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SEC Eliminates Prohibition Against General Solicitation and Advertising in Rule 506 and Rule 144A Offerings

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Overview

On July 10, 2013, the Securities and Exchange Commission ("SEC") adopted its long-awaited rules to eliminate, under certain conditions, the prohibition against general solicitation and advertising in securities offerings made pursuant to new Rule 506(c) of Regulation D ("Rule 506") and Rule 144A under the Securities Act of 1933, as amended ("Securities Act").[1] The SEC's action was mandated by the Jumpstart Our Business Startups Act ("JOBS Act") that was signed into law on April 5, 2012. The new rules will be effective 60 days after publication of the adopting release in the Federal Register.

The elimination of the prohibition on general solicitation and advertising in Rule 506(c) and Rule 144A offerings is intended to make it easier for domestic and foreign companies and private investment funds to raise capital from accredited investors and qualified institutional buyers by permitting such issuers to engage in broad based communication and solicitation efforts when seeking to raise capital. Issuers and their broker-dealer intermediaries will be able to expand the universe of investors to whom they can offer their securities beyond the inherently limited group of investors with whom they already have a prior substantive relationship; and will even be able to engage in crowdfunding type offerings online through publicly accessible internet websites and other mass communication media. Indeed, many market observers expect securities market innovators to use emerging social networking technologies to organize communities of angel and alternative investment oriented investors to more efficiently deploy this important source of private capital.

Other Related Action

The SEC also approved rules that would prohibit the use of the Rule 506 exemption (including new Rule 506(c)) for any securities offering in which certain felons and other bad actors are involved.[2] This action was required by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and many vocal investor advocacy groups had urged the SEC to adopt the bad actor rules before the prohibition on general solicitation in Rule 506(c) offerings was eliminated. An issuer cannot rely on the Rule 506 exemption if the issuer or any other person covered by the rule[3] had a "disqualifying event" which encompasses conduct "substantially similar" to the disqualifying bad actor conduct contained in Rule 262 of Regulation A and other conduct that is subject to regulatory sanctions by specified state and federal financial services industry regulators.

The SEC also voted by a 3 to 2 split vote to propose revisions to Regulation D that are intended to enhance the SEC's ability to assess developments in the private placement market now that the rule lifting the ban on general solicitation has been adopted.[4] The proposed revisions would, among other things, require issuers to file a Form D notice in advance 15 days before engaging in general solicitation, require Form D disclosure of the types of general solicitation used and the methods used to verify the accredited investor status, require that general solicitation materials include specified cautionary statements, disqualify issuers from using Rule 506 in any new offering if they fail to file required Form D notices and require issuers to submit to the SEC non-publicly written general solicitation materials during a temporary period expiring after two years.

The proposal elicited spirited discussion during the SEC's open meeting with significant objection raised by the two dissenting commissioners. The comment period expires 60 days after publication of the proposing release in the Federal Register.

Discussion

I. Rule 506 Offerings

A. Existing Rule 506(b)

Rule 506 is a non-exclusive safe harbor under the Securities Act which exempts transactions by an issuer "not involving any public offering" from the Securities Act's registration requirements. Under existing Rule 506(b), an issuer may offer and sell an unlimited amount of securities to an unlimited number of "accredited investors," as defined in Rule 501(a) of Regulation D[5] and to no more than 35 non-accredited investors who meet certain "sophistication" requirements.[6] While issuers have been permitted to raise unlimited amounts of capital from an unlimited number of private capital market investors, their access to the available pool of private capital has been unnecessarily constrained by the Rule 506(b) prohibition on general solicitation or general advertising.

Specifically, existing Rule 506(b) contains a condition that requires the issuer, or any person acting on its behalf, to avoid offering or selling securities through any form of "general solicitation or general advertising." Although the terms "general solicitation" and "general advertising" are not defined in Regulation D, the SEC staff has generally required that there be a substantive pre-existing relationship with a prospective investor prior to the issuer soliciting an investment from such prospective investor. Rule 502(c) provides examples of general solicitation and general advertising and the SEC staff has provided additional guidance as to the meaning of these terms through the years. The following types of communications are generally thought to constitute "general solicitation" or "general advertising": advertisements published in newspapers, magazines or through the social media, television and radio communications, seminars or meetings whose attendees have been invited by general solicitation or advertising, and the use of publicly available media, such as unrestricted internet websites.

