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## SECURITIES LAW CLIENT ALERT

### SEC PROPOSES RULES TO ELIMINATE THE PROHIBITION AGAINST GENERAL SOLICITATION AND GENERAL ADVERTISING IN RULE 506 AND RULE 144A OFFERINGS

#### Overview

On August 29, 2012, the Securities and Exchange Commission (SEC) proposed rules to eliminate the prohibition against general solicitation and general advertising for private offerings of securities that are conducted pursuant to Rule 506 of Regulation D of the Securities Act of 1933, as amended (Securities Act) and Rule 144A of the Securities Act, provided the securities are sold to accredited investors in the case of a Rule 506 offering, and qualified institutional buyers (QIBs) in the case of a Rule 144A offering. The proposed amendments to Rule 506 and Rule 144A were mandated by Section 201 of the Jumpstart Our Business Startups Act (JOBS Act), which was signed into law on April 5, 2012.

Rule 506 of Regulation D is one of the most often used safe harbor exemptions from the registration requirements of Section 5 of the Securities Act that issuers rely upon to conduct a private offering of their securities. Under the current Rule 506, securities may be sold to an unlimited number of accredited investors, as well as up to 35 non-accredited, but sophisticated, investors. Issuers that rely on the Rule 506 safe harbor for their private offering of securities are not currently permitted to use any form of general solicitation or general advertising when conducting such offering. This restriction is interpreted broadly and prohibits, among other things, advertisements published in newspapers and magazines, the use of publicly available websites, communications broadcast over radio and television, mass email campaigns, unrestricted websites and/or public seminars or meetings as part of an issuer's capital raising activities.

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Rule 144A is a safe harbor exemption from the registration requirements of Section 5 of the Securities Act for the reoffer and resale of unregistered securities to QIBs. Any person, other than the issuer of securities, may rely on Rule 144A. While technically a prohibition against general solicitation and general advertising does not specifically exist under Rule 144A, the requirement under Rule 144A that securities may only be offered and sold to QIBs has the same practical effect.

As directed by the JOBS Act, the SEC proposed the following rules to amend Rule 506 and Rule 144A to:

- Permit general solicitation and general advertising in private offerings under Rule 506 of Regulation D, provided that all purchasers of securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors;
- Continue to allow Rule 506 offerings without general solicitation and general advertising in accordance with current rules;
- Amend Rule 144A to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation and general advertising, provided the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs; and
- Amend Form D (which is a notice filing with the SEC by issuers claiming a Regulation D exemption, such as a Rule 506 offering) to add a separate box for issuers to indicate whether they are using general solicitation and general advertising in a Rule 506 offering.

In addition, the SEC stated in its proposed release that (i) privately offered funds, such as hedge, venture capital and private equity funds, that typically rely on the Rule 506 safe harbor, would be permitted to make a general solicitation and use general advertising when conducting a private offering, without losing either of the exclusions commonly relied on under the Investment Company Act of 1940, as amended (Investment Company Act), which exclusions prohibit public offering of securities, and (ii) concurrent offshore offerings that are conducted in compliance with Regulation S would not be integrated with domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A as proposed to be amended.

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. The proposed rules and the SEC's proposing release can be found at <http://www.sec.gov/rules/proposed/2012/33-9354.pdf>.

## **Proposed Rules**

### ***New Rule 506(c)***

To implement the proposed rule change, the SEC is proposing a new Rule 506(c), which would permit issuers to use general solicitation and general advertising to offer and sell securities under Rule 506, provided that certain conditions are satisfied, which are:

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- The issuer takes reasonable steps to verify that the purchasers of its securities are accredited investors; and
  - All purchasers of securities are accredited investors, because either:
    - The purchasers come within one of the categories of persons who are accredited investors under existing Rule 501, or
    - The issuer reasonably believes that the purchasers meet one of the categories under Rule 501 at the time of the sale of the securities; and
  - All terms and conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied.

While the SEC is proposing that a Rule 506 offering can be conducted with the use of general solicitation and general advertising, it is preserving the ability of issuers to elect to conduct their Rule 506 offering without the use of general solicitation and general advertising, since issuers may elect to raise capital by selling to up to 35 non-accredited, but sophisticated, investors.

