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SEC Proposes Rule Amendments To Permit General Solicitation in Private Offerings by Companies and Private Investment Funds

September 7, 2012

On August 29, 2012, the Securities and Exchange Commission proposed amendments to Rule 506 of Regulation D and Rule 144A in order to implement Section 201(a) of the Jumpstart Our Business Startups Act, known as the JOBS Act. The proposed amendments implement the JOBS Act mandate to permit general solicitation in offerings to accredited investors under Regulation D and to QIBs under Rule 144A. These amendments will benefit both operating companies and private investment funds. The SEC's proposals would:

- Remove the prohibition against general solicitation and advertising for offerings to accredited investors under newly designated Rule 506(c) of Regulation D and to QIBs under Rule 144A;
- Impose new investor verification requirements;
- Preserve an issuer's ability to rely on pre-amendment Rule 506, which prohibits general solicitation, in order to avoid the new investor verification requirements (this approach will be characterized as a Rule 506(b) offering);
- Confirm that general solicitation continues to be prohibited in other private offerings under Section 4(a)(2) of the Securities Act;
- Confirm the ability of private investment funds to engage in general solicitation under new Rule 506(c) without undermining their claims to exemptions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940; and
- Confirm that the use of general solicitation in Rule 506 or Rule 144A offerings will not undermine the ability of issuers to undertake simultaneous Regulation S offerings outside the United States.

We expect that the SEC will adopt the proposals without significant changes, and that the new rules will be effective before the end of this year. In the interim, issuers should continue to follow the rules in their current forms, which prohibit general solicitation.

General Solicitation under Rule 506(c)

The SEC proposes to amend Rule 506 to eliminate the rule's prohibition of general solicitation in offerings where securities are sold only to accredited investors. While general solicitation in offerings under new Rule 506(c) will be permitted, an issuer must have a reasonable belief that each investor is an accredited investor and take "reasonable steps" in forming its belief. Sales to non-accredited investors would not be permitted in offerings under Rule 506(c).

While the "reasonable steps" language is new, the SEC would permit issuers flexibility in devising the steps it employs based on the facts and circumstances. In determining what steps are appropriate, the SEC states that the issuer should consider the nature and type of purchaser, the nature of pre-offering information that the issuer has about the purchaser, the nature of the offering and the manner in which the purchaser was solicited.

The proposing release includes a variety of helpful suggestions for sources that an issuer may use to verify accredited investor status, such as information in publicly available filings. For example, for an investor that claims accredited investor status by virtue of being a registered broker-dealer, the issuer can confirm the investor's status through FINRA's BrokerCheck website. For individuals, the issuer may review a recent W-2 filing. If the investor is a named executive officer of a public company, the issuer may rely on proxy statement disclosure of annual compensation. Verification from an objectively reliable third party is also acceptable, such as from an attorney or accountant. The release also states that if the issuer knows that an investor is accredited, it need not take any additional steps to verify its status. Although not detailed by the SEC, some examples may be if a high net-worth individual or institution is a repeat investor with the issuer, or if the investor is a well known institutional investor.

While the SEC invites issuers to exercise common sense in verifying accredited investor status, it reminds issuers that they will have to retain records of their verification steps in sufficient detail in case they are later called upon to demonstrate that the requirement was satisfied.

Offerings Following the Pre-Amendment Rules: Rule 506(b)

An issuer may continue to rely on the current version of Rule 506, which will now be referred to as a Rule 506(b) offering. Under Rule 506(b), general solicitation will continue to be prohibited, but non-accredited investors may be included in the offering, and the new "reasonable steps" language in verifying accredited investor status will not apply. We expect that many issuers will continue to rely on this approach if they see no need to reach beyond traditional means for identifying investors, such as using pre-existing investor databases of broker-dealers. The use of general solicitation is likely not to be as useful a tool in institutional offerings as compared to retail offerings. In addition, general solicitation might subject the issuer to potential liability based on the second-guessing of its satisfaction of the new "reasonable steps" requirement, as well as on the application of the antifraud rules to any public statements.

It is unclear from the proposed rules whether an issuer could commence an offering under Rule 506(b), but later claim use of Rule 506(c) in the event of an accidental public statement before or during the offering period, where sales are made only to accredited investors. Accidental unintended public statements occur from time to time, and they call into question the availability of the private offering exemption if they might constitute general solicitation. Upon adoption of the JOBS Act, commentators suggested that the elimination of the general solicitation prohibition would mean that an unintended public statement would no longer be a concern as long as no sales were made to unaccredited investors. Nevertheless, it is unclear under the SEC's proposals if an issuer can switch mid-stream from a 506(b) offering, where general solicitation continues to be prohibited, to a 506(c) offering, where general solicitation is permitted. In particular, Form D is proposed to be revised to include a check box indicating a selection between 506(b) and 506(c). Presumably, an issuer would be able to amend its initial filing to alter its initial selection in the event of an unintended public statement, and the SEC Staff has indicated that it intends to clarify this issue, either in the adopting release or interpretively.

General Solicitation under Rule 144A

The proposed amendments to Rule 144A provide that securities sold under the rule may be offered to persons who are not QIBs, including by general solicitation, provided that securities are only sold to those that the seller and those acting on its behalf reasonably believe are QIBs.

Private Investment Funds and Section 3(c)(1) and 3(c)(7) Exemptions

Private investment funds that rely on Rule 506 to raise capital will have the same choice as other issuers to use Rule 506 in its current form without general solicitation, now designated as Rule 506(b), or to use the amended Rule 506(c) and satisfy the reasonable verification requirements.

For funds that decide to engage in general solicitation under Rule 506(c), the SEC has confirmed that such activities will not undermine their claims to exemptions under either Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. In particular, Section 3(c)(1) excludes from the definition of "investment company" a fund "beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." Section 3(c)(7) excludes from the definition of "investment company" a fund "the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities." Since Section 201(a) of the JOBS Act did not mention private investment funds or investment companies, there had been speculation that general solicitation in offerings under Rule 506 might be considered to run afoul of the prohibition on "public offerings" for the purposes of the two primary investment company exemptions on which private investment funds rely.

It also should be noted that a private fund operated under CFTC Rule 4.13(a)(3) must not be "marketed to the public in the United States." Accordingly, absent further guidance from the CFTC, it is unclear whether a private fund operated under Rule 4.13(a)(3) will be permitted to engage in any advertising or general solicitation.

"Directed Selling Efforts" under Regulation S

The SEC also responded to concern from commentators that general solicitation under the amended rules would constitute "directed selling efforts" in violation of Regulation S, which governs offshore offerings and prohibits directed selling efforts in the United States. Many issuers engage in private offerings under Regulation D and/or Rule 144A simultaneously with offshore offerings under Regulation S. The SEC confirmed that such general solicitation will not amount to "directed selling efforts" if conducted in conformity with amended Rules 506(c) and/or 144A.

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A copy of the SEC's proposed amendments is available at the following link: http://www.sec.gov/rules/proposed/2012/33-9354.pdf. The SEC is seeking comment on the proposed amendments at this time, which are due no later than 30 days after publication of the proposed rules in the Federal Register. We will continue to monitor this proposal and provide updates as appropriate. Please feel free to contact us with questions or comments.

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