HINSHAW

Alerts

SEC Proposes to Eliminate the Prohibition Against General Solicitation and Advertising in Certain Private Offerings

September 20, 2012
Corporate / Financial Institutions Alert

Summary

The Jumpstart Our Business Startups Act (JOBS Act) directs the U.S. Securities and Exchange Commission (SEC) to amend Rule 506 of Regulation D to permit general solicitation or general advertising in offerings made under Rule 506, provided that all purchasers of the securities are accredited investors. The issuer must take reasonable steps to verify that purchasers of the securities are accredited investors.

In addition, the SEC must adopt rules that will permit offers of securities pursuant to Rule 144A under the Securities Act of 1933 (the Securities Act), including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers (QIBs).

The SEC recently proposed rules that, if enacted, would remove the ban on general solicitation and general advertising in connection with private placements under Rule 506 of Regulation D and Rule 144A. These rules should provide opportunities for issuers to reach more potential investors. Comments are due by October 5, 2012.

Background of Rule 506

Under existing 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 who meet certain sophistication requirements. Offerings under Rule 506 are subject to all the terms and conditions of Rules 501 and 502, including Rule 502(c) which prohibits any form of general solicitation or general advertising.

Regulation D does not define the terms "general solicitation" and "general advertising." Rule 502(c), however, does provide examples of general solicitation and general advertising; these include advertisements published in newspapers and magazines, messages broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising. The use of publicly available media, such as unrestricted websites, also constitutes general solicitation and general advertising.

Attorneys

Timothy M. Sullivan

Service Areas

Business & Commercial Transactions

Business Formation

Mergers & Acquisitions

Securities

Proposed Amendments to Rule 506 and Form D

The SEC has proposed Rule 506(c), which, if adopted, would permit the use of general solicitation and general advertising in the offer and sale of securities under Rule 506, provided:

- all purchasers of securities must be accredited investors, either because they qualify as accredited investors under Regulation D or the issuer **reasonably believes** that they do at the time of the sale of the securities; and
- the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors.

Rule 506(c) would eliminate the prohibition on general solicitation and advertising. As a consequence, a number of forms of solicitation (e.g., advertisements, email, internet media, television and radio) can be used. Issuers would also be able to conduct seminars where prospective purchasers are invited by general advertising. It should be noted, however, that SEC rules will still prohibit false or misleading statements.

Other provisions of Regulation D (e.g., definition of accredited investor and the resale restrictions) will not be changed if Rule 506(c) is adopted. An issuer relying on Rule 506(c), therefore, must comply with all of the other applicable requirements of Regulation D.

Issuers planning to take advantage of Rule 506(c) will have "to take reasonable steps to verify that purchasers of the securities are accredited investors." The SEC did not propose any verification standards. In the SEC's view, whether the steps taken are "reasonable" is an objective determination, based on the particular facts and circumstances of each transaction. Under these standards, issuers may not be able to rely on the certificate of a purchaser of the purchaser's accredited investor status. Additional steps may have to be taken.

A number of factors should be considered when determining the reasonableness of the steps to verify that a purchaser is an accredited investor. Some examples of these factors include:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

Nature of the Purchaser. The definition of "accredited investor" in Rule 501(a) includes natural persons and entities that come within any of the categories in the rule, or that the issuer reasonably believes come within one of those categories, at the time of the sale of securities to that natural person or entity.

Steps that would be reasonable for an issuer to take to verify whether a purchaser is an accredited investor under proposed Rule 506(c) will vary depending on the type of accredited investor that the purchaser claims to be. For example, the steps that may be reasonable to verify that an entity is an accredited investor by virtue of being a registered broker-dealer (such as by going to FINRA's BrokerCheck website) would necessarily differ from the steps that would be reasonable to verify whether a natural person is an accredited investor.

Information about the Purchaser. The amount and type of information that an issuer has about a purchaser would be a significant factor in determining what additional steps would be reasonable to verify the purchaser's accredited investor status. Where an issuer has actual knowledge that the purchaser is an accredited investor, the issuer would not have to take any steps at all. Such information could be obtained from a variety of sources, including:

- publicly available information in filings with a federal, state or local regulatory body;
- third-party information that provides reasonably reliable evidence that a person falls within one of the enumerated categories in the accredited investor definition; and
- verification of a person's status as an accredited investor by a third party, such as a broker-dealer, attorney or accountant, provided that the issuer has a reasonable basis to rely on such third-party verification.

Nature and Terms of the Offering. The nature and terms of the offering may be relevant in determining the reasonableness of the steps taken to verify accredited investor status.

When an issuer solicits new investors through a website accessible to the general public or through a widely disseminated email or social media solicitation, the issuer would have to take additional steps to verify a purchaser's status. Conversely, an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party, such as a registered broker-dealer, would not have to take such measures. An issuer may rely on such verification provided that the issuer has a reasonable basis to rely on such third-party verification.

