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LEGAL UPDATE

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SEC PROPOSES RULES EFFECTING THE JOBS ACT'S ELIMINATION OF THE GENERAL SOLICITATION BAN IN PRIVATE OFFERINGS

Adhering to a mandate set forth in the Jumpstart Our Business Startups Act (the "JOBS Act"),[1] the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") issued on August 29, 2012 proposed rules[2] to eliminate the prohibition against general solicitation and general advertising in Rule 506 of Regulation D ("Regulation D") under the Securities Act of 1933 (the "Securities Act"). The proposed rules would also amend Rule 144(d)(1) under the Securities Act to provide that securities may be offered pursuant to Rule 144A to persons that do not satisfy that rule's definition of "qualified institutional buyer" ("QIB") so long as such securities are sold only to persons that are, or that the seller (or any person acting on its behalf) reasonably believes are, QIBs.

Comments on the proposed rules are due no later than 30 days after publication of the proposed rules in the Federal Register.

PROPOSED RULE 506(c)

The SEC's proposed new Rule 506(c) would permit an issuer to market its securities through a general solicitation under Rule 506, so long as:

- the issuer takes reasonable steps to verify that the offerees that ultimately purchase its securities in the offering are "accredited investors" as defined in Rule 501(a);
- all purchasers are accredited investors at the time of purchasing the securities (because each purchaser either objectively meets, or is reasonably believed by the issuer to meet, the criteria specified in one of the enumerated categories of accredited investor listed in Rule 501(a)[3]); and
- all of the terms and conditions of Rules 501, 502(a), and 502(d) are satisfied.

Notwithstanding the adoption of Rule 506(c), Rule 506(b) would remain available for issuers that prefer to offer their securities in reliance on Rule 506 without the use of general solicitation. Although issuers that opt to rely on Rule 506(b) would have to confine their

[1] Jumpstart Our Business Startups Act, H.R. 3606, 112th Congress (2011). The SEC adhered to this mandate in substance but not in timeliness. As was repeatedly noted in the August 29, 2012 open meeting in which the Commission voted (4-1) to propose this rule, the SEC was required by the JOBS Act to issue rules amending Rule 506 of Regulation D under the Securities Act of 1933 by July 4, 2012 (*i.e.*, not later than 90 days after the enactment of the JOBS Act on April 5, 2012).

[2] Release No. 33-9354 (August 29, 2012) (the "Proposing Release").

[3] The definition of "accredited investor" includes "any person… who the issuer reasonably believes comes within any of the [enumerated] categories." The new verification requirement is not intended to preclude reliance on this subjective prong of the definition of "accredited investor."

marketing efforts so as to avoid a general solicitation,[4] they would not be required to take additional steps to verify that the purchasers of their securities are accredited investors and would still be permitted to sell privately to a limited number of non-accredited investors who meet the sophistication requirements set out in Rule 506(d).

Verification Steps

In determining whether an issuer marketing its securities through a general solicitation has used "reasonable steps to verify" the accredited-investor status of the purchasers, new Rule 506(c) would apply an "objective", "facts and circumstances" standard. In taking this approach, the SEC has avoided creating a set of rigid rules that could become fossilized into issuers' private placement procedures and has sought to leave enough flexibility to accommodate innovation both in marketing techniques and in modes through which marketing might take place. According to the Proposing Release, in crafting a procedure for verifying a purchaser's accredited-investor status, an issuer should take into account a number of factors. The implication is that an issuer may have different procedures that apply to different types of purchasers and to different offerings. The SEC's examples of factors to be taken into account are:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information the issuer has about the purchaser;
- the nature of the offering (*e.g.*, the manner in which the particular purchaser's investment was solicited); and
- the terms of the offering (*e.g.*, the required minimum investment amount).

In practice, the first two factors will likely overlap, as a purchaser's claim to be an accredited investor of a particular type will in some cases point to the sources of information available to verify that claim. For example, the SEC notes that a reasonable step to verify an entity's accredited-investor status if it reports that it is a registered broker-dealer (and thus an accredited investor in reliance on Rule 501(a)(1)) would be to locate and note such purchaser's record on FINRA's BrokerCheck Web site. In contrast, natural person purchasers pose particular difficulties, as the information required to establish net worth (which requires measuring both assets and liabilities), or to establish prior year's annual income and a "reasonable expectation of reaching the same income level in the current year", could require access to sensitive personal documentation. In any case, issuers that conduct offerings in reliance on Rule 506(c) should specifically elicit from each prospective purchaser precisely which prong of the "accredited investor" test it satisfies (and if, for example, the purchaser claims to satisfy Rule 501(a)(1), which covers several different types of entities, the purchaser should clearly indicate whether it is a bank, savings and loan institution, broker-dealer, insurance company, business development company, or another type of entity described in the rule).

