Corporate and Securities Alert:

SEC Proposal to Permit General Solicitation and Advertising in Some Private Placements

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Summary

A core feature of U.S. securities law has long been the distinction between public offerings and private placements. The Securities Act of 1933 essentially requires every offer and sale of securities to be made as a public offering under a registration statement filed with the Securities and Exchange Commission ("**SEC**") unless a private placement exemption is available. One major exemption is **Rule 506,** which allows a company to offer and sell its securities to any number of accredited investors (and up to 35 non-accredited but "sophisticated" investors), provided there is no general solicitation or advertising in connection with the offer and sale of the securities. Another important exemption is **Rule 144A**, which permits holders that purchased securities from the company to re-offer and re-sell those securities if they do so only to qualified institutional buyers ("**QIBs**") – thus implicitly prohibiting general solicitation and advertising in Rule 144A offerings.

In April 2012 the Jumpstart Our Business Startups Act ("**JOBS Act**") was enacted in an effort to facilitate corporate capital-raising. The JOBS Act included a requirement that the SEC adopt rules allowing general solicitation and advertising in Rule 506 offerings and Rule 144A offerings. The SEC has now done so, with a rule proposal (available here) that would permit general solicitation and advertising in some Rule 506 offerings and in Rule 144A offerings. The proposed rules are subject to a 30-day comment period, after which the SEC will review the comments and decide whether to modify the rules or adopt them as proposed.

What is the proposed amendment to Rule 506?

Rule 506 is a "safe harbor" exemption under Regulation D, allowing companies to raise an unlimited amount of capital in private offerings of securities to any number of accredited investors and up to 35 non-accredited but "sophisticated" investors. Rule 506 is currently available only if the offering is not accompanied by any general solicitation or advertising, such as newspaper or magazine advertising, radio or television broadcasts, and information available through unrestricted websites.

The SEC proposal would amend Rule 506 by adding new Rule 506(c), which permits general solicitation and advertising in the offering if:

- the issuer takes reasonable steps to verify that the purchasers of its securities are accredited investors;
- all purchasers are accredited investors (because they fall into one of the categories of persons who are accredited investors as defined in Rule 501 or the company reasonably believes they do, at the time of the sale of the securities); and
- all other terms and conditions of Rule 506 are complied with, such as integration with other securities offerings and limitations on resales.

Proposed Rule 506(c) would not affect a company's ability to continue to sell securities in accordance with current Rule 506(b). That is to say, companies could continue existing practices for the offer and sale of securities under Rule 506, without general solicitation, to any number of accredited investors and up to 35 non-accredited but sophisticated investors. Companies would still have to have a reasonable belief about the investors' accredited status where applicable, but they would not have to comply with the proposed heightened standard that they take reasonable steps to verify purchasers' accredited investor status.

How would we determine whether we took "reasonable steps" to verify our purchasers' accredited investor status?

The SEC proposal does not mandate any one method, or endorse any set of methods, to verify whether purchasers are accredited investors. It notes that to do

so would be impractical (and potentially ineffective) because there are many ways that a purchaser might qualify as an accredited investor, and a method that might be reasonable under one set of circumstances might not be reasonable under a different set of circumstances. Instead, the proposal takes a more flexible approach: "[W]hether the steps taken are 'reasonable' would be an objective determination, based on the particular facts and circumstances of each transaction."

The SEC offered these examples of factors that issuers could consider in determining whether the steps taken to confirm accredited investor status are reasonable:

- Nature of the purchaser and type of accredited investor the purchaser claims to be.
  - The reasonable steps needed to verify that a registered broker-dealer is an accredited investor would be different than the reasonable steps needed to verify that a natural person is an accredited investor by virtue of income or net worth.
  - Reasonable steps to verify accredited investor status for individuals may pose practical difficulties, which are likely to be exacerbated by privacy concerns.
- Amount and type of information that the issuer has about the purchaser.
  - The more information an issuer has that indicates that a prospective purchaser is an accredited investor, the fewer steps it needs to take (and vice versa).
  - An issuer may rely on: information from public filings with a federal, state or local regulatory body; a person's Form W-2; public information that discloses average compensation for certain levels of employees in the purchaser's field, industry or workplace; third-party verification, for example by a broker-dealer, attorney or accountant.
- Nature and terms of the offering.
  - An issuer that solicits new investors through a public website or social media probably needs to take greater measures (more than relying on a checked box on a questionnaire) to verify accredited investor status than would an issuer that solicits from a database of pre-screened accredited investors, such as a registered broker-dealer.
  - An issuer may consider whether a minimum cash investment amount requirement is high enough that only accredited investors could reasonably be expected to be purchasers.

No matter what its investor verification process might be, it is critical that the issuer maintain good records of the actual steps it takes to verify the accredited investor status of purchasers.

What would the impact of the proposal be on private investment funds?

Under the proposed rules, private investment funds, such as venture capital funds, private equity funds and hedge funds, would be permitted to use general solicitation and advertising the same as other issuers. The SEC has taken the position that a private investment fund that is excluded from the definition of "investment company" under either Section 3(c)(1) or 3(c)(7) of the Investment Company Act would be able to engage in a general solicitation under a Rule 506(c) offering without losing either exclusion (which prohibits "public offerings" of the private fund's securities. However, the SEC declined to include "knowledgeable employees" (which are not counted toward total beneficial owners under Section 3(c)(1) and are not included in determining whether all securities are owned by qualified purchasers under Section 3(c)(7)) in the accredited investor definition.

What is the proposed amendment to Rule 144A?

In Rule 144A transactions, investors holding restricted securities acquired from the issuer in a private placement are permitted to re-sell those securities and are not deemed to be "underwriters" if they re-sell in compliance with Rule 144A, including the requirement that offers and sales be made only to QIBs. This requirement effectively prevents a holder from generally soliciting purchasers or marketing the securities.

The SEC proposal would amend Rule 144A so that offers can be made to persons other than QIBs, so long as the securities are sold only to QIBs or to purchasers that the seller reasonably believes to be QIBs. By changing Rule 144A to limit sales, but not offers, to QIBs, resales of securities under Rule 144A could be conducted using general solicitation (and inadvertently offering to non-QIBs would not destroy the availability of Rule 144A for a transaction).

What companies would benefit most from the rule proposal?

The proposed amendments to Rule 506 and Rule 144A were intended to make it easier for companies and private investment funds to raise capital. If adopted as proposed, it seems most likely in the short term that the changes would benefit companies seeking funding outside of traditional venture capital, or new fund managers raising initial private investment funds. In addition, companies undertaking an IPO and seeking to complete a private placement during that process, or shortly after abandoning an IPO, might find the changes useful.

When do these proposed changes go into effect?

The rule proposal is open for a 30-day comment period, from August 29. Thereafter the SEC is expected to act relatively swiftly to implement this legislative mandate, though how the SEC will respond to potential comments cannot be predicted.

Until final rules are adopted, Rule 506 and Rule 144A remain unchanged, and companies should be careful to avoid general solicitation and continue their current practices for verifying accredited investors status, and limit offers in Rule 144A transactions to QIBs only.

What if I have more questions?

If you have questions about these SEC proposals, feel free to contact any member of your Fenwick team to discuss.

For more information on these or related matters, please contact your Fenwick securities team or the authors.

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