and the size of the offering market.

Specific Issues for Privately Offered Funds

The SEC also confirmed that privately offered funds such as hedge funds, venture funds and private equity funds, would be able to utilize general solicitation and general advertising to raise capital under Rule 506(c) without running afoul of restrictions under the Investment Company Act of 1940.

Proposed Amendment to Rule 144A

Section 201(a)(2) of the JOBS Act directs the SEC to revise Rule 144A(d)(1) under the Securities Act to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of a general solicitation, provided that securities are sold only to persons that the seller and any

person acting on the seller's behalf reasonably believe is a QIB. As amended the rule would require only that the securities are sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a QIB. Under the amended rule, resales of securities pursuant to Rule 144A could be conducted using general solicitation, so long as the purchasers are similarly limited.

No Integration with Offshore Offerings

The SEC made it clear that its long standing policy that offshore offerings under Regulation S are not integrated with domestic offerings under Regulation D is unchanged by the JOBS Act and related rule amendments.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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