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The elimination of the prohibition on general solicitation and general advertising will result in issuers being able to attract a wider variety of investors with less cost. Increased competition for quality investments could also improve terms for issuers, reducing their cost of capital.

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SEC Rule Proposal Would Permit Public Offerings in "Private Placements" and Facilitate Capital Formation

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Would eliminate the prohibition on general solicitation and advertising for offerings exempt from registration by Rules 506 and 144A under the Securities Act of 1933

Would allow securities to be offered publicly without registration, as long as all purchasers are "accredited investors"

As required by the JOBS Act, the U.S. Securities and Exchange Commission (SEC) has proposed rules to eliminate the prohibition on general solicitation and general advertising in private placements exempt from registration by Rule 506 under the Securities Act of 1933, as long as all purchasers of the securities are accredited investors. The proposal would eliminate the major obstacle to companies' alerting potential investors of proposed transactions. Adoption of the proposed rules would make it easier, faster and cheaper for businesses of all sizes to raise capital, and for investors to find suitable investment opportunities. Further, these new rules would permit investment funds and others seeking to raise pools of capital to avail themselves of the new solicitation and advertising regime.

The SEC estimates that almost $900 billion was raised by businesses through exempt "Reg D" private placements in 2011. These private placements generally require a preexisting relationship between the issuer or its agent and potential investors because, under the existing Reg D regime, issuers cannot lawfully advertise their private placements on the Internet or through any other means or media. The proposed SEC rules would eliminate all of these restrictions. Once finalized and approved, these rules would allow an issuer that "reasonably believes" all purchasers of its securities are accredited investors to raise capital without SEC registration.

These proposed rules represent a victory for those raising capital. The SEC has not proposed to create any additional specific rigid requirements for confirming accredited investor status, instead proposing to rely on a "facts and circumstances" analysis. Issuers would continue to be responsible for assuring compliance with the standards provided in the rules.

Proposed Rules[1]

Amendment to Rule 506

The SEC's proposed rules would permit the use of general solicitation or general advertising to offer and sell securities, as long as the following conditions are satisfied:[2]

- all purchasers must be accredited investors (or, at least, that the issuer reasonably believes them to be accredited investors);[3]
- the issuer must take reasonable steps to verify that all purchasers are accredited investors; and
- the issuer must satisfy the requirements of Rules 501, 502(a) and 502(d) of Regulation D, including limitations on the resale of securities acquired in reliance on Rule 506(c).

Compliance with proposed Rule 506(c) does not require compliance with Rule 502(c), the provision that currently prohibits general solicitation and general advertising under Rule 506. The SEC did not propose specific factors or procedures for determining what qualifies as reasonable steps to verify accredited investor status. The SEC provided some general suggestions[4] and concluded that determinations should be reached objectively on a case-by-case basis in order to provide flexibility and aid the development of different approaches in order to adapt to market practices. The SEC further noted that many practices currently used by issuers to establish accredited investor status would satisfy the verification requirement of the proposed rules.

In its proposal, the SEC seeks to preserve under Rule 506(b) the existing exemption for offers and sales of securities without the use of general solicitation and general advertising. Rule 506(b) would continue to allow an issuer to sell securities to an unlimited number of accredited investors and no more than 35 other purchasers (as long as the issuer reasonably believes the non-accredited investors possess financial knowledge and sophistication).

Amendment of Form D

The SEC proposes to amend Form D to require issuers to designate whether an offering meets the requirements of Rule 506(b) or Rule 506(c), which will aid the SEC in tracking these types of offerings.

Amendment of Rule 144A

Rule 144A under the Securities Act grants an exemption from registration for resales of securities to purchasers that are qualified institutional buyers, or QIBs (or those reasonably believed to be QIBs).[5] While Rule 144A does not include an express prohibition on the use of general solicitation or general advertising in connection with offers or sales of securities, offers and sales can be made only to QIBs. Thus, as a practical matter, a seller of securities seeking to avail itself of the exemption provided by Rule 144A cannot currently employ general solicitation or general advertising because offers to non-QIBs would void the exemption.

The SEC's proposal to amend Rule 144A would require only that the securities are sold to a purchaser that is a QIB or that the seller and any person acting on its behalf reasonably believes is a QIB. Thus, as proposed, Rule 144A would permit securities to be offered to QIBs and non-QIBs alike, as long as the purchasers of the securities are QIBs. By expressly permitting offers to non-QIBs, amended Rule 144A would permit the use of general solicitation and general advertising in connection with Rule 144A transactions.

Significance of Strict Compliance with Requirements

While Rule 506 is not an exclusive exemption, the failure to verify accredited investor status and thus satisfy the requirements of proposed Rule 506(c) would vitiate the applicability of the Rule 506(c) exemption and leave no other exemption available for offerings using a general solicitation. (Under similar circumstances in offerings not involving a general solicitation, issuers typically seek another exemption from the Securities Act's registration requirements that would be available for the related offers and sales.) As a practical matter, the use of general solicitation or general advertising likely would render the issuer unable to avail itself of any other exemptions from registration under the Securities Act because no other exemptions from registration permit a general solicitation. Accordingly, it would be essential for an issuer to comply strictly with each requirement of Rule 506(c); otherwise, the issuer would likely violate the registration requirements of the Securities Act and be required to offer rescission to the purchasers in order to address the violation.

