News Bulletin

August 29, 2012

Solicitation Emancipation: *Proposed Rules Relating to the Relaxation of the Prohibition on General Solicitation*

Overview

The Securities and Exchange Commission today proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 to implement Section 201(a) of the Jumpstart Our Business Startups (JOBS) Act.

The proposed amendment to Rule 506 would eliminate the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D with respect to offers and sales of securities made pursuant to Rule 506, provided that all purchasers are "accredited investors." The amendments to Rule 506 would require that for offerings involving the use of general solicitation, issuers "take reasonable steps" to verify that the purchasers of the securities are "accredited investors."

The proposed amendments would provide that securities may be offered pursuant to Rule 144A to persons other than qualified institutional buyers, provided that the securities are sold only to purchasers that the seller (or someone acting on the seller's behalf) reasonably believes is a qualified institutional buyer.

Background

The JOBS Act required the SEC to adopt rules to relax the prohibition against general solicitation or general advertising in offerings made under Rule 506, provided that all of the purchasers of the securities are verified to be accredited investors. A key provision of the law, Section 201(a)(1), states that the rules "shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using methods as determined by the Commission."

Rule 506 is a non-exclusive safe harbor promulgated under Section 4(a)(2) of the Securities Act. This rule exempts transactions by an issuer "not involving any public offering" from the registration requirements of Section 5 of the Securities Act. Rule 506 allows issuers to offer and sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors," as defined in the rule, and to no more than 35 non-accredited sophisticated investors. The current rule contains a number of conditions, including a requirement that the offering cannot involve any "general solicitation or general advertising."

The proposed rules would amend Rule 506 to provide that the prohibition against general solicitation contained in Rule 502(c) shall 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 the issuer takes "reasonable steps to verify that the purchasers are accredited investors."

Rule 144A is a non-exclusive safe harbor exemption from the registration of the Securities Act for resales of certain "restricted securities" to "qualified institutional buyers" (QIBs).

Proposed amendments to Rule 506

Eliminating the prohibition against general solicitation. The SEC's proposed rules implement a bifurcated approach to Rule 506 offerings, which will be quite useful to market participants. As proposed, an issuer may choose to conduct a private offering in reliance on Rule 506 without using general solicitation.

To implement this approach, the SEC has proposed new Rule 506(c), which would permit the use of general solicitation, subject to certain conditions:

- 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 the securities; and

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

The SEC noted that the exemption applies only to offerings made pursuant to the safe harbor provided by Rule 506(c). It does not apply to offerings relying on the Section 4(a)(2) exemption in general. In various public comments made since enactment of the JOBS Act, SEC Staff had noted that the Section 4(a)(2) private offering exemption would not be affected by these changes, so the confirmation included in the SEC proposal does not come as a surprise. It does present a number of challenges for market participants, as we discuss below.

Reasonable steps to verify accredited investor status. One of the most controversial aspects of the proposed rule is the investor verification process. During the pre-rulemaking comment period, many commenters had provided their views on verification processes.

The SEC proposal provides for a flexible approach to investor verification. During the open meeting, the SEC Staff noted that the Staff had rejected a prescriptive approach to investor verification. The approach reflected in the proposed rules acknowledges that "reasonable efforts" to verify investor status may differ depending on the facts and circumstances. To that end, the Staff provides a non-exhaustive list of factors that may be appropriate to consider which include:

- *The nature of the purchaser.* The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities.

- *The nature and amount of information about the purchaser.* Simply put, the SEC states that "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa."

  The SEC attempted to strike a balance between respecting investors' privacy and the need to demonstrate that investors qualify as accredited investors. The release stops short of requiring that individuals submit financial statements, and instead suggests that reasonable steps may include:

  - Relying on publicly available information, for example, such as purchaser's compensation described in a proxy statement, or

  - Independent verification of a person's status as an accredited investor by a third party, such as a broker-dealer, attorney or accountant, so long as there is a reasonable basis to rely on the third-party verification.

- *The nature of the offering.* The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status. That is, issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email. By contrast, less intrusive verification steps may be required to the extent that solicitations are directed at investors that are pre-screened by a reliable third party.

  In the case of general solicitations made to the general public, it would not be sufficient for the investor to "check a box" indicating accredited investor status. The SEC suggests that this method of verification also would not suffice when soliciting pre-screened high net worth individuals either: "We believe that an issuer would be entitled to rely on a third party that has verified a person's status as an accredited investor, provided the issuer has a reasonable basis to rely on such third-party verification."

These factors are interconnected, the SEC states, and the more indicia that are in evidence that an investor qualifies as an accredited investor, the fewer steps that the issuer must take to verify status. Issuers should retain adequate records to document the verification process.

Reasonable belief standard. The SEC confirmed its view that Congress did not intend to eliminate the existing "reasonable belief" standard in Rule 501(a) of the Securities Act or for Rule 506 offerings. It confirmed that if a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the proposed Rule 506(c) exemption for that offering, provided 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."

