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SEC Proposes New Rules under the JOBS Act

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On August 29, 2012, the Securities and Exchange Commission ("SEC" or the "Commission") proposed rules to implement section 201 of the Jumpstart Our Business Startups Act (the "JOBS Act").[1] The JOBS Act directed the SEC to eliminate the ban on general solicitation and advertising in offerings made under Rule 506 of Regulation D ("Reg D")[2] under the Securities Act of 1933 (the "Securities Act"), provided that all purchasers of the securities are accredited investors. The JOBS Act also prescribed new rules requiring issuers using general solicitation or advertising in private offers to take reasonable steps to verify that purchasers of the securities are accredited investors, using methods determined by the Commission. The JOBS Act similarly directed the Commission to revise Rule 144A[3] under the Securities Act to permit unregistered offers of securities to persons other than qualified institutional buyers ("QIBs"),[4] including by means of general solicitation or general advertising, provided that the securities are actually sold only to persons that the seller, and any person acting on behalf of the seller, reasonably believes are QIBs.

The SEC emphasizes in the Release that it sought to propose only those amendments that are, in the Commission's view, necessary to implement the mandate in section 201(a) of the JOBS Act, given the tight time frame for compliance. It acknowledged, without currently responding to, public comments suggesting further amendment to the definition of accredited investor, to Form D filing requirements and contents, and to rules governing the content and manner of advertising and solicitations used in offerings conducted under amended Rule 506, particularly with respect to privately offered funds.

Amendments to Regulation D

Section 4(a)(2) (formerly section 4(2)) of the Securities Act,[5] exempts transactions by an issuer "not involving any public offering" from the registration requirements of section 5 of the Securities Act.[6] Rule 506 is a non-exclusive safe harbor under this section allowing an issuer to offer and sell securities, without any limitation on the offering amount, to an unlimited number of accredited investors,[7] and to no more than 35 non-accredited investors who meet certain sophistication requirements. An issuer seeking to comply with Rule 506 today must also comply with a condition under Rule 502[8] requiring that neither it, nor any person acting on its behalf, offers or sells securities through any form of "general solicitation or general advertising." Rule 502 explains the terms "general solicitation" and "general advertising" by example as including advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising. Interpretive releases and other guidance modernize this list by providing

that other publicly available media, such as Facebook postings, unrestricted websites, and email blasts, also constitute general advertising.[9]

As proposed, new Rule 506(c) would permit the use of general solicitation to offer and sell securities under Rule 506, provided that certain conditions are satisfied. These conditions are:

- The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors
- At the time of the sale of the securities, all purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they do
- All terms and conditions of Rules 501, 502(a) and 502(d) must be satisfied[10]

Notably, the Release preserves the continued availability of existing Rule 506(b) for issuers that either do not engage in general solicitation in their Rule 506 offerings (and thereby do not become subject to the new enhanced requirements to take reasonable steps to verify the accredited investor status of purchasers), or who wish to sell to a limited number of non-accredited investors who meet Rule 506(b)'s sophistication requirements. Retaining the safe harbor under existing Rule 506 may also benefit issuers that have established a pre-existing substantive relationship[11] with each investor and offeree insofar as it reduces the additional burdens imposed by Rule 506(c), as proposed, relating to verifying accredited investor status. In addition, section 4(a)(2) of the Securities Act is not itself amended by the JOBS Act, such that the statutory exemption is also still available without compliance with all the stated conditions necessary for the new safe harbor. Finally, it is worth noting that broker-dealers and private fund issuers participating in or conducting offers under the new safe harbor remain subject to limitations of, respectively, the rules of the Financial Industry Regulatory Authority ("FINRA") and the Investment Advisers Act of 1940, as amended (including related rules) (the "Advisers Act"),[12] pertaining to marketing, advertising and other communications with the public.

The JOBS Act mandated that issuers using general solicitation be required "to take reasonable steps to verify that purchasers of the securities are accredited investors,"[13] and delegated to the SEC to determine what would constitute "reasonable steps." In doing so, the Release emphasizes the SEC's intent to provide a flexible guide to accommodate the different types of issuers that would conduct offerings under proposed Rule 506(c) and the different types of accredited investors that may purchase securities in these offerings. Thus, whether the steps taken are "reasonable" would be based on the particular facts and circumstances of each transaction.

