
SEC Proposes Rules to Eliminate the Prohibition Against General Solicitation and General Advertising for Rule 506 and Rule 144A Offerings

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As mandated by the Jumpstart Our Business Startups Act (the “JOBS Act”),¹ on August 29, 2012, the SEC proposed amendments² to Rule 506 of Regulation D and to Rule 144A promulgated under the Securities Act of 1933, as amended (the “Securities Act”), to eliminate the current prohibitions against general solicitation and general advertising in certain unregistered securities offerings. Section 201(a)(1) of the JOBS Act directed the SEC to revise Regulation D of the Securities Act (i) to permit general solicitation and general advertising in a Rule 506 unregistered securities offering as long as all purchasers of securities sold in the offering are accredited investors and (ii) to require the issuer undertaking such an offering to take reasonable steps to verify a purchaser’s status as an “accredited investor,” using methods determined by the SEC. Section 201(a)(2) of the JOBS Act directed the SEC to revise Rule 144A to allow securities sold in reliance on that exemption from registration to be offered to persons other than “qualified institutional buyers,” including by means of general solicitation and general advertising, as long as securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers.

Rule 506 and Rule 144A Safe Harbors

Under Rule 506, an issuer may offer and sell its securities, without any limit on the offering amount, to an unlimited number of “accredited investors” as defined in Rule 501(a) of Regulation D.³ The availability of the Rule 506 safe harbor is subject to a number of requirements, including a condition that the issuer, or any person acting on its behalf, not offer or sell securities through any form of “general solicitation or general advertising.” The Rule 144A safe harbor from the registration requirements of Section 5 of the Securities Act is conditioned, in part, on offers and resales of the subject securities by persons other than the issuer being made only to qualified institutional buyers (commonly referred to as “QIBs”) or to offerees or purchasers that the seller and any person acting on behalf of the seller reasonably believes are QIBs. Although Rule 144A does not contain an express prohibition on general solicitation and general advertising, its requirement that offerees be QIBs or persons that sellers and their agents reasonably believe are QIBs effectively prevents general solicitation and general advertising. As a result of the ban on general solicitation and

general advertising, issuers and their agents have been subject to significant restrictions on communications with the public in the context of private securities offerings.

If adopted, the proposed rules would eliminate the need for an issuer that complies with the Rule 506 safe harbor to restrict its marketing activities if the issuer satisfies certain new conditions. Specifically, new Rule 506(c) would permit general solicitation and general advertising by an issuer in connection with a Regulation D offering if the following conditions are met:

- the issuer has taken reasonable steps to verify that the purchasers of its securities are accredited investors;
- each purchaser of the issuer’s securities is an accredited investor because the purchaser qualifies under one of the enumerated categories of persons that are accredited investors or the issuer had a “reasonable belief” that the purchaser was accredited at the time of the sale of the securities; and
- all terms and conditions of Rule 501 and Rules 502(a) and 502(d) must be satisfied.⁴

Similarly, if adopted, the proposed amendments to Rule 144A would eliminate the need for an issuer and its investment bank “initial purchasers” conducting a Rule 144A transaction to forego general solicitation and general advertising as long as the securities are ultimately sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

Issuers Must Take “Reasonable Steps to Verify” in connection with Rule 506(c) Offerings

The most burdensome aspect of the proposed rules is the requirement that issuers that engage in general solicitation or advertising take “reasonable steps to verify” that the purchasers of securities are in fact accredited investors. In its proposing release, the SEC stated that the determination of whether verification steps are “reasonable” would be assessed objectively, based on the particular facts and circumstances of each transaction. The SEC indicated that issuers might look to the following factors in determining whether their process of verification is reasonable in connection with any given transaction:

The nature of the purchasers and the type of accredited investor that the purchaser claims to be. The steps necessary to verify a purchaser’s accredited status will vary depending on the type of accredited investor that the purchaser claims to be. For example, the SEC noted that steps that may be reasonable to verify that an entity is accredited—such as, in the case of a broker-dealer purchaser, reviewing FINRA’s BrokerCheck website—would necessarily be different from the steps that would be reasonable to verify whether a natural person is an accredited investor.⁵

The amount and type of information that the issuer has about the purchaser. The more information an issuer has about a purchaser’s accredited status, the fewer steps the issuer would have to take to verify that status, and vice versa. Importantly, if an issuer has actual knowledge that a purchaser is an accredited investor, then the issuer would not have to take any steps at all to verify such purchaser’s status.