B. New to Rule 506(c)

Elimination of Prohibition on General Solicitation and Advertising – The SEC amended Rule 506 to include a new paragraph (c) that will permit general solicitation or advertising in offerings made under the new rule, provided that the issuer takes "reasonable steps to verify" that all purchasers of the securities are accredited investors. Under Rule 506(c), either all purchasers of the securities must be accredited investors under Rule 501, or the issuer must *reasonably believe* that all purchasers are accredited investors at the time of the sale of the securities. As a result, issuers relying on Rule 506(c) will not be able to offer securities to up to 35 non-accredited investors which an issuer is otherwise permitted to do for offerings conducted in reliance on Rule 506(b).

The elimination of the general solicitation and advertising restriction relates only to offerings relying on the safe harbor of Rule 506(c), and not to other types of private offerings under Section 4(a)(2) of the Securities Act. Importantly, issuers may continue to rely on existing Rule 506(b), and therefore avail themselves of the ability to offer their securities to up to 35 non-accredited investors, so long as they do not engage in general solicitation or advertising in connection with the offering. Issuers relying on existing Rule 506(b) may, therefore, continue to rely on existing guidance relating to offerings under that rule, including guidance as to the nature and effect of substantive pre-existing relationships with prospective investors.

Reasonable Steps to Verify Accredited Investor Status – Issuers relying on Rule 506(c) are required to take reasonable steps to verify that all purchasers of securities are accredited investors. The new rule does not mandate that any particular steps be taken to verify a prospective investor's accredited investor status, nor does it proscribe a specified verification methodology. The SEC maintained its flexible, objective principles-based approach to verification and added a non-exclusive list of acceptable verification methods for determining the accredited investor status of natural persons in response to public comments. With its principles-based approach, Rule 506(c) provides issuers with latitude to determine what verification methods it should employ, requiring only that the method selected be reasonable, taking into account the facts and circumstances of the transaction. The SEC offered up three examples of interconnected factors that issuers could take into account in determining the reasonableness of their verification methodology, as set forth below:

- Nature of the Purchaser: The nature of the purchaser is a relevant factor in determining whether an issuer has taken reasonable steps to verify the accredited investor status of a purchaser. The SEC acknowledges the wide variety of purchasers that may be accredited investors, and that any verification process will vary depending on the type of accredited investor. Thus, the SEC believes, that an issuer should take the verification "steps that would be reasonable," based on the type of accredited investor involved. For example, for purchasers claiming to be registered broker-dealers or investment companies, an issuer may choose to obtain verification by searching the Financial Industry Regulatory Authority's ("FINRA") website or publicly available SEC filings, respectively. For high net worth or high income individuals claiming accredited investor status, the verification process becomes more difficult and implicates legitimate privacy concerns. The SEC acknowledged these concerns and noted that the type of information that would be sufficient under the particular facts and circumstances of each purchaser may also depend on other factors, as described below.

- Information about the Purchaser: The "amount and type" of information that an issuer may have about a purchaser is a significant factor in determining whether additional verification procedures are warranted. Examples provided by the SEC include the use of publicly available information (such as whether the individual is an executive officer of an Exchange Act registrant, such that the registrant's proxy statements include information as to the individual's compensation for the last three fiscal years), reliable third-party documentation that provides "reasonably reliable evidence" that a purchaser is an accredited investor (such as W-2s or information as to the average salary of persons in the same industry at the same level of seniority as the purchaser), or verification by a third party (i.e., providers of verification services or managers of web-based Rule 506 offering portals), if the issuer has a reasonable basis to rely on such third party verification. In each case, the more information that an issuer has that validates a prospective purchaser as an accredited investor, the fewer

steps it may have to take to meet the reasonable steps standard. Accordingly, if an issuer has actual knowledge that a purchaser is an accredited investor, such issuer will not have to take any such steps.

- Nature and Terms of the Offering: The nature and the terms of the offering are relevant factors in determining whether an issuer has taken reasonable steps to verify the accredited investor status of a purchaser. For example, an issuer that solicits purchasers through a public website, social media or through a widely distributed email will be held to a higher standard of proof that it has taken reasonable steps, in comparison to an offering to a group of purchasers that have been prescreened by a reliable source, such as a broker-dealer. The SEC noted that with respect to the former, self-accreditation simply through checking a box or signing a form would not be viewed as satisfying the reasonable verification standard.