Absent other information, an issuer would not have taken reasonable steps if it required only that a person check a box in a questionnaire or sign a form.

Record Keeping. Issuers should retain adequate records that document the steps taken to verify that a purchaser was an accredited investor. An issuer claiming an exemption has the burden of showing that it is entitled to that exemption.

Misrepresentations by a Purchaser. It is possible that a purchaser could circumvent measures put in place by an issuer to verify the purchaser's status. If a purchaser is not an accredited investor, the issuer would be able to rely on the proposed Rule 506(c) exemption, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that the purchaser was an accredited investor.

Current Rule 506 Offerings. Existing Rule 506(b) allows issuers to conduct Rule 506 offerings without the use of general solicitation or general advertising; this provision will not be changed. Issuers that do not wish to engage in general solicitation or general advertising in their Rule 506 offerings would not be obligated to take reasonable steps to verify the accredited investor status of purchasers. However, as required by Rule 506(b), an issuer would still have to reasonably believe at the time of sale that an investor is an accredited investor. Issuers relying on Rule 506(b) will be able to sell to up to 35 non-accredited investors who meet Rule 506(b)'s sophistication requirements.

Amendment to Form D

Form D is the notice of an offering of securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D. Under Rule 503 of Regulation D, an issuer offering or selling securities in reliance on Rule 504, 505 or 506 must file with the SEC a notice of sales on Form D for each new offering no later than 15 calendar days after the first sale of securities in the offering.

Form D would be revised to add a separate field or check box for issuers to indicate whether they are claiming an exemption under Rule 506(c). Proposed Rule 506(c) would not require that a Form D be filed before an issuer undertook general solicitation or advertising.

Specific Issues for Privately Offered Funds

Privately offered funds, such as hedge funds, venture capital funds and private equity funds, typically rely on the Rule 506 safe harbor without registration under the Securities Act. Such funds generally rely on Section 3(c)(1) or 3(c)(7) under the Investment Company Act when making a Rule 506 offering.

Privately offered funds are precluded from relying on either of the two exclusions if they make a public offering of their securities. 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 less than 100 beneficial owners. 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". In addition, under either exemption, the issuer must not be making and must not at the time of the sale propose to be making a public offering of its securities.

In the SEC's view, privately offered funds are permitted to use general solicitation or advertising when selling securities under Rule 506(c) without losing either of the exemptions available under the Investment Company Act.

Background of Proposed Amendment to Rule 144A

Rule 144A is a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain “restricted securities” to QIBs. In order for a transaction to come within existing Rule 144A, a seller must have a reasonable basis for believing that the offeree or purchaser is a QIB and must take reasonable steps to ensure that the purchaser is aware that the seller may rely on Rule 144A. Further, only securities that, when issued, were not of the same class as securities listed on a U.S. securities exchange or quoted on a U.S. automated interdealer quotation system are eligible for resale under Rule 144A. Also, the seller and a prospective purchaser designated by the seller must have the right to obtain from the issuer, upon request, certain information on the issuer, unless the issuer falls within specified categories as to which this condition does not apply.

Rule 144A does not include an express prohibition against general solicitation or general advertising. Because offers of securities under Rule 144A must be limited to QIBs, Rule 144A offerings do not use general solicitations or advertising.

Amendment to Rule 144A

The SEC is proposing 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 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.

Unlike the requirements of Rule 506(c), an issuer relying on Rule 144A would not have to implement verification measures. However, the issuer must reasonably believe that the buyers are QIBs.

Integration With Offshore Offerings

Regulation S provides a safe harbor for offers and sales of securities outside the United States and includes an issuer and a resale safe harbor. Two general conditions apply to both safe harbors: (1) the securities must be sold in an offshore transaction and (2) there can be no directed selling efforts in the United States. Regulation S offerings are often conducted in conjunction with offerings made in the U.S. The U.S. portion of the offering is usually conducted in accordance with Rule 144A or Rule 506 and the offshore portion is conducted in reliance on Regulation S.

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 the proposed amendments to Rule 506 or Rule 144A. As a consequence, issuers will be able to use general solicitation or advertising in the Rule 506 and Rule 144A offerings that are conducted with Regulation S offerings.

For further information, please contact Tim Sullivan, Michael D.Morehead or your regular Hinshaw attorney.

Download PDF

Tax Advice Disclosure: To ensure compliance with the Internal Revenue Service regulations governing the issuance of advice on Federal tax issues, we advise you that any tax advice in this communication (and any attachments) is not written with the intent that it be used, and cannot be used, to avoid penalties that may be imposed under the Internal Revenue Code.

This alert has been prepared by Hinshaw & Culbertson LLP to provide information on recent legal developments of interest to our readers. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship.