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SEC Proposes Rules to Allow General Solicitation in Private Offerings under Rule 506

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As required by Section 201(a) of the Jumpstart Our Business Startups (JOBS) Act, the Securities and Exchange Commission (SEC) has proposed rules under Section 4(a)(2) of the Securities Act of 1933, as amended (the Securities Act), to eliminate the prohibitions on general solicitation and general advertising for certain private placements of securities conducted in accordance with Rule 506 under the Securities Act's Regulation D.[1] Rule 506 provides a non-exclusive safe harbor from the registration requirements of the Securities Act for transactions by an issuer "not involving any public offering." Under Rule 506, an issuer may offer and sell securities, without any limitation on the offering amount, to an unlimited number of accredited investors, as defined in Regulation D, and to no more than 35 non-accredited investors.

Historically, a fundamental condition of reliance on Rule 506 was that no general solicitation or advertising could take place in connection with the private placement, which greatly constrained the methods by which prospective investors could be identified to participate in a private offering. When these proposed rules required by the JOBS Act are finalized and take effect, issuers will have the option to solicit investors in their private offerings broadly through such means as Internet websites, newspaper advertisements and other widely available media, provided that the conditions of the new rule, as described below, are satisfied.

Section 201(a)(1) of the JOBS Act directed the SEC to amend Rule 506 to permit general solicitation or general advertising in private placements, as long as all investors who actually purchase securities in the offering are accredited investors. The JOBS Act also provides that "[s]uch rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the [SEC]."

These changes will also affect offerings pursuant to Rule 144A under the Securities Act, which is a non-exclusive safe harbor from the registration requirements of the Securities Act for resales of securities to larger institutional investors, known as qualified institutional buyers (QIBs). Offers of securities under current Rule 144A are limited to QIBs, which generally include only institutions that own and invest, on a discretionary basis, at least $100 million in securities. Under the revised rules as proposed, offers of securities in Rule 144A transactions could be made to investors who are not QIBs as long as the securities are sold only to persons whom the seller reasonably believes are QIBs.

Proposed Rule 506(c)

The proposed rules would create a separate category of private placement, under proposed Rule 506(c), pursuant to which an issuer would be permitted to use general solicitation and general advertising to offer its securities, provided that:

- The issuer must take "reasonable steps" to verify that all ***purchasers*** of the securities are accredited investors.

- The issuer must be able to conclude that all purchasers of the securities are accredited investors, either because, at the time of the sale of the securities:
    - They come within one of the specific categories of persons who are identified as accredited investors,[2] or
    - The issuer has a "reasonable belief" that the investors fall into one of the accredited investor categories.

The definitions contained in Rule 501(a) under Regulation D, the rules on integration of sales of securities with Regulation D offerings set forth in Rule 502(a) under Regulation D, and the requirement of Rule 502(d), providing that securities sold under Regulation D will be restricted securities, will also apply to Rule 506(c) offerings.

In discussing the steps that an issuer must take to verify that a purchaser is an accredited investor, the SEC declined to require specific methods of making this determination. Instead, the proposing release provides that issuers must consider the facts and circumstances of the specific offering, and may need to adapt the steps that it undertakes for this purpose depending on a number of factors, including:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be. For example, the SEC observes that the steps that may be reasonable to verify whether a broker-dealer is an accredited investor, such as by checking FINRA's BrokerCheck website, will be different from the steps that would be needed to verify whether an individual is an accredited investor.
- The amount and type of information that the issuer has about the purchaser. For example, keeping in mind privacy concerns, an issuer may be able to rely on publicly available information about a potential purchaser to verify accredited investor status. This information could include:
    - Compensation disclosure for an individual as made available in proxy statements filed with the SEC;
    - Information as to total assets for an organization as made available in federal tax returns; or
    - Verification of a person's status as an accredited investor from a third party, such as a broker-dealer, attorney or accountant, as long as the issuer has a reasonable basis to rely on the information from the third party.
- The nature of the offering, including:
    - The manner in which the purchaser was solicited to participate in the offering. For example, the steps that would be reasonable in the context of investors who were solicited through a publicly accessible website or social media solicitation would likely differ from the steps that would be reasonable for investors who were obtained from a pre-screened database of accredited investors maintained by a broker-dealer.
    - The terms of the offering, such as a minimum investment amount. For example, if the minimum investment amount was sufficiently high that it would be unlikely to be possible for a non-accredited investor to participate in the offering, this could be used as a factor in determining whether the proposed investor indeed is accredited.

