ADVISORY

SULLIVAN & WORCESTER LLP CORPORATE ADVISORY

SEC Proposes Rules Lifting Ban on General Solicitation and Advertising in Offerings under Rules 506 and 144A

The Securities and Exchange Commission has released proposed rules to lift the ban on general solicitation and general advertising[1] in connection with certain private securities offerings. The proposed rules stem from a mandate under the Jumpstart Our Business Startups Act (JOBS Act) that the SEC write new rules permitting general solicitation in certain Rule 506 and 144A offerings.

This advisory addresses only the portion of the JOBS Act related to Rules 506 and 144A. For more complete coverage and additional resources, including up-to-date JOBS Act news and in-depth analysis of the JOBS Act's other provisions, please visit our JOBS Act Resources Portal.

RULE 506

Securities may generally be sold in the United States only if the sales are registered with the SEC or their sale qualifies for one of a number of exemptions to registration. Rule 506 is one of these exemptions, and it operates as a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act of 1933. Rule 506 is popular because, unlike some other exemptions, there is no limit to the amount of capital it can be used to raise. However, one of the conditions for qualifying for the Rule 506 exemption is that potential purchasers of the securities sold thereunder who are not previously known to the company may not be solicited or introduced to the offering through advertising.

The JOBS Act directed the SEC to write rules permitting general solicitation under Rule 506 when securities are sold only to "accredited investors." Individuals or entities are accredited investors within the meaning of Rule 506 if the company reasonably believes they meet certain enumerated conditions.[2] For example, a natural person is an accredited investor if the company reasonably believes that the person has a net worth in excess of $1 million, or that the person's annual income is greater than $200,000 per year.

SEC Proposal. The SEC has proposed, among other things, adding a new subsection to Rule 506. New Rule 506(c) would operate separately and distinctly from the existing exemption (the requirements of which are set forth in Rule 506(b)), by permitting general solicitation with respect to offerings meeting its conditions, but preserving the existing safe harbor for companies not conducting general solicitation.

IF YOU WOULD LIKE ADDITIONAL INFORMATION, PLEASE CONTACT:

Howard E. Berkenblit
617 338 2979
hberkenblit@sandw.com

Kristen A. Young
617 338 2427
kyoung@sandw.com

Robert S. Hatfield
617 338 2446
rhatfield@sandw.com

BOSTON
Sullivan & Worcester LLP
One Post Office Square
Boston, MA 02109

NEW YORK
Sullivan & Worcester LLP
1633 Broadway
New York, NY 10019

WASHINGTON, DC
Sullivan & Worcester LLP
1666 K Street, NW
Washington, DC 20006

ISRAEL
Zysman, Aharoni, Gayer and Sullivan & Worcester LLP
41-45 Rothschild Blvd., Beit Zion
Tel Aviv, 65784 Israel

SULLIVAN & WORCESTER

As proposed by the SEC, Rule 506(c) would have three requirements:

- First, as directed by the JOBS Act, the company must take reasonable steps to verify that the purchasers of the securities are accredited investors. Notably, and as discussed below, the proposed rule does not contain a safe harbor for steps deemed to be considered "reasonable."
- Second, all purchasers of the securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the company reasonably believes that they do, at the time of the sale of the securities.
- Finally, certain terms and conditions which apply in traditional Rule 506 offerings will continue to apply to offerings under Rule 506(c), such as restrictions relating to the resale of the securities issued and SEC filing obligations, while others, such as information delivery requirements pertaining to sales to unaccredited investors, will not apply.

The SEC has deliberately eschewed bright-line rules regarding the reasonableness of the steps companies must take to verify purchasers' accredited investor status. Instead, it has stated a preference for an objective determination based on the facts and circumstances of each transaction. According to the SEC's commentary, such circumstances might 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 company 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.

In proposing a facts and circumstances test, the SEC rejected comments calling for mandatory verification procedures, as well as comments advocating rules that would make certain verification procedures categorically sufficient or insufficient. The SEC believes that the flexible approach it has proposed will permit the rules to adapt with changing market practices while promoting innovation. The SEC noted its expectation that many procedures currently in use will satisfy proposed Rule 506(c)'s verification requirement. It also noted the importance of companies' maintaining adequate documentation and records of the verification procedures they employ.

That said, the SEC did note that "[a]n issuer that solicits new investors through a website accessible to the general public or through a widely disseminated email or social media solicitation would likely be obligated to take greater measures to verify accredited investor status than 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." Given that the JOBS Act also provides for the ability of online platforms to pair investors and companies relying on 506(c) for purposes of issuing securities without registering as a broker or dealer, it seems curious that the SEC would not provide a safe harbor for what constitutes "reasonable steps" in the context of securities offered via a platform.[3] In its proposing release, the SEC merely stated that it does not believe that a company would have taken reasonable steps to verify an investor's status as an accredited investor if it required only that a person check a box in a questionnaire or sign a form, without other information indicating that the purchaser is an accredited investor.

