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September 11, 2012

Alert
SEC Disclosure and Corporate Governance

SEC Proposes Amendments to Rule 506 and Rule 144A to Permit General Solicitation in Private Offerings

- **Ban on general solicitation and advertising use in private offerings would not apply to such offerings under proposed new Rule 506(c)**
- **Rule 506(c) offerings using general solicitation/ advertising require the issuer to take "reasonable steps to verify" that all purchasers are accredited investors**
- **Issuers that prefer to conduct "quiet" private placements can continue to do so without taking "reasonable steps to verify"**
- **Offers under amended Rule 144A can be made to persons other than QIBs, as long as securities are sold only to persons the seller (or person acting on its behalf) reasonably believes are QIBs**
- **Private funds can make a general solicitation under amended Rule 506 without losing Investment Company Act exclusions from registration**

In the first round of rulemaking under the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), the Securities and Exchange Commission ("SEC") recently issued what Chairman Mary Schapiro described as a "narrow proposal" to implement Congress's mandate – set forth in Section 201(a) of the JOBS Act – that the agency eliminate the existing ban on use of general solicitation and/or general advertising applicable to unregistered offerings made in reliance upon non-exclusive safe harbors set forth in each of Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (the "Securities Act"). If adopted substantially as proposed, these amendments would follow the statutory directive to focus exclusively on the status of actual purchasers of securities without regard to the manner of offering, subject to specified conditions discussed below. There is an abbreviated comment period of thirty days, with comments due on or before October 5, 2012 (30 days after the proposal was published in the Federal Register). A copy of the SEC proposing release, which was posted on the SEC's web site on the date of the SEC vote, August 29, 2012 ("Proposing Release"), is available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

The critical aspects of the Proposing Release are summarized immediately below, followed by a more detailed discussion of the specific proposed amendments:

- A new, non-exclusive Rule 506(c) has been proposed that would enable issuers, for the first time, to use general solicitation/advertising techniques to offer securities to anyone, so long as these essential conditions are met:
  - (i) all purchasers in a particular offering must be "accredited investors" as the term is defined in Rule 501(a) of Regulation D,[1] which means that each such purchaser either must fall within one of the enumerated categories of individuals or entities deemed to qualify as an "accredited investor," or the issuer must "reasonably believe" that the purchaser is an "accredited investor" at the time of sale (even if he, she or it is not);
  - (ii) the issuer must take "reasonable steps to verify" that all purchasers of the securities are accredited investors; and
  - (iii) all other applicable provisions of Regulation D are met (e.g., limits on resale of "restricted securities," non-integration with other offerings).

- Those issuers that choose not to employ general solicitation and/or general advertising techniques may continue to conduct private placements in reliance upon either or both "old" Rule 506, which would be re-codified in new Rule 506(b)(still allowing offers/sale to be made to up to 35 non-accredited, but "sophisticated," investors if certain informational and other requirements are satisfied), or/and the existing statutory private placement exemption set forth in Section 4(a)(2) of the Securities Act.
- Resales of specified "restricted securities" could be made to qualified institutional buyers, or "QIBs," in reliance upon Rule 144A (as proposed to be amended), even if offers are made to non-QIBs by means that include general solicitation and/or general advertising.
- Privately offered funds, such as private equity funds, venture capital funds and hedge funds, may continue to rely on the Section 3(c)(1) and 3(c)(7) exclusions from registration under the Investment Company Act of 1940 ("Investment Company Act"), even if they engage in general solicitation or general advertising.
- Use of general solicitation/general advertising in a Rule 144A transaction in the United States would not cause this transaction to be integrated with a concurrent offering conducted abroad in compliance with Regulation S under the Securities Act.

Proposed Amendments to Rule 506 and Form D

Some General Observations

To date, the most controversial aspect of Section 201(a)'s mandate that the SEC permit general solicitation and/or general advertising in Rule 506 and Rule 144A offerings has been the "reasonable steps to verify" element, which would apply only to issuer private placements accompanied by general solicitation/advertising under amended Rule 506. Section 201(a) does not specify the methods required to satisfy this reasonable verification standard, but merely directs that issuers use "such methods as determined by the Commission." As discussed further below, the SEC has chosen not to prescribe any such methods, proposing instead an objective, "facts-and-circumstances" analysis and outlining some guidance as to its application.

Another knotty question left unanswered by Congress in Section 201(a): what are the consequences of selling securities to an ineligible (i.e., non-accredited) investor under liberalized Rules 506 and 144A? We anticipate that many commenters will ask the SEC to clarify that sales to ineligible purchasers in an offering accompanied by general solicitation/advertising should not trigger loss of either the new Rule 506(c) or revised Rule 144A exemptive safe harbors if the issuer or other seller (as the case may be) reasonably believed that such ineligible purchasers were "accredited investors" or QIBs, respectively, at the time of sale.