The following factors are relevant in determining whether an issuer's verification process is reasonable:

Nature of the Purchaser. The nature of the investor is one factor. The definition of "accredited investor" in Rule 501(a) includes accreditation standards for natural persons, public and private for-profit and not-for-profit corporations, general and limited partnerships, business and other types of trusts, and funds and other types of collective investment vehicles. Natural persons may

be accredited based on net worth or income criteria and entities based either on their status, or a combination of status and assets under management.

The Release provides that the steps that would be reasonable to verify accredited investor status under proposed Rule 506(c) "would likely vary depending on the type of accredited investor that the purchaser claims to be."[14] For example, an investor claiming to be accredited by virtue of being a registered broker-dealer may be verified by going to FINRA's BrokerCheck website. Other investors, such as natural persons, need to provide income and/or assets information, or otherwise support their representations of accredited status.

Information sufficient to verify accredited investor status may also vary. The amount and type of information that an issuer already has or can access about a purchaser would be a significant factor. For example, issuers that previously relied on the preexisting, substantive relationship requirement in establishing that there has not been a general solicitation may already have relevant and sufficient current information about certain investors, subject to verification that inputs are still accurate. Also, the Release notes that issuers could review or rely upon publicly available information in regulatory filings, such as a proxy statement identifying an investor as an executive officer of an Exchange Act registrant and disclosing the investor's compensation for the last three completed fiscal years, or a tax-exempt, nonprofit organization's assets as disclosed in its Form 990 IRS return. The Release even suggests that third-party information, such as a trade publication that discloses specific information about the average compensation earned at the investor's workplace by persons at the level of the investor's seniority, may be sufficient, as would verification by "a broker-dealer, attorney or accountant, provided that the issuer has a reasonable basis to rely on such third-party verification."[15] Notably, the Release does not state that the broker-dealer, attorney or accountant necessarily needs to be a service provider to the investor in order for there to be a reasonable basis for reliance.

Nature of the Offering. The nature of the offering also is relevant in determining what constitutes a reasonable process to verify accredited investor status. The more general the solicitation, such as through a website accessible to the general public, a mass mailing (electronic or otherwise), or social media solicitation, would suggest greater measures are warranted to verify accredited investor status than solicitation of new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party. In the Release, the SEC clarified its view on one common current practice—for broad general solicitations, the SEC does not believe that reasonable verification can be achieved by requiring only that a person check a box in a questionnaire or sign a form, absent other information about the person supporting accredited investor status. Although the Release, in this regard, is commenting on the "reasonable steps" element of the proposed Rule 506(c) safe harbor, its reference to this being the Commission's view on current practices has broader implications. Owners of websites that use this check-box process to "protect" the website from non-accredited traffic for purposes of Rule 506(b) compliance should review the adequacy of this approach with counsel. Regarding targeted solicitations, the Release is likely to create a new or wider market for monetization of databases of pre-screened or simply high-net-worth individuals. All kinds of businesses can purport to have useful data in this regard and, as noted, there may be data privacy and security issues in navigating these opportunities.[16] Furthermore, targeted advertising, such as through the use of online tracking technologies or email, may create issues under section 5 the Federal Trade Commission Act (the "FTC Act"),[17] state unfair

trade practices regulations, and the CAN-SPAM Act.[18] Issuers and their agents should consult with counsel about what type of conduct triggers these non-securities-law-based advertising regulations, and how contract terms with data or access providers affect which party is responsible for compliance.

Terms of the Offering. The terms of the offering may be another factor affecting whether the verification methods used are reasonable. For example, a purchaser's ability to meet a high minimum investment amount could be relevant where the minimum is sufficiently high such that only accredited investors could reasonably be expected to meet it. Whether the investor has to meet this threshold solely in cash without outside financing is also relevant.

Having taken these interconnected factors into consideration, if it appears likely that a person qualifies as an accredited investor, the issuer would have to take fewer steps to verify accredited investor status, and vice versa.