The SEC clearly believes that the rigor required in order for verification procedures to be considered reasonable is inversely related to how indiscriminately the offering is broadcast. At one end of the spectrum one finds a "website accessible to the general public" and "a widely disseminated email or social media solicitation", which would require more significant verification procedures than the other end of the spectrum, where one finds "a database of pre-screened accredited investors created and maintained by a … registered broker-dealer." Interestingly, in a footnote the SEC observes that "[i]f an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer would not have to take

[4] Issuers relying on Rule 506(b) to offer their securities would continue to be required to comply with the SEC's guidance regarding such offerings, including its guidance regarding pre-existing substantive relationships with the offerees. See footnote 40 of the Proposing Release.

any [verification] steps at all." Issuers seeking to rely on the guidance in this footnote, however, may find themselves wondering what records would need to be assembled to adequately support their claim of "actual knowledge". In general, the SEC's discussion of these first two factors suggests that an issuer should aim to base its verification of accredited-investor status on documents that are publicly available through reliable sources or that are produced by third-parties on which the issuer can reasonably rely.

An issuer that imposes a required minimum investment – as most private investment funds do – will have a very strong basis for relaxing its verification procedures under the last factor cited above. In the Proposing Release, the SEC observes that even where the issuer "knows little about the potential purchaser… but the terms of the offering require a high minimum investment amount, then it may be reasonable for the issuer to take no steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by the issuer or by a third party, absent any facts that may indicate that the purchaser is not an accredited investor." While the presence of a high required minimum investment amount does not wholly obviate the need for verification procedures, it clearly enables private investment funds to rely on Rule 506(c) with minimal, tailored verification methods. Naturally, however, a private investment fund that waives the minimum investment amount for a particular purchaser must then apply suitable additional verification procedures in that instance. Moreover, in the Proposing Release, the SEC specifically solicits input from potential commenters about whether an issuer, even when imposing a high required minimum investment amount on a potential purchaser, should nonetheless verify other features of such purchaser or its investment, beyond the above-mentioned confirmation that there has been no third-party financing.

Knowledgeable Employees

In the Proposing Release the SEC specifically discusses a few issues of particular relevance to private investment funds that rely on the exclusions from the definition of "investment company" provided in Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act of 1940 (the "ICA"). Nonetheless, the SEC does not propose to include "Knowledgeable Employees", as defined in Rule 3c-5 under the ICA, in the definition of "accredited investor" or otherwise to accommodate the ability for hedge funds, private equity funds, and other private investment funds to, on the one hand, market their securities through a general solicitation under Rule 506, and, on the other hand, accept as investors Knowledgeable Employees who do not meet the "accredited investor" threshold. Consequently, if the new rule is adopted as proposed, it appears that private investment funds that have historically permitted up to thirty-five non-accredited Knowledgeable Employees to invest in their Section 3(c)(1) or 3(c)(7) funds as contemplated by the ICA will have to forgo conducting general solicitations in reliance on Rule 506(c), and instead continue to adhere to the requirements of Rule 506(b).

Form D

In the Proposing Release, the SEC proposes to revise Form D, which is currently required by Rule 503 to be filed by all issuers relying on Regulation D to issue their securities. Under the proposal, issuers relying on Rule 506(c) would specifically indicate this reliance by checking a new box to be added in Item 6 of Form D.

Rule 144A(d)(1) Amendments

The SEC proposes to amend Rule 144A(d)(1) to eliminate the references to "offer" and "offeree". As a result of these changes, Rule 144A, which currently requires that offerees be, or be reasonably believed by the seller to be, QIBs, would thereafter require only that the securities sold pursuant to Rule 144A

be sold to a QIB or to a purchaser that the seller (and any person acting on behalf of the seller) reasonably believes is a QIB. If adopted, the amended Rule 144A would permit resales of securities pursuant to Rule 144A to be marketed broadly, including by general solicitation, provided that the offerees that ultimately purchase such securities meet the QIB condition.

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The foregoing is merely a discussion of the SEC's proposed rules effecting the JOBS Act's elimination of the general solicitation ban in private offerings. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Bertrand C. Fry by phone at 212-326-0134 or by email at bfry@pryorcashman.com.

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Bertrand Fry is a partner in Pryor Cashman's Corporate Group and is co-head of the firm's Investment Management Group. Bert has nearly twenty years of general corporate and transactional experience that includes extensive experience with alternative investment vehicles. In addition to having launched and advised a diverse array of U.S. and non-U.S. investment products, including vehicles engaged in macro, distressed, private equity, venture capital, and real estate investing, debt origination, and quantitative trading of securities and futures, his practice has included, among other things, structuring and advising investment managers and advisers, private company mergers & acquisitions, and joint ventures.

Bert is particularly well attuned to the business needs of his clients, based on more than a decade of in-house experience at the D. E. Shaw group, where Bert was a Senior Vice President and served for a period as Acting General Counsel. During his tenure there, the D. E. Shaw group included several SEC-registered investment advisers and, at its apex, managed approximately $40 billion across various strategies and multiple funds. Bert also launched and advised a wide range of hedge funds, funds of funds, and their managers as a member of the London office of Dechert LLP.

Bert earned his J.D., with honors, from The University of Texas at Austin School of Law, where he was also an articles editor for the Texas Law Review and received the Outstanding Second-Year Member Award from the Texas Law Review, the Gilbert I. Low Endowed Presidential Scholarship in Law, and Highest Achievement in Contracts.

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David is a 2007 graduate of the Benjamin N. Cardozo School of Law, and earned a B.A. from the University of Michigan in 2004. While in law school, David served as a judicial intern for the Honorable Richard B. Lowe III in the Commercial Division of the New York State Supreme Court, New York County.