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SEC PROPOSES TO PERMIT PUBLIC COMMUNICATIONS IN PRIVATE PLACEMENT RULES

In late August, the Securities and Exchange Commission ("SEC") proposed, by a 4-1 vote, to permit general solicitation and general advertising under two of its private placement safe harbor rules.[1] This will come in the form of rule amendments that are mandated by Section 201(a) of the Jumpstart Our Business Startups Act ("JOBS Act"). The first amendment will eliminate the prohibition against general solicitation and general advertising as a condition to the exemption from registration for a securities offering conducted under Rule 506 of Regulation D under the Securities Act of 1933 ("Securities Act") if (i) all purchasers in the offering are accredited investors and (ii) the issuer has taken reasonable steps to verify such status. As part of this proposed change, the SEC has provided guidance as to what it means for an issuer to take "reasonable steps" to verify accredited investor status. Also, the SEC is proposing a complementary change to Form D. The second amendment will explicitly allow for general solicitation and general advertising in offerings of securities made in compliance with Rule 144A under the Securities Act.

The SEC had initially considered issuing interim final rules that would have been effective immediately upon their adoption. Based in part on an adverse reaction to this approach, however, it ultimately proceeded with proposed rules in the more traditional manner.[2] The SEC is seeking comment on the proposed amendments by October 5, 2012.

REGULATION D PROPOSED CHANGES

Background On Rule 506

Rule 506 of Regulation D is a safe harbor under the exemption from registration in Section 4(a)(2)[3] of the Securities Act for "[t]ransactions by an issuer not involving any public offering." Rule 506 is one of three exemptions from Securities Act registration in Regulation D[4] which is subject to definitions and conditions generally common to all three of the exemptions. One such common condition, set forth in Rule 502(c) of Regulation D, is that, to qualify for an exemption from registration, an offering must not involve any "general solicitation" or "general advertising."[5]

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[1] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9354 (Aug. 29, 2012) ("Proposing Release"). Commissioner Aguilar voted against the proposed rules. The text of the proposed rules is included in the Proposing Release, which is available on the SEC's website.

[2] Commissioners Paredes and Gallagher both criticized this change in approach. Each would have preferred that the SEC adopt interim final rules, particularly given the JOBS Act's explicit requirement that the rules implementing Section 201(a) be implemented by July 4, 2012 (90 days after the statute's enactment).

[3] The JOBS Act renumbered Section 4(2) of the Securities Act as Section 4(a)(2).

[4] 17 CFR § 230.500, *et seq*.

[5] Rule 502(c) provides, in relevant part: "Except as provided in [Rule 504(b)(1)], neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general

(footnote continues . . .)

Rule 502(c)'s prohibition on general solicitation and general advertising for offerings under Rule 506 was imported from a predecessor private placement safe harbor, former Rule 146, which contained manner of offering limitations similar to those in Rule 502(c). References to general solicitation and general advertising are not found in the U.S. Supreme Court's seminal case construing the term "public offering," *SEC v. Ralston Purina*,[6] or, prior to the JOBS Act, in the Securities Act itself. Nonetheless, both the SEC and courts after *Ralston Purina* have taken into account the manner in which a securities offering was made, including whether an offering involved public means of distribution and promotion, in determining what constitutes a non-public offering.[7]

While the ban on general solicitation and general advertising may find longstanding and seemingly logical support for an exemption for non-public offerings, the condition, as applied under Rule 506, has increasingly been criticized as too restrictive for a safe harbor that has other important investor protection provisions, particularly in a modern, multi-media communications environment. One criticism has been the lack of a bright-line test defining the scope of general solicitation and general advertising, forcing issuers to make subjective determinations concerning whether their actions in this regard might be construed as impermissible.[8] In addition, there has been criticism that the prohibition on general solicitation and general advertising effectively prohibits issuers from taking advantage of the efficiencies and reach of the Internet and other modern communications technologies.[9] Finally, the prohibition on general solicitation and general advertising to persons who do not ultimately purchase securities in a private placement has been criticized as overly broad.[10]

Taking into account these kinds of concerns in enacting the JOBS Act, Congress mandated that the SEC adopt rules allowing for general solicitation and general advertising in offerings under Rule 506 if all purchasers are accredited investors and the issuer has sought to verify that status. In doing so, Congress sought to "modernize" Rule 506 in order to allow issuers to raise capital from accredited investors more easily.[11] The need for investors to raise capital from equity investors because bank lending standards had recently tightened served as a further catalyst for Congress to act when it did.[12]

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advertising, including, but not limited to, the following:

> (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
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> (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising" [provisos omitted].

[6] 346 U.S. 119 (1953).