Recordkeeping. The Release reminds issuers that an issuer claiming an exemption from Securities Act registration requirements has the burden of showing that it is entitled to that exemption.[19] Issuers seeking to rely on new Rule 506(c) must maintain adequate records that document the steps taken to verify that a purchaser was an accredited investor, regardless of the particular steps taken.

Commentary. The Commission acknowledged that early commentators already provided robust, if conflicting, suggestions about determining what would constitute reasonable steps– from cautions against imposing any additional burdens, to the urging of prescriptions creating a higher standard than already exists. The Commission stated it considered these comments and determined the appropriate approach is to require issuers to take reasonable steps to verify that the purchasers are accredited investors, but not to require them to follow uniform verification methods that may be ill-suited or unnecessary to particular facts and circumstances. This approach is intended to give market participants the flexibility to adapt approaches to changing facts and market practices, and to innovate with changing resources and technology. The SEC also noted that the factors and steps discussed in the Release are not per se sufficient. The SEC went on to state that there may be circumstances where the steps and methods discussed would not actually verify accredited investor status, or where issuers may unreasonably overlook or disregard other information indicating that a purchaser is not, in fact, an accredited investor. In those cases, mere execution of the steps discussed in the Release would likely not satisfy the safe harbor of proposed Rule 506(c). A method that is reasonable under one set of circumstances may not be reasonable under a different set of circumstances. In the absence of a prescriptive list, issuers have both the burden and the flexibility to choose appropriate verification methods, under their specific circumstances and in consideration of cost.[20]

The Release advises issuers to be mindful that steps necessary to verify the status of natural persons may trigger such persons' privacy concerns about disclosure of personal financial information. We note that privacy concerns may be implicated, for example, when obtaining data from third parties. There is substantial potential for Rule 506(c) to create a market for data about high-net-worth individuals compiled or accessed by any number and type of data owners. Broker-dealers and issuers obtaining data from third parties should obtain legal advice and properly document arrangements to purchase or access third-party data. And data providers

must consider whether such arrangements may cause them to be required to register as a broker-dealer. In addition, third-party data may raise the bar on the issuer's duty to determine whether it is reasonable to rely on the data to form a belief that the purchaser is an accredited investor at the time of purchase.

The SEC noted that it intends to monitor and study the development of verification practices by issuers, securities intermediaries and others as well as the impact of compliance with this requirement on investor protection and capital formation. It may also be reasonable to assume that investment advisers using general solicitation to offer private fund shares can expect heightened attention to marketing and advertising material in adviser exams and investigations.

Reasonable Belief that All Purchasers Are Accredited Investors

The Release also provides the SEC's interpretation of an ambiguity created by drafting in the JOBS Act. Whereas Section 201(a)(2) of the JOBS Act, calling for amendments to Rule 144A, specifically refers to a "reasonable belief" standard as to whether a purchaser is a QIB, section 201(a)(1) does not recite a similar "reasonable belief" standard with respect to accredited investor status under proposed Rule 506(c). Early commentators expressed concern that this inconsistency might imply that an issuer must have an absolute, rather than a reasonable belief when determining accredited investor status. In this matter, the SEC unequivocally states that the definition of accredited investor remains unchanged with the enactment of the JOBS Act, and that definition itself included persons that come within any of the listed categories of accredited investors, as well as persons that the issuer reasonably believes come within any such category. The Commission attributes the difference in the JOBS Act's statutory language to the existing difference between Rule 506 and Rule 144A (the former includes the reasonable belief standard in the Rule 501(a) definition of "accredited investor," while Rule 144A includes the "reasonable belief" standard as a condition to the use of the exemption) and does not represent a Congressional intent to eliminate the existing reasonable belief standard in Rule 501(a) or for Rule 506 offerings.

The Release acknowledges that the "reasonable belief" standard remains good policy to protect issuers when potential investors provide false information or documentation to an issuer, or otherwise circumvent or sabotage verification measures.[21] The issuer would not lose the ability to rely on the proposed Rule 506(c) exemption if a person who does not meet the criteria purchased securities in the offering, so long as the issuer took reasonable steps to verify or establish a reasonable belief that the investor was an accredited investor at the time of purchase.