In addition to the changes to Rule 506 itself, the SEC has proposed a corresponding revision to Form D, which must be filed with the SEC when a company offers or sells unregistered securities under a Regulation D exemption. The proposal calls for the addition of a check box that would require the company to indicate whether it is relying on the Rule 506(c) exemption.

While the flexibility in the proposed rules is appealing, the lack of a safe harbor may prove challenging for companies.

RULE 144A

Like Rule 506, Rule 144A is an exemption from the general requirement that sales of securities be registered. In its present form, it operates by permitting unregistered resales of restricted securities if they are offered and sold only to qualified institutional buyers (QIBs).[4] The safe harbor also applies to resales to those the seller or any person acting on its behalf reasonably believes are QIBs. Though Rule 144A does not expressly

prohibit general solicitation, sales of securities made in reliance on Rule 144A may only be offered to QIBs, thereby effectively restricting the communications that can properly be made to others.

The JOBS Act instructed the SEC to write new rules to allow securities sold in reliance on Rule 144A to be offered to persons other than QIBs, and by means that include general solicitation, provided that such securities are only sold to QIBs or to persons that the seller or someone acting on its behalf reasonably believes to be QIBs.

SEC Proposal. The SEC has proposed amending Rule 144A(d)(1), which enumerates the conditions a Rule 144A offering must meet, to eliminate references to "offer" and "offeree." Such revision would simply remove Rule 144A's offering restrictions while preserving its restriction on sales to persons other than QIBs or those reasonably believed to be QIBs. The SEC's proposal does not address steps to support a "reasonable belief" that a purchaser is a QIB.

PRIVATELY OFFERED FUNDS

The SEC has clarified that privately offered funds may engage in general solicitation under new Rule 506(c) without jeopardizing their exemptions from regulation under the Investment Company Act. Privately offered funds, which include many hedge funds, venture capital funds and private equity funds, are generally not subject to regulation under the Investment Company Act. This is because such funds are able to qualify for certain exclusions from the definition of "investment company" under the Investment Company Act. To qualify for these exclusions, entities must not engage in public offerings. Some commenters on the JOBS Act were concerned that a privately offered fund that engaged in general solicitation under Rule 506(c) could be deemed to have made a public offering and would lose its ability to rely on such exclusions.

In its proposing release, the SEC interprets Section 201(b) of the JOBS Act, which provides that offerings under new Rule 506(c) will not be considered public offerings under federal securities laws, to permit privately offered funds to engage in general solicitation under Rule 506(c) without losing their ability to rely such exclusions.

INTEGRATION WITH REGULATION S OFFSHORE OFFERINGS

The impending repeal of the ban on general solicitation in Rule 506 and 144A offerings has created tension with Regulation S. Regulation S excludes from the registration requirements certain offers and sales of securities that take place outside of the United States. For purposes of the exemption, an offer or sale of a security is deemed to take place outside of the United States if: (1) the offer or sale is made in an offshore transaction and (2) no directed selling efforts are made in the United States. With the enactment of the JOBS Act, there has been concern that engaging in general solicitation, once permitted under Rules 506(c) and 144A, will preclude reliance on Regulation S because such solicitation could be considered a prohibited directed selling effort. In its proposing release, the SEC confirmed that Regulation S offerings would not be integrated with concurrent Rule 506(c) or 144A offerings. More specifically, a company will be able to undertake general solicitation under Rule 506(c) or 144A for a domestic offering without compromising its reliance on Regulation S for a simultaneous offshore offering.

* * * * *

The proposed rules are subject to comment until October 5, 2012, after which the SEC is expected to act quickly to consider the comments received and issue final rules.

* * * * *

To obtain further information about the JOBS Act, other SEC rules, private placements, or securities offerings generally, please contact the lawyer at Sullivan & Worcester LLP with whom you regularly consult, or any of the lawyers listed above.

---

[1] We refer to general solicitation and general advertising collectively as general solicitation in this advisory.

[2] For more details concerning recent changes to the accredited investor definition, see our advisory "Companies Raising Capital Now Have a Smaller Pool of Investors to Choose From."

[3] For more information about Rule 506 offerings via platforms, please refer to our advisory "'Private' Capital-Raising Under the JOBS Act."

[4] QIBs are certain investment companies, banks, registered dealers, and large institutional investors (such as insurance companies, employee benefit plans, and investment advisers), which large institutional investors, acting for their own account or the accounts of other QIBs, in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the investing entity.