[7] *See, e.g.*, Letter of General Counsel discussing the factors to be considered in determining the availability of the exemption from registration provided by the second clause of Section 4(1), Release No. 33-285 (Jan. 24, 1935), reprinted in 1 Fed. Sec. L. Rep. (CCH) ¶2740; Non-Public Offering Exemption, Release No. 33-4552 (Nov. 6, 1962); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 900 (5th Cir. 1977); *Hill York Corp. v. Am. Int'l Franchises, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971). *See also* former Securities Act Rules 146, 240 and 242, as well as current Rules 504 and 505 of Regulation D.

[8] *See* Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (April 23, 2006), at 75, available on the SEC's website.

[9] *See id.*

[10] *See* Letter of SEC Chairman Schapiro to Congressman Darrell E. Issa (Apr. 6, 2011), available on the SEC's website.

[11] *See, e.g.*, Statement of Rep. Maxine Waters, 157 Cong. Rec. H7290 (daily ed. Nov. 3, 2011) related to language in H.R. 2940 that was later incorporated into Section 201(a) of the JOBS Act.

[12] *See, e.g.*, Report from the Committee on Financial Services, House of Representatives, accompanying H.R. 2940, Report 112-263 (Oct. 31, 2011), at 2.

Amendments to Rule 506

To implement Section 201(a)(1) of the JOBS Act, the SEC has proposed an amendment to Rule 506 to add a new exemptive feature to the exemption, Rule 506(c). Rule 506(b), which provides the current set of conditions that must be complied with by issuers conducting offerings under the rule, would remain unchanged and available to issuers choosing not to rely upon general solicitation and general advertising. New Rule 506(c), however, would remove, as a condition of the safe harbor, compliance with Rule 502(c)'s prohibition on general solicitation and general advertising and, in its place, add two conditions:

- all purchasers in the offering must be accredited investors; and
- the issuer must have taken reasonable steps to verify that all purchasers are accredited investors.[13]

Thus, under the proposal, issuers would be permitted to use advertisements, articles, notices and other communications published in a newspaper, magazine or similar media, broadcast over television or radio or posted on a website when making offers and sales of securities in Rule 506(c) offerings solely to accredited investors. Issuers may also hold seminars and meetings for such offerings where attendees have been invited by general solicitation or general advertising.

In proposing Rule 506(c), the SEC confirmed that issuers which choose not to use general solicitation and general advertising may still avail themselves of Rule 506(b), which will not change. This might be important in a number of circumstances. First, for instance, an issuer may prefer to maintain the option of selling to a non-accredited investor, such as when a solicited investor turns out not to qualify as an accredited investor. In that case, the option would be precluded if the investor has been identified or contacted by a general solicitation or general advertising. Second, the verification standards that could evolve around new Rule 506(c) may seem too rigorous for an issuer involved in a small offering with well-known and sophisticated investors whom the issuer reasonably believes are accredited.

Reasonable Verification of Accredited Investor Status

In its mandate to amend Rule 506, the JOBS Act required that the new feature to the exemption require issuers to verify accredited investor status using "such methods as determined" by the SEC. In this regard, however, the SEC declined to set forth a prescriptive set of uniform rules or a non-exclusive list of factors, electing instead to provide guidance on how issuers should approach the obligation to verify investor status under the proposed new feature in the rule.[14] At the center of this guidance is the SEC's statement that whether the steps taken by an issuer to verify accredited investor status are "reasonable" would be "an objective determination, based on the particular facts

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[13] The term accredited investor, which contains eight enumerated categories of investors, is set forth in Rule 501(a) of Regulation D.

[14] In coming to this approach, the SEC explained:

> We believe 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 investors who are not, in fact, accredited investors. We also recognize, however, that it would be necessary that our proposed amendment to Rule 506 provide sufficient flexibility to accommodate the different types of issuers that would conduct offerings under proposed Rule 506(c) and the different types of accredited investors . . . that may purchase securities in these offerings.

Id. at 13-14 (internal citation omitted).

and circumstances of each transaction."[15] To apply this principle, the SEC notes that a number of factors would go into this determination, including, but not limited to,

- 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.[16]

Each of these factors is discussed in the Proposing Release.[17] The SEC explained that the factors are interconnected and that the information gained by looking at the factors should help an issuer assess the reasonable likelihood that a potential purchaser is accredited, which, in turn, would help inform what steps would be reasonable to verify such status. Thus, the SEC posited a sliding scale analysis under which the more likely it is that a person is accredited the fewer steps to verify such status would be necessary, and vice versa. At one end of this continuum, "[i]f an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer would not have to take any steps at all."[18] At the other end of the continuum, if a potential purchaser is a natural person with whom the issuer has no prior relationship and the purchaser learned of the offering via an unrestricted website, the issuer would be obliged to undertake additional steps to verify such purchaser's accredited investor status. In evaluating each potential purchaser's accredited investor status, an issuer may not overlook or disregard information indicating that a purchaser is not an accredited investor, simply because such information did not come into the issuer's possession in response to any particular verification step undertaken by the issuer. Undertaking any number of verification steps could not overcome the fact that an issuer knew a purchaser was not an accredited investor.