Form D Check Box for Rule 506(c) Offerings

Currently, an issuer offering or selling securities in reliance on Rule 504, 505 or 506 must file a notice of sales on Form D with the Commission for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering. The information required to be provided in a Form D filing includes basic identifying information; identification of the exemption or exemptions being claimed for the offering; and certain terms of the offering, such as type of securities offered and total offering amount. The Release proposes to add a separate field or check box for issuers to indicate whether they are claiming an exemption under Rule 506(c) to

assist SEC efforts to monitor the use of general solicitation in Rule 506(c) offerings and the size of this offering market. Also, the current check box for "Rule 506" would be renamed "Rule 506(b)," and the current check box for "Section 4(5)" would be renamed "Section 4(a)(5)" to update these references.

Specific Issues for Privately Offered Funds

Privately offered funds, such as hedge funds, venture capital funds and private equity funds, typically offer securities not only in reliance on exemptions from the Securities Act, but also in reliance on one of two exclusions from the definition of "investment company" under the Investment Company Act of 1940, as amended (the "Company Act"). Both common exclusions, set forth in sections 3(c)(1) and 3(c)(7) of the Company Act,[22] become unavailable if the issuer makes a public offering of its securities.[23] Section 3(c)(1) excludes from the definition of "investment company" any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 beneficial owners, and which is not making and does not currently propose to make a public offering of its securities. Section 3(c)(7) excludes from the definition of "investment company" any issuer whose outstanding securities 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 its securities.

While the JOBS Act directs the Commission to lift the ban against general solicitation for certain Rule 506 offerings, it makes no specific reference to privately offered funds. However, the JOBS Act also provides that "[o]ffers and sales exempt under [the new implementing rules] shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation."[24] The Release confirms the Commission's view that the effect of this provision is to permit privately offered funds to make a general solicitation under new Rule 506(c) without losing either of the exclusions under the Company Act (or private fund adviser status under the Advisers Act).

Proposed Amendment to Rule 144A

Section 4(a)(1) (formerly section 4(1)) of the Securities Act,[25] exempts from registration transactions by any person "other than an issuer, underwriter, or dealer." Rule 144A is a non-exclusive safe harbor exemption under section 4(a)(1), for resales of certain "restricted securities"[26] to QIBs. Because Rule 144A is available solely for resale transactions, issuers often raise capital by offering securities to one or more financial intermediaries acting as the initial purchasers in a transaction that is exempt from registration pursuant to section 4(a)(2) or Regulation S,[27] followed by the immediate resale of those securities by the initial purchasers to QIBs in reliance on Rule 144A.

As directed by section 201(a)(2) of the JOBS Act, the Commission proposes to revise Rule 144A(d)(1) to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that securities are sold only to persons that the seller, and any person acting on behalf of the seller, reasonably believes is a QIB.

Integration With Offshore Offerings

Regulation S provides an issuer and a resale safe harbor for offers and sales of securities outside the United States, subject to the conditions (1) the securities are sold in an offshore transaction and (2) there have been no directed selling efforts in the United States.[28] The safe harbors allow U.S. and foreign companies to engage in concurrent unregistered offerings inside and outside the United States, where some or all of the non-U.S. portion is conducted as a public offering in reliance on Regulation S, and the U.S. portion is based on reliance on Rule 144A or Rule 506.

Referring back to its adopting release for Regulation S, the Commission affirmed its view that offshore transactions in compliance with Regulation S will not be integrated with offers under new Rule 506(c) or amended Rule 144A, just as they are not integrated with offers in the United States that are conducted in reliance on other exemptions from registration under the Securities Act.

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[1] Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. (Apr. 5, 2012). *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9354 [77 FR 54464] (Aug. 29, 2012), http://www.sec.gov/news/press/2012/2012-170.htm (the "Release").

[2] 17 C.F.R. § 230.506.

[3] 17 C.F.R. § 230.144A.