Potential Impact

The impact of the proposed rules could be far-reaching. Most significantly, issuers would be able to offer their securities to anyone and everyone, whether through television or newspaper advertising, on their own websites, on third-party websites or through other media. With the new option of using general solicitation or general advertising under proposed Rule 506(c), issuers should be able to attract a wider variety of investors with less cost. For example, the ability to advertise its offer of securities on its own website or a third-party website designed to facilitate these types of offerings could obviate the need to engage an investment banker and may enable issuers to attract investors that they otherwise would be unable to reach. Increased competition for quality investments could also improve terms for issuers and funds, reducing their cost of capital.

Accredited investors and QIBs also would be able to locate more and varied attractive investment prospects with greater ease, potentially reducing search costs and exposing these investors to a greater quantity of quality investment opportunities. Increased investment activity under amended Rules 506 and 144A may impact existing public companies by improving pricing on so-called PIPEs transactions and other "private" placements by affording issuers the opportunity to attract a wider range of accredited investors and QIBs to their companies. The proposed rules, combined with the amendment pursuant to the JOBS Act of Section 12(g) of the Exchange Act,[6] may result in issuers and funds being able to raise more capital, more quickly and easily than at present, and issuers who sell to accredited investors would be able to remain as non-reporting companies for a much longer period of time, avoiding the cost of becoming a public company and the disclosures required of public companies.

As a result of the foregoing, the number of Rule 506 offerings should increase and more investors will hold securities issued in "private placements" that may require compliance with holding periods under Securities Act Rule 144 before securities may be resold. Rule 144 requires securities of a non-SEC reporting company to be held for one year before they may be resold (other than resales to QIBs under Rule 144A). It will be interesting to see whether the use of the statutory exemption available under Securities Act Section 4(a)(1), without reliance on Rule 144, becomes more prevalent as the number of accredited investors in non-SEC reporting companies increases as a result of the proposed rules.

Finally, the elimination of the prohibition on general solicitation and general advertising is unlikely to come without cost. The ability to attract a broad range of accredited investors and, perhaps to a lesser extent, QIBs, could provide additional avenues for fraudulent behavior. The absence of congressional action to provide additional funding for the SEC to support enforcement of the federal securities laws in tandem with Congress' passage of the JOBS Act, the paucity of state funds available to enforce securities laws and the status of securities offered under Rule 506 as "covered securities" (exempting such offerings from state registration requirements), could result in fraudsters having an advantage – at least over the near term.

For Further Information

If you would like more information about the topics discussed in this *Alert*, please contact David J. Kaufman, Laurence S. Lese, Darrick M. Mix, Richard A. Silfen, Brian D. Meltzer, any of the members in our Capital Markets Group or the attorney in the firm with whom you are regularly in contact.

Notes

[1] The Jumpstart Our Business Startups Act ("JOBS Act") became law on April 5, 2012. Title II of the JOBS Act mandates that the Securities and Exchange Commission amend Securities Act of 1933 Rule 506 of Regulation D ("Rule 506") and Rule 144A ("Rule 144A") to permit general solicitation and general advertising under certain circumstances. On August 29, 2012, the SEC proposed rules for this JOBS Act mandate.

[2] Examples of general solicitation or general advertising include published advertisements, broadcast communications and seminars attended by people invited through general solicitation or general advertising. Rule 502(c) of Regulation D. The SEC has also interpreted that use of unrestricted websites is a form of general solicitation or general advertising.

[3] The definition of accredited investor includes those satisfying any of a number of categories, or a purchaser whom the issuer "reasonably believes" to satisfy one of such categories, including among other categories, individuals whose net worth exceeds $1,000,000 or whose individual income exceeds $200,000 in the two most recent years, as well as any corporation, business trust or partnership (not formed for the specific purpose of acquiring the securities offered) with total assets in excess of $5,000,000. Rule 501(a) of Regulation D.

[4] Examples of factors offered by the SEC include (i) the nature of the purchaser and type of accredited investor status claimed (*e.g.*, evidence of accredited investor status under the broker-dealer category may be verified at FINRA's BrokerCheck website); (ii) the nature and quantity of information the issuer has about the purchaser (*e.g.*, information contained in public filings such as proxy statements or Form 990s, third-party information such as W-2s or published compensation, and verification by a reasonably relied upon third party); and (iii) the nature and terms of the offering (*e.g.*, use of broad Internet solicitation would require steps beyond a mere check box or signed form, but solicitation through a pre-screened database of accredited investors may require only simple third-party verification).

[5] Generally, a qualified institutional buyer is one of several specified institutions that own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the institutions. A registered broker-dealer qualifies as a QIB if it owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the broker-dealer. Rule 144A(a)(1).

[6] As amended by the JOBS Act, Section 12(g)(1) of the Exchange Act now provides that a company must register with the SEC within 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding $10,000,000 and a class of equity security (other than an exempted security) held of record by either (i) 2,000 persons or (ii) 500 persons who are not accredited investors.