Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS SEPTEMBER 10, 2012

The SEC Proposes Rules to Allow General Solicitation and Advertising in Certain Private Securities Offerings

The Securities and Exchange Commission (the *"SEC"*) recently proposed rules to eliminate the prohibition against general solicitation and general advertising in securities offerings conducted in reliance on Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (the *"Securities Act"*), as directed by the Jumpstart Our Business Startups Act (the *"JOBS Act"*). The proposed rules are intended to create increased opportunities for private companies, including private funds, to reach a larger and broader potential investor audience. Comments on the proposed rules are due by October 5, 2012.

The SEC Release containing the proposed rules is available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf. For information on the JOBS Act, please see our April 2012 client alert available at http://www.chapman.com/media/news/media.1171.pdf.

If adopted, the proposed rules would:

- permit the use of general solicitation and advertising to offer and sell securities under Rule 506, provided that (i) the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors, (ii) all purchasers are in fact accredited investors at the time of sale (or the issuer reasonably believes they are), and (iii) all other applicable existing terms and conditions of Regulation D are satisfied; and
- allow securities sold pursuant to Rule 144A to be offered to persons other than qualified institutional buyers ("QIBs"), including by means of general solicitation and 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 QIBs.

Proposed Amendments to Rule 506 of Regulation D

As mandated by the JOBS Act, the SEC has proposed amendments to Rule 506 of Regulation D (*"Rule 506"*) which, if adopted, would permit the use of general solicitation and advertising in offerings and sales of securities under Rule 506, provided the following conditions are satisfied:

- the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;
- all purchasers of the securities are accredited investors at the time of sale of such securities, either because they come within one of the enumerated categories of persons that qualify as accredited investors or because the issuer reasonably believes they do; and
- all other applicable existing terms and conditions of Regulation D are satisfied.[1]

Reasonable Steps to Verify Accredited Investor Status

Rather than proposing specific methods that an issuer could use to verify the accredited investor status of purchasers in a Rule 506 offering that uses general solicitation and advertising, the SEC is proposing a

1 The SEC is also proposing to amend Form D—the notice required to be filed with the SEC by each issuer claiming a Regulation D exemption—to add a check box to indicate whether an offering is being conducted pursuant to the proposed amendment to Rule 506 that would permit general solicitation.

requirement that issuers using general solicitation "take reasonable steps to verify" that purchasers of the securities are accredited investors. The SEC indicates that the determination of what constitutes "reasonable" steps for verification purposes will depend on the particular facts and circumstances of each transaction. In many cases, such determination will likely require verification beyond self-certification by purchasers of their accredited investor status. As such, the SEC provides that an issuer should consider a number of factors, including:

- 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.

The SEC acknowledges that the steps that would be reasonable for an issuer to take to verify whether a purchaser is an accredited investor would likely 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 checking FINRA's BrokerCheck website) would necessarily differ from the steps that would be reasonable to verify whether a natural person is an accredited investor, since verifying the accredited investor status of natural persons—which implicate individual or joint net worth and income tests—likely poses greater practical difficulties.

The SEC indicates that an issuer may be able to take fewer steps than otherwise necessary to verify the accredited investor status of a prospective purchaser depending on the amount of information it has indicating that the purchaser is an accredited investor. Examples of the types of information that issuers could review (any of which might, depending on the circumstances, in and of themselves constitute reasonable steps to verify a purchaser's accredited investor status) include information publicly available in filings with a federal, state or local regulatory body, such as the SEC; Forms W-2 provided by a natural person; and other verification provided by a third party such as a broker-dealer, attorney or accountant.

In addition, the nature and terms of the offering may be relevant in determining the reasonableness of the steps taken to verify accredited investor status. For instance, an issuer that solicits new investors through a website accessible to the general public 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 reliable third party such as a registered broker-dealer. The SEC states in the proposed rules that it does not believe that an issuer would have taken reasonable steps to verify accredited investor status in an offering involving solicitation through such a website or through, for example, a widely disseminated email or social media solicitation, if it required only that a person check a box in a questionnaire or sign a form. A purchaser's ability to meet a high minimum investment amount in an offering could also be taken into consideration in verifying accredited investor status, assuming a direct cash investment that is not financed by the issuer or any other third party. In any case, an issuer should retain adequate records that document any steps it has taken to verify that a purchaser was an accredited investor at the time of sale of the securities.