On a related note, the SEC reminded issuers that the burden of proving an exemption from registration is on the issuer. Thus, it is important that issuers retain adequate records documenting the steps they take to verify the accredited investor status of purchasers.

Reasonable Belief as to Accredited Investor Status

The SEC clarified that the proposed amendments to Rule 506(c) would not preclude the reasonable belief component of the definition of the term accredited investor in Rule 501(a), which provides that a purchaser may be accredited if the issuer "reasonably believes" the investor has that status. Thus, under this standard, an issuer conducting an offering under new Rule 506(c) would not be subject to an absolute test of accreditation. So, for example, an issuer would not lose the ability to rely on proposed Rule 506(c) if an investor provided false information to an issuer, but the issuer took reasonable steps to verify the investor's accredited status and, as a result, had a reasonable belief that the investor was accredited.

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[15] *Id.* at 14. This presumably means a determination made by a reasonable third party, as opposed to a subjective assessment made by the issuer.

[16] *Id.*

[17] *See id.* at 14-20.

[18] *Id.* at 17 n.51.

Amendments to Form D

With proposed Rule 506(c), the SEC also proposed a complementary amendment to Form D, providing a new box to check if an issuer is relying on the proposed new exemptive provision.[19] The SEC stated that its objectives in adding the new box were to (i) assist in its efforts to monitor the use of general solicitation and general advertising under Rule 506(c) and the size of this new offering market and (ii) help the SEC examine the verification practices of issuers and the effectiveness thereof.

Guidance for Privately Offered Funds

In the Proposing Release, the SEC clarified that privately offered funds would not lose the ability to rely upon certain exclusions from the Investment Company Act of 1940 as a result of engaging in general solicitation and general advertising in offerings of their interests under proposed Rule 506(c). The SEC recognized that privately offered funds, such as private equity funds, generally rely on one of two exclusions from the definition of "investment company" under the Investment Company Act. These exclusions, found in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, are unavailable to funds that have made a public offering of securities. Relying upon Section 201(b) of the JOBS Act,[20] the SEC clarified that using general solicitation and general advertising in offerings under proposed Rule 506(c) would not cause the offerings to be "public offerings." The SEC stated, "We believe the effect of Section 201(b) is to permit privately offered funds to make a general solicitation under amended Rule 506 without losing either of the exclusions under the Investment Company Act."[21]

RULE 144A PROPOSED CHANGES

Background on Rule 144A

Rule 144A is a safe harbor under the definition of "underwriter" in the Securities Act to facilitate private resales of securities to qualified institutional buyers ("QIBs").[22] Any person, other than the issuer or a dealer, who offers or sells securities in compliance with Rule 144A is deemed not to be engaged in a distribution of such securities and, therefore, not to be an "underwriter" within the meaning of Sections 2(a)(11) and 4(a)(1) of the Securities Act. Notably, no condition to Rule 144A involves a limitation on the manner of the offering, other than indirectly under Rule 144A(d)(1).[23] Nonetheless, the SEC generally takes the position that a public offering is necessary for a

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[19] An issuer relying on an exemption from registration provided by Regulation D is required to file a Form D. *See* Rule 503 of Regulation D. Filing of the Form D is not a condition to any exemption, however.

[20] Section 201(b) of the JOBS Act states, "Offers and sales exempt under [Rule 506] (as revised pursuant to Section 201 of the [JOBS] Act) shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation."

[21] Proposing Release at 32.

[22] The definition of QIB is in Rule 144A(a)(1) and generally includes an entity falling into one of nine enumerated categories "acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity."