The terms of an offering are also relevant. The SEC again acknowledged that a high minimum investment amount, achieved by direct investment and not financed by the issuer or a third party, could be relevant to the issuer's evaluation of the reasonableness of the steps taken, particularly where the minimum investment is sufficiently high such that only accredited investors could reasonably be expected to meet it. In such a case, it may be reasonable for the issuer to apply no further verification measures, other than to ensure the investment is not financed by a third party.

These factors are interconnected, and an issuer must examine the totality of the facts and circumstances of both the offering and the purchaser to ascertain whether it has taken reasonable steps to determine the accreditation status of a purchaser. If the issuer employs reasonable verification methods, and reasonably believes the purchaser to be an accredited investor at the time of the sale of the securities, then the issuer would not lose the ability to rely on Rule 506(c) if, in fact, an investor is not an accredited investor.

With respect to the verification of natural persons as accredited investors, the SEC observed that such task posed greater practical difficulties potentially exacerbated by privacy concerns over disclosure of personal financial information. To address this, the SEC added to the final rule four specific non-exclusive methods of verifying a natural person's accredited status, each of which is deemed to constitute reasonable steps to verify as required by the rule. These non-exclusive methods of verification include:

- Income Verification. For accreditation based on income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtaining a written representation from the purchaser that the purchaser has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.

- Net Worth Verification. For accreditation based on net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:

  – With respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and

- With respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies.

- Third Party Written Confirmation. Obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor:

  - A registered broker-dealer;

  - An investment adviser registered with the SEC;

  - A licensed attorney who is in good standing under the laws of the jurisdictions in which the attorney is admitted to practice law; or

  - A certified public accountant who is duly registered and in good standing under the laws of the place of the accountant's residence or principal office.

- Prior Purchasers. For any accredited investor who purchased and still holds securities purchased in an issuer's Rule 506(b) offering prior to the effective date of Rule 506(c), and who is investing in a subsequent Rule 506(c) offering, obtaining a certification by such investor at the time of sale that the investor qualifies as an accredited investor.

New Rule 506(c) also requires that a purchaser of securities be, or the issuer reasonably believes the purchaser to be, an accredited investor at the time of the sale of the securities. In its commentary on new Rule 506(c), the SEC stated that an issuer may rely on the reasonable belief standard even if, for example, the issuer was provided with falsified documentation from a purchaser. If the issuer took the reasonable steps described above to verify the purchaser's accredited investor status based on falsified information provided by such purchaser, the issuer would not lose the ability to rely on Rule 506(c) as long as it had a reasonable belief that such purchaser was an accredited investor at the time of sale.

Regardless of the approach taken, the SEC emphasized the importance that issuers maintain adequate records that document each step taken in the verification process and underscored in this respect that any issuer claiming this exemption has the burden of showing that it is entitled to such exemption. SEC officials commented during the open meeting that the agency will use its examination authority to review verification records of broker-dealers and investment advisers.

C. Impact on Privately Offered Funds

Privately offered funds, such as hedge funds, venture capital funds and private equity funds, generally rely on one of two exclusions from the definition of "investment company" under the Investment Company Act of 1940, as amended ("1940 Act"), set forth in Section 3(c)(1) and Section 3(c)(7) of the 1940 Act. Section 3(c)(1) and 3(c)(7) both preclude an issuer which is relying on these exclusions from making a public offering of its securities. The SEC again stated its view that the JOBS Act is intended to permit privately offered funds to make general solicitations without losing the ability to rely on either of these exclusions under the 1940 Act.

As a result, private funds that engage in general solicitation and advertising in accordance with Rule 506(c) will be able to continue to rely on the exceptions afforded by sections 3(c)(1) and 3(c)(7) of

the 1940 Act. Private fund advisers are now able to conduct public advertising campaigns for their funds by taking out advertisements, discussing funds in media interviews, and sponsoring seminars and other broad-based capital raising meetings. The ability to advertise may prove of particular benefit to new and/or small funds that lack name recognition by allowing such funds to target a broader audience of prospective investors and potentially attract interest in otherwise inaccessible markets. Private fund advisers should keep in mind, however, that any such advertisements or solicitations will still be subject to the antifraud provisions of the Investment Advisers Act of 1940 ("Advisers Act") and the rules promulgated thereunder, which include prohibitions against the use of testimonials, past specific recommendations and restrictions on the presentation of performance data in connection with the offer and sale of private fund securities and the investment activities of private funds. The SEC specifically reminded investment advisers that they are subject to Rule 206(4)-8 under the Advisers Act which prohibits any investment adviser to a pooled investment vehicle from disseminating misleading disclosure or engaging in deceptive conduct.[7] In addition, the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 thereunder, would apply to the offer and sale of private fund securities and the funds' investment activities relating to the purchase or sale of securities. Finally, fund sales materials and efforts used by broker-dealers that are members of FINRA will need to comply with applicable FINRA rules and policies.