The SEC indicates that it is mindful of the differing views and concerns expressed by commentators to date on how the SEC should implement the verification mandate included in the JOBS Act—many cautioning that the SEC should avoid unduly prescriptive or burdensome verification requirements while others advocating that the SEC should enhance current practices or standards.[2] The SEC believes that its reasonable-steps-to-verify approach appropriately addresses these competing concerns by obligating issuers to take steps to verify accredited investor status without requiring them to follow uniform verification methods that may be ill-suited or unnecessary to a particular offering or purchaser under the facts and circumstances. The SEC does anticipate that many practices currently used by issuers in connection with existing Rule 506 offerings would likely satisfy the proposed verification requirements.

Preservation of Current Rule 506 Offerings

Issuers may continue to conduct traditional Rule 506 offerings without the use of general solicitation or advertising, even after any proposed rule changes are adopted. As such, issuers that do not wish to engage in general solicitation or advertising in their Rule 506 offerings would not become subject to the new requirement to take reasonable steps to verify the

2 To facilitate public input on JOBS Act rulemaking before the issuance of rule proposals, the SEC invited members of the public to make their views known on various JOBS Act initiatives in advance of any rulemaking by submitting advance comment letters to the SEC.

accredited investor status of purchasers. Such issuers, however, would still be required to reasonably believe that a purchaser is an accredited investor at the time of sale. Additionally, such issuers may continue to offer securities to up to 35 non-accredited investors who meet specified sophistication requirements (in addition to any accredited investors).

Private Funds

Many private funds, such as hedge funds, that rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 conduct offerings under Rule 506. These sections prohibit such funds from making a public offering of their securities. The SEC Release makes clear that general solicitation and advertising pursuant to the proposed changes to Rule 506 will not be deemed a public offering under the Federal securities laws and, therefore, private funds relying on Section 3(c)(1) or 3(c)(7) will not lose their status as private funds should they engage in such general solicitation or advertising.

The SEC Release, however, does not address whether general solicitation and advertising under the proposed changes to Rule 506 will preclude the adviser or sponsor of a fund from relying on certain exemptions from commodity pool operator ("CPO") registration. For instance, the exemption from registration as a CPO under CFTC Rule 4.13(a)(3) requires that interests in a fund be offered and sold without marketing to the public in the United States, which presumably prohibits the type of solicitation and advertising that would be allowed under the proposed rules for a Rule 506 offering. There are similar uncertainties regarding the implication of the proposed rules on the availability of the exemption from certain CPO requirements available under CFTC Rule 4.7(b). Advisers and sponsors of private funds relying on CFTC Rule 4.13(a)(3) or CFTC Rule 4.7(b) may wish to avoid engaging in general solicitation or advertising on behalf of such funds until further guidance is available.

Proposed Amendments to Rule 144A

As mandated by the JOBS Act, the proposed rules 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 the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. As amended, therefore, resales of securities pursuant to Rule 144A could be conducted using general solicitation and advertising, so long as the actual purchasers are limited in this manner.

Unlike the proposed amendments to Rule 506, the proposed amendments to Rule 144A would not impose investor verification requirements on any person in connection with the offer and sale of securities in reliance on Rule 144A. As noted above, however, sellers of securities in Rule 144A offerings would still be required to reasonably believe that actual purchasers are QIBs.[3]

Integration of Proposed Amendments with Regulation S

The SEC Release makes clear that offshore offerings conducted in accordance with Regulation S will not be integrated with unregistered domestic offerings made under Rule 506 or Rule 144A, as proposed to be amended. Accordingly, issuers would be able to generally solicit investors in a domestic offering under Rule 506 or Rule 144A that is conducted concurrently with an offshore offering made in compliance with Regulation S without violating the condition in Regulation S that prohibits directed selling efforts in the United States.

3 Rule 144A currently provides a list of non-exclusive methods of establishing a prospective purchaser's ownership and discretionary investments of securities for purposes of determining whether a prospective purchaser is a QIB. For example, a seller and any person acting on its behalf may rely on a prospective purchaser's publicly available financial statements, information contained in certain other public documents, or on a certification as to such matters by the chief financial officer or other executive officer of the purchaser. The SEC solicits comment on how well this non-exclusive list has worked in practice.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Corporate Finance and Securities Department or visit us online at chapman.com.

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