[23] The conditions of Rule 144A generally are that (1) the securities are offered or sold only to QIBs or to an offeree or purchaser that the seller (and any person acting on its behalf) reasonably believes is a QIB, (2) the seller (and any person acting on its behalf) takes reasonable steps to ensure that the purchaser is aware that the seller may rely on the exemption from registration provided by the rule and (3) the securities were not, when issued, of the same class as securities listed on a national securities exchange or quoted in a U.S. automated inter-dealer quotation system such as Nasdaq. *See* Securities Act, Rule 144A(d).

distribution.[24] And, based on this position, both issuers and practitioners have long been reluctant to use general solicitation or general advertising in connection with conducting resales of securities purchased from an issuer in a non-public offering, for fear that such public activities may easily reach non-QIBs and therefore be contrary to the condition in Rule 144A(d)(1) barring an offering to non-QIBs. In addition, the practical ban on general solicitation and general advertising has arisen to protect the issuer's private placement exemption for the initial offer and sale of the securities that are later resold under Rule 144A. Although Congress' motivation in enacting this provision of the JOBS Act is less clear than for the provision concerning Rule 506, it appears Congress was focused on consistency between Rule 506 and Rule 144A. If an issuer utilized the ability afforded by new Rule 506(c) to engage in general solicitation and general advertising in a private placement offering of securities, the purchasers buying such securities should also have the ability to engage in general solicitation and general advertising in reselling them to QIBs.

Amendments to Rule 144A

In accordance with the JOBS Act, the SEC proposed amendments to subsection (d)(1) of Rule 144A to provide that securities sold under such revised exemption may be offered to persons other than QIBs, including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller (or a person acting on the seller's behalf) reasonably believes are QIBs.[25] Arguably, since there has never been a prohibition on general solicitation and general advertising in connection with resales of securities made in compliance with Rule 144A, this change may be less significant than the explicit change in Rule 506. On the other hand, the concerns under Rule 144A(d)(1) about how to use means of general distribution at the same time as the "offering" was limited to QIBs have been well-grounded, and the JOBS Act clarification will be a welcome addition to the rule. Once adopted, the change to Rule 144A(d)(1) will provide additional certainty to market participants that general solicitation and general advertising of restricted securities made in connection with resales under Rule 144A will not bar use of the rule.

SEC Guidance Regarding Regulation S

In response to comments received prior to these proposing amendments, the SEC addressed in the Proposing Release the impact that the use of general solicitation and general advertising in offerings under Rules 506 and 144A would have on the availability of the Regulation S safe harbor for concurrent offerings made offshore.[26] Confirming an earlier position, the SEC stated that, "Consistent with the historical treatment of concurrent Regulation S and Rule 144A/Rule 506 offerings, 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, as proposed to be amended."[27] This is not exactly the assurance that some had sought. Some commenters had asked the SEC to confirm, for example, that general solicitation and general advertising in connection with a Rule 506 or Rule 144A offering would not be deemed to constitute "directed selling efforts" by that issuer in connection with a contemporaneous offering

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[24] *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Release No. 33-6806 (Oct. 25, 1988) at 11 ("The Commission has recognized by its interpretations that a 'public offering' is necessary for 'distribution.'") (internal citations omitted)

[25] *See* Proposing Release at 37 (noting the proposed amendments to Rule 144A which eliminate the references to "offer" and "offeree" in clause (d)(1) thereof).

[26] Regulation S provides a safe harbor exemption from registration for offers and sales of securities made outside the United States by an issuer, as well as a resale safe harbor.

[27] Proposing Release at 39-40.

pursuant to Regulation S.[28] It remains to be seen whether this comment will be re-raised in light of the SEC guidance which has now been provided.

CONCLUSION

Changes to permit use of general solicitation and general advertising in securities offerings under Rule 506 and resales of securities using Rule 144A should be welcomed developments. New freedoms will bring new compliance risks, however, and even before final rules are adopted, issuers, their agents and other capital markets participants will need to consider how best to use public means of offering securities in transactions that will be exempt from registration because they involve investors who meet specific regulatory criteria.

At the meeting at which the amendments were proposed, Chairman Schapiro noted that the private offering area is one on which the SEC was focused before the JOBS Act and will continue to focus following adoption of final rules amending Rule 506, Form D and Rule 144A. In part, this focus will be in response to the same Congressional interest that generated the JOBS Act in the first place. In larger part, however, it also reflects the inherent tensions in the regulation of the private offering market with which the SEC has long wrestled. This bubbled up at the open meeting, when Commissioner Aguilar voted against the proposed rules because they failed to mitigate increased risks of fraud on investors[29] and when Commissioner Walter pointed out that allowing more widespread solicitation of purchasers for unregistered offerings could have investor protection implications, notwithstanding a general consensus that allowing issuers to take advantage of new communications technologies was the right approach. It may be likely that the SEC will adopt final rules that are fairly close to what has been proposed. What is still hard to predict, however, are what countermeasures, if any, will be taken to allay the investor protections concerns implicit in the changes.

If you have any questions concerning the material discussed in this client advisory, please contact any member of our securities practice group, including any of the following individuals:

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[28] *See id.* at 39.

[29] *See* "Increasing the Vulnerability of Investors," prepared written statement of Commissioner Aguilar at SEC open meeting on August 29, 2012, available on the SEC's website.