The proposing release gives several examples of information on which issuers could rely:

- Publicly available information in filings with a federal, state or local regulatory body.
 - If a purchaser is a named executive officer of an SEC registrant, the issuer could review the registrant's proxy statement to obtain the purchaser's annual compensation.
 - If a purchaser claims to be an eligible 501(c)(3) entity, the issuer could review the purchaser's tax returns to verify its total assets.
- Third-party information that provides "reasonably reliable evidence that a person" meets the Rule 501(a) accredited investor criteria.
 - If a purchaser is a natural person, the issuer could review any Forms W-2 provided by the purchaser.
 - If a purchaser works in a field where trade publications disclose average annual compensation of employees, the issuer could review specific information regarding employees at the purchaser's level of seniority.
- Verification of accredited investor status by a third party, such as broker-dealer, attorney or accountant, if the issuer has a reasonable basis to rely upon such third-party verification.

The nature of the offering, such as the manner in which the purchaser was solicited to participate. An issuer that solicits purchasers through a generally accessible public website or "through a widely disseminated email or social media" platform would need to take more stringent measures to verify a purchaser's status as an accredited investor than an issuer that solicits prospective purchasers from a database of pre-screened investors that is assembled by a reliable third party, such as a registered broker-dealer. The SEC was careful to note that an issuer who solicited purchasers through a public website or through a widely disseminated electronic communication could not satisfy the "reasonable steps to verify" requirement by merely requiring a purchaser to check a box in a questionnaire or sign a form attesting to such purchaser's status as an accredited investor.

The SEC noted that a purchaser's ability to meet a high minimum investment amount might play a significant factor in verifying accredited investor status. The SEC stated that in a case where the minimum investment was "sufficiently high" it may be reasonable for the issuer to take no steps to verify a purchaser's accredited investor status (other than to confirm that the purchaser's cash investment is not being financed by the issuer or a third party) assuming that there are no other facts available that would cast doubt on whether the purchaser is actually an accredited investor.⁶ However, the SEC also "anticipate[s] that many practices currently used by issuers in connection with Rule 506 offerings would satisfy the verification requirement proposed for offerings pursuant to Rule 506(c)."

Amendment to Form D

The SEC also 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). This would provide an indication as to whether the issuer filing the Form D proposes to engage in general solicitation or advertising in connection with the unregistered offering.

Implications for Privately Offered Funds

Privately offered funds, such as hedge funds, venture capital funds and private equity funds, typically

rely on Securities Act Section 4(a)(2) and the Rule 506 safe harbor to offer and sell their interests without registration under the Securities Act. In addition, privately offered funds generally rely on one or two exclusions from the definition of “investment company” set forth in Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act of 1940, as amended, both of which require funds not to make a public offering of their securities. The JOBS Act directs the SEC to eliminate the prohibition against general solicitation for a new subset of Rule 506 offerings but makes no specific reference to privately offered funds. Stating that the SEC historically has regarded Rule 506 transactions as non-public offerings for purposes of Section 3(c)(1) and 3(c)(7), the SEC proposal will permit privately offered funds to engage in general solicitation and general advertising under the new Rule 506(c) without foregoing either of the exclusions under the Investment Company Act.⁷

Clarification Regarding Rule 501(a) Definition of “Accredited Investor”

The current Rule 501(a) definition of “accredited investor” encompasses not only purchasers falling into any of eight enumerated categories of accredited investors but also purchasers that an issuer *reasonably believes* meet the criteria of one of the eight enumerated categories. Market participants have raised concerns that the language of the JOBS Act is ambiguous as to whether the Rule 506 safe harbor would continue to apply to situations in which an issuer had engaged in general solicitation or advertising and securities are sold to a purchaser that the issuer reasonably believed at the time of sale to be an accredited investor but who, in fact, was not an accredited investor. In the proposing release, the SEC clarified that the Rule 501(a) definition of “accredited investor” should remain unchanged. Therefore, if a purchaser that does not qualify as an accredited investor purchases securities in a Rule 506(c) offering, under the proposed rules, the issuer would not lose the ability to rely on the Rule 506(c) exemption so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time the securities were sold.

