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SEC Proposes Rules Under JOBS Act Eliminating Prohibition Against General Solicitation and Advertising in Certain Reg. D/Rule 144A Offerings

BY THE INVESTMENT MANAGEMENT PRACTICE

Overview

On August 29, 2012, the Securities and Exchange Commission ("SEC") proposed rules eliminating, under certain conditions, the prohibition against general solicitation and advertising in certain securities offerings made pursuant to Rule 506 of Regulation D ("Rule 506") and Rule 144A under the Securities Act of 1933 ("Securities Act").[1] The proposed rules are mandated by the Jumpstart Our Business Startups Act ("JOBS Act") that was signed into law on April 5, 2012. The JOBS Act's relaxation of the general solicitation and advertising prohibition in Rule 506 and Rule 144A offerings is intended to make it easier for domestic and foreign companies and private investment funds to raise capital from accredited investors and qualified institutional buyers by permitting such issuers to engage in broad based communication and solicitation efforts when seeking to raise capital.

The proposed rules are subject to a 30 day comment period.

Discussion

I. Rule 506 Offerings

A. Existing Rule 506(b)

Rule 506 is a non-exclusive safe harbor under the Securities Act which exempts transactions by an issuer "not involving any public offering" from the Securities Act's registration requirements. Under existing Rule 506(b), an issuer may offer and sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors," as defined in Rule 501(a) of Regulation D[2] and to no more than 35 non-accredited investors who meet certain "sophistication" requirements.[3]

The availability of the Rule 506(b) safe harbor is subject to a number of requirements and is currently conditioned on the issuer, or any person acting on its behalf, not offering or selling securities through any form of "general solicitation or general advertising." Although the terms "general solicitation" and "general advertising" are not defined in Regulation D, the SEC staff has generally required that there be a substantive pre-existing relationship with a prospective investor prior to the issuer soliciting an investment from such prospective investor. Rule 502(c) provides examples of general solicitation and

general advertising and the SEC staff has provided additional guidance as to meaning of these terms through the years. The following types of communications are generally thought to constitute "general solicitation" or "general advertising": advertisements published in newspapers, magazines or through the social media, television and radio communications, seminars or meetings whose attendees have been invited by general solicitation or advertising, and the use of publicly available media, such as unrestricted websites.

B. Proposed Revisions to Rule 506

Elimination of Prohibition on General Solicitation and Advertising – As proposed, amended Rule 506 will include a new paragraph (c) that will permit general solicitation or advertising in offerings made under that Rule, provided that the issuer takes "reasonable steps" to verify that all purchasers of the securities are accredited investors. Under proposed Rule 506(c), either all purchasers of the securities must be accredited investors under Rule 501, or the issuer must *reasonably believe* that all purchasers are accredited investors at the time of the sale of the securities. As a result, issuers relying on revised Rule 506(c) would not be able to take advantage of current Rule 506(b), which permits offers of up to 35 non-accredited investors.

The elimination of the general solicitation and advertising restriction relates only to offerings relying on the safe harbor of Rule 506(c), and not to other types of private offerings under Section 4(a)(2). Importantly, issuers may continue to rely on existing Rule 506(b), and therefore avail themselves of the 35 person non-accredited investor limitation, so long as they do not engage in general solicitation or advertising in connection with the offering. Issuers relying on existing Rule 506(b) may therefore continue to rely on existing guidance relating to offerings under that Rule, including guidance as to the nature and effect of substantive pre-existing relationships with prospective investors.