[4] The term "qualified institutional buyer" is defined in Rule 144(a)(1) to include certain institutions that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers not affiliated with buyer. Other thresholds apply to specified regulated financial institutions.

[5] 15 U.S.C. § 77d(a)(2).

[6] 15 U.S.C. § 77e.

[7] The term "accredited investor" is defined in Rule 501(a) of Regulation D [17 C.F.R. § 230.501(a)] to include any person who comes within one of several enumerated categories of persons, or whom the issuer "reasonably believes" comes within any of the enumerated categories, at the time of the sale of the subject securities to that person.

[8] 17 C.F.R. § 230.502(c).

[9] *See Use of Electronic Media for Delivery Purposes*, Release No. 33-7233 (Oct. 6, 1995) [60 FR 53458] at Ex. 20; *Use of Electronic Media*, Release No. 33-7856 (Apr. 28, 2000) [65 FR 25843] at footnotes 79-80 and accompanying text.

[10] The Release notes that securities acquired under proposed Rule 506(c) will be "restricted securities" as defined in both Rule 144(a)(3)(ii) [17 C.F.R. § 230.144(a)(3)(ii) and Rule 144(a)(3)(i) [17 C.F.R. § 230.144(a)(3)(i)].

[11] Rule 502(c)'s prohibition against general solicitation is generally complied with by demonstrating that the issuer (or its agent or intermediary) has a pre-existing substantive relationship with the offerees. See, *e.g.*, Mineral Lands Research and Marketing Corp. (Nov. 3, 1985); E.F. Hutton & Co. (Dec. 3, 1985); IPONET (July 26, 1996); Lamp Technologies, Inc. (May 29, 1998).

[12] 15 U.S.C. § 80b.

[13] Section 201(a)(1) of the JOBS Act.

[14] See SEC Release No. 33-9354 (Aug. 29, 2012) at p. 16.

[15] *See* SEC Release No. 33-9354 (Aug. 29, 2012) at p. 19.

[16] *See* http://www.reedsmith.com/Believe-But-Verify-Evaluating-Accredited-Investors-Under-the-SECs-Proposed-Rule-506c-09-06-2012/

[17] 15 U.S.C. § 45, et seq.

[18] 15 U.S.C. § 7701, et seq.

[19] Citing *SEC v. Ralston Purina*, 346 U.S. 119, 126 (1953) ("Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable.").

[20] It is interesting that the Commission inserted cost as a consideration, without further commentary. See SEC Release No. 33-9354 (Aug. 29, 2012) at p. 21. Given the widely discussed potential for fraud on retail investors, it is hard to imagine in what way cost of more or more substantial steps would be an adequate defense. This is perhaps an area when further SEC guidance would be helpful.

[21] *See* SEC Release No. 33-9354 (Aug. 29, 2012) at p. 29.

[22] 15 U.S.C. § 80a-3(c)(1) and 15 U.S.C. § 80a-3(c)(7).

[23] *See also* section 202(a)(29) of the Advisers Act (defining a "private fund" as an issuer that would be an investment company under the Investment Company Act, but for sections 3(c)(1) and 3(c)(7) of that Act). Many issuers of asset-backed securities ("ABS") also rely on the exclusions contained in sections 3(c)(1) and 3(c)(7) of the Investment Company Act. These ABS issuers frequently participate in Rule 144A offerings.

[24] Section 201(b) of the JOBS Act.

[25] 15 U.S.C. § 77d(a)(1).

[26] "Restricted securities" are defined in Securities Act Rule 144(a)(3) [17 C.F.R. § 230.144(a)(3)] to include, in part, "[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a chain of transactions not involving a public offering."

[27] Regulation S under the Securities Act [17 C.F.R. §§ 230.901- 230.905] is a safe harbor from Securities Act registration requirements for any offer or sale of securities made outside the United States.

[28] Rule 902(c)(1) [17 C.F.R. § 230.902(c)(1)] broadly defines "directed selling efforts" as: any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities offered in reliance on Regulation S. Directed selling efforts may include advertising in a publication "with a general circulation in the United States" that refers to the Reg S offering.