#### Reasonable Steps to Verify Accredited Investor Status

Section 201(a)(1) of the JOBS Act mandates that the SEC's amendments to Rule 506 require issuers using general solicitation and general advertising in Rule 506 offerings "to take reasonable steps to verify that purchasers of the securities are accredited investors" and to use such methods to verify the status of the purchasers as determined by the SEC. The SEC did not propose specific verification methods that issuers must use to verify the accredited investor status of the purchasers that would be deemed "reasonable" for the purposes of proposed Rule 506(c). Instead, the SEC stated that the determination of whether the steps taken are "reasonable" would be an objective test, based on the particular facts and circumstances of each. In the proposing release, the SEC provided guidance for some of the factors that issuers will want to consider when determining the reasonable steps needed to be taken to verify investor status, including:

- ***The nature of the purchaser and the type of accredited investor that the purchaser claims to be.***
  - For instance, purchasers may claim to be an accredited investor based on their status as a registered broker or dealer or a registered investment company, which have publicly available information available about each of them and which may require less investigation as compared to a natural person, whose status as an accredited investor is based on such person's net worth or annual income.
- ***The amount and type of information that the issuer has about the purchaser.***
  - Examples of the type of information that that could be relied upon include, without limitation, (1) publicly available information in filings with federal, state or local regulatory bodies (e.g. executive compensation disclosure of a named executive officer in SEC filings), (2) third party information, such as a Form W2 or industry or trade publications or (3) verifications provided by a third party such as a registered broker-dealer, attorney or accountant, provided there is a reasonable basis to rely upon such third party.

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- **The nature of the offering.**
    - For instance, purchasers solicited through a website accessible to the general public or through a widely disseminated email or social media solicitation may require greater measures by an issuer to verify accredited investor status than those identified from a database of pre-screened accredited investors maintained by a registered broker dealer.
  
  - **The terms of the offering.**
    - For instance, offerings requiring a purchaser to satisfy high minimum investment amounts that only an accredited investor could reasonably be expected to meet may require a more limited investigation than those with lower threshold investment amounts. Such a factor would be predicated on the purchaser's ability to make direct investment that is not, for example, financed by the issuer or any other third party.

In providing these factors, the SEC has signaled that the use of the proposed Rule 506(c) will require a more robust investigation of purchaser accreditation than the traditional affirmative representation as to their status as an accredited investor typically found in a subscription agreement for a private offering. In response to criticism that the verification process may raise privacy concerns, the SEC noted that the proposed Rule 506(c) is sufficiently flexible in prescribing accreditation methods to accommodate such concerns should a potential purchaser cite a privacy concern.

The SEC confirmed that even if a potential purchaser later proves not to meet the criteria of an accredited investor, the offering may remain exempt under the proposed Rule 506(c) so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and, as a result, held a reasonable belief that such purchaser was an accredited investor. Regardless of the verification methods used by an issuer, it will be important that the issuer maintain adequate records of the steps taken to verify that the purchaser is an accredited investor.

### **Form D**

Registered issuers are required to file a notice of an offering of securities on "Form D" with the SEC whenever an offering of securities is made without registration under the Securities Act in reliance of an exemption under Regulation D. The proposed rules would amend Form D to add a separate box for issuers to check if they are claiming the proposed Rule 506(c) exemption permitting general solicitation and general advertising. The proposed change to Form D is made to assist the SEC in monitoring the use of general solicitation in proposed Rule 506(c) and the size of the market of such offerings.

### **Rule 144A**

Section 201(a)(2) of the JOBS Act directs the SEC to revise Rule 144A to permit Rule 144A offerings to be offered to persons other than QIBs, including by means of general solicitation, provided that the securities are sold only to persons whom the seller and any person acting on behalf of the seller reasonably believe is a QIB. By amending Rule 144A to require that only securities be sold to a QIB or to a purchaser that the seller reasonably believes is a QIB, the resale of securities pursuant to Rule 144A could be conducted using general solicitation and general advertising.

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## ***Investment Company Act Exclusion for Private Funds***

Privately offered funds typically rely upon the Rule 506 when conducting a private offering of their interests to purchasers. In addition, privately offered funds generally rely upon one of two exclusions from the definition of “investment company” set forth in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act which, if satisfied, enables these funds to be excluded from the regulatory provisions of the Investment Company Act. These exclusions to the Investment Company Act cannot be relied upon if a privately offered fund makes a public offering of its securities. In the proposed release, the SEC confirmed that privately offered funds will be able to use general solicitations and general advertisements in accordance with the proposed rules without losing the benefit of either exclusion under the Investment Company Act.

## ***Regulation S***

The mandate contained in the JOBS Act and the proposed changes to Rule 506 and Rule 144A have prompted various commentators to question whether the use of general solicitation would taint a simultaneous Regulation S offering occurring outside of the United States. Regulation S provides a safe harbor for offers and sales of securities outside the United States, provided that the securities are sold in an offshore transaction and the issuer has not engaged in any “directed selling efforts” in the United States. In the proposing release, the SEC confirmed its previous position that offshore transactions made in compliance with Regulation S will not be integrated with concurrent domestic unregistered offerings that are conducted in compliance with Rule 506 or Rule 144A as proposed to be amended.

Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed above, or to any other Patton Boggs LLP lawyer with whom you have consulted in the past on similar matters.

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