Nor is it entirely clear from the statute, at least in the view of some, whether the "reasonable steps to verify" standard of Section 201(a) somehow affected, or perhaps even superceded, the current "reasonable belief" standard that is incorporated into the definition of "accredited investor" set forth in Rule 501(a) of Regulation D. More specifically, this definition includes persons or entities that come within any of the enumerated categories of accredited investors,[2] as well as any person or entity that the issuer "reasonably believes comes within any of the [enumerated] categories" at the time of sale to that person or entity. Fortunately for issuers, the SEC indicated in the Proposing Release that nothing in Section 201(a) changes the investor eligibility criteria outlined in Rule 501(a), meaning that the new

Rule 506(c) safe harbor (as proposed) will not be lost if an issuer were to sell securities to a non-accredited investor, so long as the issuer reasonably believed at the time of sale that the investor was "accredited," and otherwise took the necessary "reasonable steps to verify" that investor's status as "accredited."

Finally, the SEC answered a question that was not addressed in the final version of the JOBS Act signed into law by the President, while acknowledging that at least some in Congress appeared to have considered the question as reflected by the language of certain predecessor bills:[3] whether issuers would be able to make "quiet" private placements if they preferred to forego use of general solicitation/advertising.[4] According to the SEC, Section 201(a) did not affect the statutory exemption codified in Section 4(a)(2)(formerly Section 4(2)) of the Securities Act, and likewise did not preclude the SEC from preserving, in a successor to "old" Rule 506 (in the form of proposed Rule 506(b)), "the existing ability of issuers to conduct Rule 506 private offerings without the use of general solicitation."[5] As a result, "issuers that either do not wish to engage in general solicitation in their Rule 506 offerings (and become subject to the new requirement to take reasonable steps to verify the accredited investor status of purchasers) or wish to sell privately to non-accredited investors who meet Rule 506(b)'s sophistication requirements)[],"[6] may still do so.

Reasonable Steps to Verify Accredited Investor Status – Factors to Consider in the Determination

Proposed Rule 506(c) would require that issuers using general solicitation/advertising "take reasonable steps to verify" that the purchasers of the offered securities are accredited investors. The SEC deliberately chose not to propose either a uniform verification method or a non-exclusive menu of specified methods for satisfying the proposed "reasonable" verification standard. Instead, under the proposed approach, the determination of whether the verification steps taken in a given transaction are "reasonable" would be based on an objective analysis by the issuer of the particular facts and circumstances surrounding that transaction. In this regard, the SEC observed that "many current practices currently used by issuers … in existing Rule 506 offerings would satisfy the verification requirement proposed for offerings pursuant to Rule 506(c)."[7] On the other hand, the SEC warned that self-certification alone is unlikely to be sufficient in situations where the issuer "solicits new investors through a website accessible to the general public or through a widely disseminated e-mail or social media solicitation…."[8] Underscoring the need for careful documentation (more on this below), the highly fact-specific nature of the diligence inquiry demanded as a condition to use of publicity in this context may well be susceptible to "20/20 hindsight" assessment.

The Proposing Release outlines the following three-pronged menu of illustrative factors intended to facilitate an issuer's analysis of what "reasonable" measures should be taken in a particular offering to verify that each purchaser qualifies as an "accredited investor" which, under the applicable Rule 501(a) definition, means that each such purchaser actually falls within one or more of the Rule 501(a)-enumerated categories, or the issuer has a "reasonable belief" that this is the case at the time of sale:

- **The nature of the purchaser and the type of accredited investor the purchaser claims to be**. The SEC expects that the accredited investor verification steps would vary depending on the type of accredited investor the purchaser claimed to be. For example, what will be considered reasonable in verifying that a broker-dealer registered with the SEC and FINRA is an accredited investor necessarily will differ from what would be reasonable to verify the eligibility of a natural person under the relevant Rule 501(a) net worth and/or annual income categories.