D. Changes to Form D

The SEC amended Form D, which issuers must file with the SEC (and as required with state securities authorities) when offering securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D. The revised form includes a new separate box for issuers to check if they are claiming the new Rule 506(c) exemption that would permit general solicitation and general advertising.

II. Rule 144A and Regulation S

Rule 144A is a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain "restricted securities" to Qualified Institutional Buyers[8] ("QIBs"). By its terms, Rule 144A is available solely for resale transactions; but has been principally used by market participants since its adoption to facilitate capital raising in transactions that involve a primary offering of securities by an issuer to one or more financial intermediaries – commonly known as the "initial purchasers" – in transactions that are exempt from registration pursuant to Section 4(a)(2) of the Securities Act or Regulation S, followed by the resale of those securities by the initial purchasers to QIBs in reliance on Rule 144A. Although Rule 144A does not include an express prohibition against general solicitation or advertising, offers of securities under Rule 144A currently must be limited to QIBs, which has the same practical effect.

A. Offers to Persons Other Than Qualified Institutional Buyers

Section 201(a)(2) of the JOBS Act directs the SEC to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation or advertising, 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. Under the new rules, resales of securities pursuant to Rule 144A could be conducted using general solicitation or advertising, so long as the purchasers are limited in this manner. The SEC confirmed that the general solicitation permitted in Rule 144A resales from the initial purchaser to QIBs will not affect the availability of the Section 4(a)(2) private

placement exemption or Regulation S for the initial sale of securities by the issuer to the initial purchaser.

The standards for reasonably determining whether a purchaser is a QIB, contained in Rule 144A(d), remain unchanged.

B. Regulation S

The SEC noted in its proposing release that with the ability to engage in general solicitation in connection with Rule 506 and Rule 144A transactions, questions had been raised as to the impact of the use of general solicitation on the availability of the Regulation S safe harbor for offshore offerings conducted concurrently with unregistered offerings inside and outside the United States. The SEC reaffirmed its view and stated that concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A, a view that is consistent with prior policy positions taken with respect to Regulation S offerings and registered offerings (or exempt offerings) concurrently conducted in the United States.

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[1] For the full text of the SEC Release, see http://www.sec.gov/rules/final/2013/33-9415.pdf.

[2] For the full text of the SEC Release, see http://www.sec.gov/rules/final/2013/33-9414.pdf.

[3] The final disqualification rule covers the issuer, including its predecessors and affiliated issuers, as well as: (a) directors and certain officers, general partners, and managing members of the issuer, (b) 20 percent beneficial owners of the issuer, (c) promoters, (d) investment managers and principals of pooled investment funds, and (e) persons compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor.

[4] For the full text of the SEC Release, see http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

[5] An "accredited investor" is defined in Rule 501 of Regulation D and generally includes: (a) a bank or savings and loan association, a registered broker or dealer, insurance company, registered investment company, business development company, or small business investment company; (b) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if the investment decisions are made by a plan fiduciary or if the plan has total assets in excess of $5 million; (c) a charitable organization, corporation, or partnership with assets exceeding $5 million; (d) a director, executive officer, or general partner of the issuer (or a director, officer, or general partner of the general

partner of the issuer); (e) an entity in which all the equity owners are accredited investors; (f) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person; (g) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year; or (h) a trust with assets in excess of $5 million whose purchases are directed by a sophisticated person (See note 3 below).

[6] Under Rule 506(b)(2)(ii), non-accredited investors must be "sophisticated" in that they must possess, or the issuer must reasonably believe that the non-accredited investor possesses, either alone or with his or her purchaser representative, such knowledge or experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment.

[7] Rule 206(4)-8 prohibits (1) making any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

[8] The term "qualified institutional buyer" is defined in Rule 144A(a)(1) and includes specified institutions that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with such institutions. Banks and other specified financial institutions must also have a net worth of at least $25 million. A registered broker-dealer qualifies as a QIB if it, in the aggregate, owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the broker-dealer.