Reasonable Steps to Verify Accredited Investor Status – Issuers relying on Rule 506(c) would be required to take reasonable steps to verify that all purchasers of securities are accredited investors. The proposed Rule does not mandate that any particular steps be taken to verify a prospective investor's "accredited investor" status, nor does it proscribe a specified verification methodology or provide a non-exclusive list of acceptable verification methods. Instead, the proposed Rule provides issuers with latitude to determine what verification methods it should employ, requiring only that the method selected be reasonable, taking into account the facts and circumstances of the transaction. The SEC offered up three examples of factors that issuers could take into account in determining the reasonableness of their verification methodology, as set forth below:

- Nature of the Purchaser: The nature of the purchaser is a relevant factor in determining whether an issuer has taken reasonable steps to verify the accredited investor status of a purchaser. The SEC acknowledges the wide variety of purchasers that may be accredited investors, and that any verification process will vary depending on the type of accredited investor. Thus, for purchasers claiming to be registered broker-dealers or investment companies, an issuer may choose to obtain verification by searching the Financial Industry Regulatory Authority's ("FINRA") website or publically available SEC filings, respectively. For high net worth or high income individuals claiming accredited investor status, the verification process becomes more difficult and implicates legitimate privacy concerns. The SEC acknowledges these concerns and notes that the type of information that would be sufficient under the particular facts and circumstances of each purchaser may also depend on other factors, as described below.

- Information about the Purchaser: The "amount and type" of information that an issuer may have about a purchaser is a significant factor in determining whether additional verification procedures are warranted. Examples provided by the SEC include the use of publically available information (such as whether the individual is an executive officer in an Exchange Act registrant, such that the Registrant's proxy statements include information as to the individual's compensation for the last three fiscal years), reliable third-party documentation that provides "reasonably reliable evidence" that a purchaser is an accredited investor (such as W-2s or information as to the average salary of persons in the same industry at the same level of seniority as the purchaser), or verification by a broker-dealer, attorney, accountant, placement agent or other third party.

- Nature and Terms of the Offering: The nature and the terms of the offering are relevant factors in determining whether an issuer has taken reasonable steps to verify the accredited investor status of a purchaser. For example, an issuer that solicits purchasers through a public website, social media or through a widely distributed email will be held to a higher standard of proof that it has taken reasonable steps, in comparison to an offering to a group of purchasers that have been prescreened by a reliable source, such as a broker-dealer. The SEC noted that with respect to the former, self-accreditation simply through checking a box or signing a form would not be viewed as satisfying the reasonable verification standard.

The terms of an offering are also relevant. The SEC acknowledged that a high minimum investment amount, achieved by direct investment and not financed by the issuer or a third party, could be relevant to the issuer's evaluation of the reasonableness of the steps taken, particularly where the minimum investment is sufficiently high such that only accredited investors could reasonably be expected to meet it. In such a case, it may be reasonable for the issuer to apply no further verification measures, other than to ensure the investment is not financed by a third party.

These factors are interconnected, and an issuer must examine the totality of the facts and circumstances of both the offering and the purchaser to ascertain whether it has taken reasonable steps to determine the accreditation status of a purchaser. Regardless of the approach taken, the SEC emphasized the importance that issuers maintain adequate records that document each step taken in the verification process; any issuer claiming this exemption has the burden of showing that it is entitled to such exemption.

If the issuer employs reasonable verification methods, and reasonably believes the purchaser to be an accredited investor at the time of the sale of the securities, then the issuer would not lose the ability to rely on proposed Rule 506(c) if in fact an investor is not an accredited investor.

C. Impact on Privately Offered Funds

Privately offered funds, such as hedge funds, venture capital funds and private equity funds, generally rely on one of two exclusions from the definition of "investment company" under the Investment Company Act of 1940, as amended ("1940 Act"), set forth in Section 3(c)(1) and Section 3(c)(7) of the 1940 Act. Section 3(c)(1) and 3(c)(7) both preclude an issuer who is relying on these exclusions from making a public offering of its securities. In proposing Rule 506(c), the SEC states its view that the JOBS Act intended to permit privately offered funds to make general solicitations without losing the ability to rely on either of these exclusions under the 1940 Act.