- **The amount and type of information the issuer has about the purchaser.** The more information that an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps the issuer would have to take to verify the purchaser's eligibility, and vice versa. The Proposing Release offers a non-exhaustive list of examples of the types of information an issuer could review or rely upon in undertaking the "reasonable steps to verify" analysis, any one of which might be sufficient under a particular set of facts and circumstances:
  - Publicly available information filed with a federal, state or local regulatory body (e.g., the purchaser is a named executive officer of reporting company and his or her compensation is disclosed in the company's proxy statement);
  - Third-party information that provides "reasonably reliable" evidence that the person falls within an enumerated category of the accredited investor definition (e.g., Forms W-2 or trade publications disclosing average compensation for employees in the purchaser's field and at the purchaser's level of employment); or
  - Verification of the purchaser's status by a third-party (e.g., a broker-dealer, attorney or accountant), provided that the issuer has a reasonable basis to rely on such third-party verification.
- **The Nature and Terms of the Offering.** The means through which the issuer publicly solicits purchasers may be relevant in determining the reasonableness of steps taken to verify a particular purchaser's accredited investor status. An issuer that solicits new investors via a website accessible to the general public, or a widely-disseminated e-mail or social media solicitation, likely would be required to take more stringent verification measures than an issuer that solicits purchasers included in a database of pre-screened accredited investors maintained by a "reasonably reliable" third-party such as a registered broker-dealer. Depending on the facts, the terms of an offering also may be relevant. To illustrate, "the ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors could reasonably be expected to meet it, with a direct cash investment that is not financed by the issuer or any other third party, could be taken into consideration in verifying accredited investor status."[9]

The Proposing Release emphasizes that the non-exclusive menu of factors discussed above are interconnected, and that the information gained from examining these factors would help an issuer assess the reasonable likelihood that a prospective purchaser is an accredited investor. This assessment, in turn, would affect the types of steps that would be considered reasonable for an issuer to take in order to verify the purchaser's accredited investor status.

Whatever the steps taken in a specific offering to verify that a purchaser qualifies as "accredited" pursuant to the Rule 501(a) definition, the "reasonableness" of these steps may be challenged after the fact. In this connection, the SEC cautions that it is important for issuers to retain adequate records to document those steps that were taken to verify a purchaser's accredited investor status. As the SEC aptly points out, the issuer ultimately will bear the burden in a litigation context of establishing the availability of an exemption from the registration provisions of the Securities Act.

Form D Check Box for Rule 506(c) Offerings

The SEC has proposed a revision to Form D to amend the current Rule 506 check box that would require issuers to indicate specifically whether they are relying on the proposed Rule 506(c) exemption.

An issuer that prefers a "quiet" private placement would check the proposed Rule 506(b) box, highlighting (however unintentionally) the SEC's belief that the two exemptive rules are mutually exclusive in operation if communications that constitute general solicitation/advertising are implicated.

Notably, the SEC has not proposed to elevate the Form D filing obligation (set forth in Rule 503) to the level of a condition to reliance on either Rule 506(c) or 506(b), which means that the exemption invoked is not necessarily lost if a Form D were not filed (this approach, of course, is not recommended). According to the Proposing Release, the purpose of this proposed amendment is to assist the SEC in gathering information needed to monitor the use of general solicitation/advertising in Rule 506(c) offerings, gauge the size of this new "offering market," and examine the effectiveness of issuer accredited investor verification practices in excluding non-accredited investors.

Applicability of Amended Rule 506 to Private Funds

Private investment funds (including private equity, hedge funds and venture capital funds) rely on two primary exclusions from the definition of "investment company" subject to registration under the Investment Company Act – Section 3(c)(1) for private funds with fewer than 100 beneficial owners, and Section 3(c)(7) for private funds whose beneficial owners are "qualified purchasers." Both exclusions are conditioned upon the private fund not engaging, or proposing to engage, in a public offering of its securities. While the JOBS Act directs the SEC to eliminate the prohibition against general solicitation/general advertising for a new subset of Rule 506 offerings, it does not expressly address the interrelationship between proposed Rule 506(c) and Sections 3(c)(1) and 3(c)(7). However, Section 201(b) of the JOBS Act does provide that a Rule 506 offering that utilizes methods constituting general solicitation and/or general advertising will not be deemed to be a public offering "under the Federal securities laws." In the Proposing Release, the SEC confirmed its belief that the effect of Section 201(b) is to permit private funds "to make a general solicitation under amended Rule 506 without losing either of these exclusions under the Investment Company Act." Thus, private funds will be able to engage in general solicitation and general advertising to raise capital without risking the loss of either exclusion from registration under the Investment Company Act – provided that the issuer otherwise has complied with the conditions to reliance upon proposed Rule 506(c).

Private funds that rely on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act are currently permitted to sell interests to their "knowledgeable employees" without counting such employees toward the 100 beneficial owner restriction or the "qualified purchaser" requirements of Sections 3(c)(1) or 3(c)(7), respectively. In practice, this means that private funds can sell interests to knowledgeable employees regardless of whether such employees are "accredited investors." Under proposed Rule 506(c), however, private funds that engage in general solicitation/advertising with respect to an offering will only be permitted to sell fund interests to "knowledgeable employees" who are also "accredited investors." The SEC declined the request of certain pre-rulemaking commenters to revise the accredited investor definition in Rule 501(a) to include "knowledgeable employees."