Impact on Existing Rule 506(b) Safe Harbor

Implementation of the proposed new Rule 506(c) would not affect the availability of the Rule 506(b) safe harbor. Issuers will be able to continue to sell securities to non-accredited investors in private offerings not involving general solicitation or advertising so long as no more than 35 non-accredited investors purchase securities in the offering and the purchasing, non-accredited investors meet the sophistication requirements set forth in Rule 506(b).

Preservation of Records

The SEC noted that any issuer relying on an exemption from the registration requirements of the federal securities laws (such as Rule 506) has the burden of demonstrating that it was entitled to rely on such exemption. Therefore, if the rule amendments are adopted as proposed, issuers engaging in general solicitation or advertising must retain adequate records that document the steps taken to verify a purchaser’s status as an accredited investor, regardless of what factors are considered in its pre-offering investor diligence process.

Amendment to Rule 144A

The amendments to Rule 144A proposed in response to Section 201(a)(2) of the JOBS Act would simply remove the references to “offer” and “offeree” in Rule 144A(d)(1). As amended, the Rule 144A safe harbor would continue to apply in offerings in which general solicitation or advertising is used as long as all securities resold pursuant to Rule 144A are ultimately sold to QIBs or to purchasers that the seller and any person acting on behalf of the seller reasonably believe is a QIB.

Regulation S and Integration

The mandate contained in the JOBS Act and the prospective changes to Rule 506 and Rule 144A have prompted concern among market participants as to whether general solicitation in the United States would taint a simultaneous Regulation S offering occurring outside of the United States (Regulation S requires that there be no “directed selling efforts” in the United States). In connection with the proposed rule amendments, the SEC confirmed its previous position that “[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act,” even in circumstances in which general solicitation or advertising is employed in a future Rule 506 or Rule 144A offering.

Request for Comments

Among other things, the SEC requested comments on what constitutes “reasonable steps to verify” accredited investor status in light of current practices employed by issuers, what kind of information is reasonable to request from investors, and whether the SEC should articulate more specific guidelines, such as a minimum dollar investment that would establish a presumption that an investor is accredited. Comments are due within 30 days after the proposed rules are published in the Federal Register, which effectively means that comments will be due in early October.

¹ The text of the JOBS Act is available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

² The text of the proposing release is available at <http://sec.gov/rules/proposed/2012/33-9354.pdf>.

³ Rule 506 also allows the issuer to offer and sell its securities to up to 35 non-accredited investors subject to certain other sophistication criteria and substantially higher informational requirements as set forth in Rule 502(b). As described herein, the proposed amendments to Rule 506(c) would require that all purchasers of the issuer’s securities be accredited investors. Accordingly, any issuer that offers and sells its securities to non-accredited investors will continue to be subject to the prohibition in Rule 502(c) on the use of general solicitation or general advertising.

⁴ These terms and conditions would not be changed by the proposed rule amendments. Rule 501 includes the definition of “accredited investor” and certain other definitions. Rule 502(a) establishes rules relating to the integration of offerings and Rule 502(d) establishes rules relating to resale restrictions on securities acquired in a Regulation D offering.

⁵ The SEC did, however, acknowledge the practical difficulties associated with verifying that a natural person meets the annual income or net worth thresholds prescribed by Rule 501(a) and in doing so, suggested that issuers examine the facts and circumstances of each natural person by analyzing the other factors described below.

⁶ It is unclear how an issuer would confirm whether or not a purchaser financed the purchase of securities, as the SEC did not provide guidance on this point.

⁷ For additional analysis regarding the impact of the SEC's proposed rule amendments on privately offered funds, please see the client alert memo from WilmerHale's Investment Management Practice Group available at <http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=10215>.

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