The SEC's proposing release notes that proposing specific verification methods that an issuer must use "would be impractical and potentially ineffective in light of the numerous ways in which a purchaser can qualify as an accredited investor … We are also concerned that a prescriptive rule that specifies required verification methods could be overly burdensome in some cases, by requiring issuers to follow the same steps, regardless of their particular circumstances, and ineffective in others, by requiring steps that, in the particular circumstances, would not actually verify accredited investor status." The proposing release emphasizes that issuers should keep adequate records to document the processes by which they verify that purchasers are accredited investors. Issuers will need to be able to sustain the burden of proof if their ability to rely on Rule 506(c) for a specific offering is ever challenged.

The proposed rules do not address whether, in the case of an offering with multiple closings over an extended period of time, an issuer would need to update the verification process before each closing. In such a case, we would advocate that an issuer should be able to rely on the results of one verification process absent actual

knowledge of a meaningful change in an investor's circumstances.

The proposing release does provide that, if an investor in a Rule 506(c) offering turns out not to have been an accredited investor, the issuer will not lose its ability to rely on Rule 506(c) as the exemption for the offering as long as the issuer had taken reasonable steps to verify that the investor was in fact accredited and had a reasonable belief that the investor qualified as such.

Under the proposed rules, the pre-existing exemptions set forth in Rule 506(b) under Regulation D would be maintained, allowing issuers who do not intend to utilize general solicitation or advertising to conduct a Rule 506 private placement without the need to comply with the accredited investor verification provisions of proposed Rule 506(c).

Rule 144A

Under the proposed rules, securities sold pursuant to Rule 144A could 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.

Form D

The proposed rules would also amend Form D, which is an informational form that issuers are required to file on EDGAR when they sell securities under Regulation D. The revised form would add a separate box for issuers to check if they intend to rely on Rule 506(c) and engage in general solicitation and general advertising of the offering.

Timing

The proposed rules will be open for public comment until October 5, 2012, after which the SEC will review the comments received and finalize the rules. Until the rules are finalized and take effect, issuers may not take advantage of the general solicitation and general advertising provisions in conducting private placements under Rule 506. The SEC declined as part of these amendments to make any other changes to Regulation D that had been suggested by commentators, such as amendments to the accredited investor definition as it relates to individuals, and requiring the filing of a Form D as a condition of reliance on the Rule 506 exemption.

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In commenting on the proposed rules, SEC Chairman Mary Schapiro stated: "I believe that the proposed rules fulfill Congress's clear directive that issuers be given the ability to communicate freely to attract capital, while obligating them to take steps to ensure that this ability is not used to sell securities to those who are not qualified to participate in such offerings." This rule is consistent with the overarching theme of the JOBS Act, which was to ease restrictions on capital-raising by smaller and emerging issuers in the wake of the Great Recession. We hope that these rules do have the intended salutary effect on the ability of our clients and other market participants to take advantage of the private placement market and obtain the capital necessary to operate their businesses.

Please contact the Mintz Levin attorney who is responsible for your corporate and securities law matters if you have any questions or comments regarding this information. We will continue to keep our clients and friends informed as to further developments in this area.

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Endnotes

[1] The proposed rules can be found at http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

[2] An accredited investor is generally any person or entity that falls within one of the following categories at the time of the investment:

- Any bank, savings and loan association or other institution as defined in the Securities Act; any broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934, as amended; any insurance company as defined in Section 2(13) of the Securities Act; any investment company registered under the Investment Company Act

of 1940 or a business development company as defined in Section 2(a)(48) of that act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in Section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

- Any private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940;
- Any organization described in Section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;
- Any director, executive officer, or general partner of the issuer of the securities, or any director, executive officer, or general partner of a general partner of that issuer;
- Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000, excluding the value of the person's primary residence, subject to additional conditions as set forth in Rule 501(a);
- Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
- Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person; and
- Any entity in which all of the equity owners are accredited investors.

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