Following recent changes in the regulation of commodities pool operators and commodity trading advisors as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, many private investment funds intend to rely on Rule 4.13(a)(3) of the Commodity Exchange Act (the "Commodity Exchange Act"), which provides a registration exemption for commodity pool operators that use commodity interests on a limited basis, if the pool is offered only to accredited investors, knowledgeable employees and certain "qualified eligible" persons. Rule 4.13(a)(3) includes a

restriction against "marketing to the public." In addition, Rule 4.7 of the Commodity Exchange Act provides an exemption from certain requirements for registered commodity pool operators and commodity trading advisors with respect to offerings to "qualified eligible persons" as defined under Rule 4.7(a)(3). In the adopting release for Rule 4.7, the Commodity Futures Trading Commission noted that in order to qualify for the exemption under Rule 4.7, the offering of the interests of the commodity pool would have to be done "in a manner consistent with the initial marketing limitations applicable to a private offering under [Section 4(a)(2)] of the Securities Act."[10] Therefore, it appears that, absent future guidance from the Commodities Futures Trading Commission to the contrary, private funds which intend to claim a Rule 4.13(a)(3) or Rule 4.7 exemption may not be able to use general solicitation and general advertising pursuant to proposed Rule 506(c).

Private funds that intend to use general solicitation and general advertising under Rule 506(c)(assuming its adoption substantially as proposed) should keep in mind that all such communications are subject to the anti-fraud provisions of the federal securities laws (including Rule 10b-5 under the Securities Exchange Act of 1934 and Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act")), as well as other provisions of the Advisers Act such as the advertising rules and the recordkeeping rules. It is likely that the SEC will scrutinize the content and use of such communications in connection with the SEC staff's periodic audits of registered investment advisers and otherwise.

Proposed Amendment to Rule 144A

Offers to Persons other than QIBs

Section 201(a)(2) of the JOBS Act directs the SEC to revise Rule 144A(d)(1) to provide that eligible securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation or general advertising, so long as these securities are sold only to persons that the seller (and any person acting on the seller's behalf) reasonably believes is a QIB. Because there is no express reference to the terms "general solicitation" or "general advertising" in existing Rule 144A – instead, Rule 144A(d)(1) simply bars offers and sales to non-QIBS – the SEC has proposed amending Rule 144A(d)(1) to eliminate the references to "offer" and "offeree." As proposed to be amended, the rule would require only that the securities are sold to a QIB or to a purchaser that the seller (and any person acting on the seller's behalf) reasonably believes is a QIB.

Integration with Offshore Regulation S Offerings

Regulation S provides both a primary and a resale safe harbor for offers and sales of securities outside the United States. Two general conditions apply to both safe harbors: (i) the securities must be sold in an offshore transaction and (ii) there can be no directed selling efforts in the US. The Section 201(a) mandate to permit the use of general solicitation/general advertising in transactions under Rule 506 and Rule 144A raised questions about whether these public solicitation techniques would constitute "directed selling efforts" proscribed by Regulation S, thereby impairing issuers' ability to engage in concurrent unregistered offerings conducted within and outside the US. In the Proposing Release, the SEC confirmed the application of its longstanding position that that offshore offerings conducted in compliance with the conditions of Regulation S will not be integrated with concurrent US offerings accompanied by general solicitation/advertising in accordance with amended Rule 506/ Rule 144A.

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any of the following:

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We thank our colleagues Adé Heyliger and Venera Ziegler for their contributions to this Alert.

Endnotes

[1] There are eight categories of "accredited investor" set forth in Rule 501(a), Regulation D's definitional rule, along with a "catch-all" that brings within this defined term "any person … who the issuer reasonably believes comes within" any of the enumerated categories at the time of sale. Five of the eight enumerated categories are focused exclusively on institutional investors, while only two refer expressly to "natural persons" or individual investors – Rule 501(a)(5)(individual or joint net worth, with a spouse, of more than $1 million, excluding the value of the primary residence) and Rule 501(a)(6)(annual income in each of the two preceding fiscal years exceeding $200,000 – or combined income with a spouse in excess of $300,000 for each such year, and a reasonable expectation of reaching the same level in the current year).

[2] *See* endnote 1, above.

[3] *See* Proposing Release at 11n. 35 and accompanying text.

[4] According to the SEC, "[a]n issuer relying on Section 4(a)(2) is restricted in its ability to make public communications to attract investors for its offering because public advertising is incompatible with a claim of general solicitation under Section 4(a)(2)." *Id.* at 11 (citing Non-Public Offering Exemption, SEC Rel. No. 33-4552)[27 FR 11316]). *See also* Rules 502(c) and 506(b)(1) of Regulation D.

[5] Proposing Release at 12.

[6] *Id*.

[7] *Id.* at 25.

[8] *Id.* at 19.

[9] *Id.* at 20.

[10] *See* 57 FR 34853 (Aug. 7, 1992).