Form D. The SEC proposed to add a separate check box for issuers to indicate whether they are claiming an exemption under Rule 506(c). During the open meeting, Commissioner Walter also suggested that the SEC Staff devise a process to gather information regarding the types of offerings in which general solicitation is used, and the steps taken in such offerings to verify investor status. In response to questions from Commissioner Walter, Meredith Cross noted that it is the Staff's intention to form a multi-divisional task force to monitor these offerings as a means of gaining insight into market practices.

Private funds. The SEC confirmed that the effect of Section 201(b) of the JOBS Act is to permit privately offered funds (including private equity funds and hedge funds, among others) to make a general solicitation under amended Rule 506 without losing the ability to rely on the exclusions from the definition of an "investment company" available under Section 3(c)(1) and 3(c)(7) of the Investment Company Act. (These sections provide that only issuers who do not make or propose to make a public offering of securities may rely on the exclusions.)

Request for comment. Among other things, the SEC specifically asked for comments on its proposed approach to implementing the verification mandate of Section 201(a), and whether it should identify specific methods that issuers should use to verify accredited investor status.

Preliminary Thoughts

We appreciate the SEC's bifurcated approach to Rule 506 offerings. As noted in various studies, including a relatively recent study from the SEC's Division of Risk Strategy and Financial Innovation, private offerings have become increasingly important. Private offerings are relied upon as a capital raising alternative by operating companies of varying sizes and levels of sophistication, including companies that have been public for years. Much of this nuance and detail seems to have gotten obscured in recent months as commentary has focused on potential fraud in connection with Regulation D offerings.

For public companies that seek to finance through a private placement conducted in reliance on Rule 506, it is unlikely (given Regulation FD and other market concerns) that they will rely on the use of general solicitation. Nonetheless, the guidance on general solicitation is very helpful as a means of addressing inadvertent communications. We anticipate that many private operating companies will find the new flexibility to use general solicitation helpful in their financing efforts. It is likely that for larger, more established, private companies, financings will be conducted with the assistance of a financial intermediary that will have pre-existing relationships with investors that are verified accredited investors. Many more questions will need to be answered in the context of smaller, emerging companies that seek to finance through Rule 506 offerings using general solicitation. Likewise, more questions may be raised for private funds that seek to avail themselves of this opportunity to communicate more freely. However, we anticipate that market participants will proceed cautiously, especially given that the broader Section 4(a)(2) exemption has not changed.

A one-size fits all, prescriptive approach to investor verification may have its supporters as it does provide certainty. However, the facts-and-circumstances approach advanced in the release acknowledges the realities of the Regulation D marketplace. We suspect that depending on the character of the proposed offering, some market participants will weigh carefully the benefits associated with using general solicitation, against the additional steps that would be required to verify investor status (beyond the verification process that already is in place). We anticipate that for some this may be a close question, while for larger private offerings, it won't even be close.

Proposed amendment to Rule 144A

Offers to persons other than qualified institutional buyers. Section 201(a)(2) of the JOBS Act directs the SEC to amend its rules to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a QIB. The SEC proposed to amend the rule to eliminate references to "offer" and "offeree," and thus 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 this proposed amendment, resales of securities pursuant to Rule 144A could be conducted using general solicitation, so long as the purchasers are limited in this manner.

Offshore offerings

The SEC noted that the JOBS Act did not address the impact of the use of general solicitation on the availability of the Regulation S safe harbor for concurrent unregistered offerings inside and outside the United States.

The SEC confirmed that it will continue to follow its historical treatment of concurrent Regulation S and Rule 506 offerings. That is, it will not integrate offshore offerings that are conducted in compliance with Regulation S with domestic unregistered offerings conducted in compliance with Rule 506 or Rule 144A.

Comment period

Public comments must be received on or before a date 30 days after publication in of the proposals in the Federal Register.

Other observations

In her opening statement, Chairman Mary Schapiro said that in proposing the rules, the Commission was fulfilling a "narrow mandate" required by the JOBS Act, and suggested that the Commission would take a more thorough look at the private placement market in the future.

Commissioner Walter noted her support for modification of the communications rules in order to make these rules more contemporary. She noted that allowing general solicitation is "a profound change," which likely will have "unintended consequences."

Both Commissioners Paredes and Gallagher expressed their support for the proposal, while noting their significant concerns with the rulemaking process itself. The two Commissioners noted that the original rulemaking course, which had been to release an interim final rule (not a proposal), had been changed in midstream. This change had been occasioned after significant concerns had been expressed by various groups, including state regulators.

In proposing these amendments, the SEC did not address particular standards for general solicitations or advertisements for issuers, including private funds such as hedge funds or private equity funds. Some have called for the SEC to adopt standards similar to those that apply to mutual funds.

You can find more information, including breaking news, about JOBS Act developments at our MoFo JUMPSTARTER blog.

You can also follow us on Twitter: @thinkingcapmkts.

Author

Contacts

Kelley Howes
(303) 592-2237
khowes@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on The American Lawyer's A-List for nine straight years, and Fortune named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.