As a result, private funds that engage in general solicitation and advertising in accordance with proposed Rule 506(c) would be able to continue to rely on the exceptions afforded by sections 3(c)(1)

and 3(c)(7) of the 1940 Act. Once Rule 506(c) is adopted and becomes effective, private fund advisers may be able to conduct public advertising campaigns for their funds by taking out advertisements, discussing funds in media interviews, and sponsoring seminars and other broad-based capital raising meetings. The ability to advertise may prove of particular benefit to new and/or small funds that lack name recognition by allowing such funds to target a broader audience of prospective investors and potentially attract interest in otherwise inaccessible markets. Private fund advisers should keep in mind, however, that any such advertisements or solicitations will still be subject to the antifraud provisions of the Investment Advisers Act of 1940 and rules promulgated thereunder, which include prohibitions against the use of testimonials, past specific recommendations and restrictions on the presentation of performance data in connection with the offer and sale of private fund securities and the investment activities of private funds. In addition, the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 thereunder, would apply to the offer and sale of private fund securities and the funds' investment activities relating to the purchase of sale of securities. Finally, fund sales materials and efforts used by broker-dealers that are members of FINRA will need to comply with applicable FINRA rules and policies.

D. Changes to Form D

The proposed rules amend Form D, which issuers must file with the SEC (and as required with state securities authorities) when offering securities made without registration under the Securities Act in reliance on an exemption provided by Regulation D. The revised form would include a new separate box for issuers to check if they are claiming the new Rule 506(c) exemption that would permit general solicitation and general advertising.

II. 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 Qualified Institutional Buyers[4] ("QIBs"). Resales to QIBs in accordance with the conditions of Rule 144A are exempt from registration under Section 4(a)(1) of the Securities Act, which exempts transactions by any person "other than an issuer, underwriter, or dealer." Although Rule 144A does not include an express prohibition against general solicitation or advertising, offers of securities under Rule 144A currently must be limited to QIBs, which has the same practical effect.

A. Offers to Persons Other Than Qualified Institutional Buyers

Section 201(a)(2) of the JOBS Act directs the SEC 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. Under the proposed rules, resales of securities pursuant to Rule 144A could be conducted using general solicitation or advertising, so long as the purchasers are limited in this manner.

The standards for reasonably determining whether a purchaser is a QIB, contained in Rule 144A(d), remain unchanged.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Arthur Zwickel
1.213.683.6161
artzwickel@paulhastings.com

New York

Michael Rosella
1.212.318.6800
mikerosella@paulhastings.com

Domenick Pugliese
1.212.318.6295
domenickpugliese@paulhastings.com

Michael Zuppone
1.212.318.6906
michaelzuppone@paulhastings.com

Jacqueline May
1.212.318.6282
jacquelinemay@paulhastings.com

Christopher Tafone
1.212.318.6052
christophertafone@paulhastings.com

San Francisco

David Hearth
1.415.856.7007
davidhearth@paulhastings.com

Mitchell Nichter
1.415.856.7009
mitchellnichter@paulhastings.com

Washington, D.C.

Wendell Faria
1.202.551.1758
wendellfaria@paulhastings.com

[1] For the full text of the SEC Release, see http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

[2] An "accredited investor" is defined in Rule 501 of Regulation D and generally includes: (a) a bank or savings and loan association, a registered broker or dealer, insurance company, registered investment company, business development company, or small business investment company; (b) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if the investment decisions are made by a plan fiduciary or if the plan has total assets in excess of $5 million; (c) a charitable organization, corporation, or partnership with assets exceeding $5 million; (d) a director, executive officer, or general partner of the issuer (or a director, officer, or general partner of the general partner of the issuer); (e) an entity in which all the equity owners are accredited investors; (f) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person; (g) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year; or (h) a trust with assets in excess of $5 million whose purchases are directed by a sophisticated person (See note 3 below).

[3] Under Rule 506(b)(2)(ii), non-accredited investors must be "sophisticated" in that they must possess, or the issuer must reasonably believe that the non-accredited investor possesses, either alone or with his or her purchaser representative, such knowledge or experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment.

[4] The term "qualified institutional buyer" is defined in Rule 144A(a)(1) and includes specified institutions that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with such institutions. Banks and other specified financial institutions must also have a net worth of at least $25 million. A registered broker-dealer qualifies as a QIB if it, in the aggregate, owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the broker-dealer.