Cooley

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Summary

On August 29, 2012, the Securities and Exchange Commission (SEC) issued a release proposing amendments to the rules governing private placements of securities (and resales of securities by institutional investors) that would allow companies to widely and publicly promote or advertise "private" sales of securities.

The SEC's proposed amendments would:

- permit a company (or another person acting on its behalf) to make a "general solicitation" or engage in "general advertising"[1] in connection with a sale of its securities to accredited investors made in reliance on Rule 506 of Regulation D, so long as the company takes reasonable steps to verify that all purchasers of the securities are accredited investors; and
- eliminate the practical prohibition on publicizing offers of securities intended to be resold in reliance on Rule 144A under the Securities Act.

The SEC confirmed that:

- Offshore offerings pursuant to Regulation S and concurrent Rule 144A/Rule 506 offerings under the proposed rules would not be integrated; and
- Because Rule 506 transactions are non-public offerings for purposes of Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act, privately offered investment funds would be allowed to make a "general solicitation" pursuant to amended Rule 506 without losing their ability to rely on those sections for exemption from registration as an investment company.

The proposed amendments are subject to a 30-day comment period, after which the SEC will determine whether to adopt the amendments as proposed or with further modifications.

Background

Section 201(a) of the JOBS Act required the SEC to act to remove the prohibition on general solicitation in Rule 506 private placements and Rule 144A transactions meeting certain conditions. At the SEC open meeting held on August 29, 2012, the SEC proposed rules to implement the requirements of Section 201(a) of the JOBS Act.

Proposed Rule 506(c)

The SEC proposes to eliminate the prohibition against general solicitation in offers and sales of securities made pursuant to a new Rule 506(c) of Regulation D. Currently under Rule 506, an issuer cannot sell securities through any form of general solicitation.[2] New Rule 506(c) would eliminate this prohibition so long as:

- all purchasers of such securities are "accredited investors" as defined in Rule 501(a) of Regulation D;
- the issuer takes reasonable steps to verify that the purchasers of such securities are accredited investors; and
- the issuer otherwise satisfies other terms and conditions applicable to Rule 506.[3]

The requirement that all purchasers be accredited investors will be satisfied if either (1) they actually fall within one of the enumerated categories of persons that qualify as accredited investors or (2) the issuer reasonably believes that they do, in either case at the time of the sale of the securities. The new verification requirement would only apply to offerings of securities conducted pursuant to the new Rule 506(c). The proposed amendments also would amend Form D to add a new check box to indicate that an issuer is claiming an exemption under new Rule 506(c).[4]

Verification requirement

The proposed rules do not specify uniform verification methods to determine whether an issuer has taken reasonable steps to verify that purchasers of securities are accredited investors, but instead provide that such a determination would be objective, based on the facts and circumstances of each particular transaction, and would take into account a number of interconnected 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 (which may include publicly available information); 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's release explains that solicitations of new investors through a generally-accessible website or a broadly disseminated email or social media platform likely would require an issuer to take greater steps to verify accredited investor status than solicitations of new investors from a database of pre-screened accredited investors set-up and maintained by a reasonably reliable third-party, like a registered broker-dealer. With respect to the former, an issuer would not have taken reasonable steps to verify that a person is an accredited investor simply by requiring that such person check a box in a questionnaire or sign a form, without other information indicating that such person is an accredited investor. By contrast, an issuer that has a reasonable basis to rely on a third-party's verification of a person's status as an accredited investor would be entitled to rely on such verification. A required minimum investment amount would be an example of an offering term that also may be relevant under this factor. If the minimum investment is high enough such that only accredited investors could reasonably be expected to meet it, the SEC indicated that it may be reasonable for the issuer to take no steps other than to confirm that neither the issuer nor another third party is financing it. The SEC's release states that it would be important for issuers to retain sufficient records that document the steps taken to verify that a purchaser of its securities was an accredited investor, regardless of the particular steps it took, and that if an issuer claims the new exemption, it would have the burden of showing that it is entitled to the exemption.

The proposed amendments modify only the regulatory safe harbor provided by Rule 506 (and not the broader private placement exemption provided by Section 4(a)(2) of the Securities Act), and would not affect an issuer's existing ability to conduct Rule 506 offerings without using general solicitation.

Forms of advertising

Interestingly, the SEC's proposed amendments do not impose any limitations or restrictions on the forms of advertising or promotion, or other manner of sale, that can be employed in connection with sales of securities in reliance on new Rule 506(c). Rather, the SEC opted to focus solely on the nature of the purchasers (accredited investors) and the steps an issuer must take to verify accredited investor status. This is not to say issuers and intermediaries will have free reign to engage in deceptive marketing practices because federal and state antifraud rules will still apply, and state regulatory agencies retain their authority to bring enforcement actions based on fraud.[5]

Rule 144A—offerings to persons other than QIBs

The SEC also proposed amendments to Rule 144A to allow issuers of securities intended to be resold to Qualified Institutional Buyers (QIBs) in reliance on Rule 144A to more broadly disseminate the offer of such securities beyond persons reasonably believed to be QIBs, thereby effectively permitting the same type of general solicitation as contemplated by new Rule 506(c). Rule 144A is a regulatory safe harbor exemption from the registration requirements of the Securities Act for resales of restricted securities to QIBs, and is used to facilitate a primary offering of securities by an issuer to one or more financial intermediaries, which is followed by an immediate resale of such securities to QIBs. Although existing Rule 144A does not contain an express prohibition against general solicitation, "offers" of securities pursuant to Rule 144A can only be made to QIBs, which has the same practical effect. As amended, Rule 144(A)(d)(1) would eliminate the references to "offer" and "offeree" and require only that securities be sold to a QIB or to a purchaser that the seller or any person acting on behalf of the seller reasonably believes is a QIB.

Possible impact of the proposed rules

It is difficult to predict how far-reaching the impact will be from eliminating the prohibition on general solicitation in private placements (both in offerings pursuant to new Rule 506(c) and amended Rule 144A). The proposed amendments could represent a watershed moment in how private placements are conducted. With the amended rules, the SEC effectively is removing the "private" from "private placements" and will open the door to broadly marketed, unregistered offerings and sales of securities, albeit in offerings limited to purchases by accredited investors. Examples of the potential impact include:

- Privately held companies and intermediaries now will be able to advertise offerings of their securities in any medium—Internet, print media, radio and television—without impacting an issuer's ability to effect a Rule 506(c) private placement.
- Web-based securities platforms that match issuers, buyers and sellers of securities and facilitate securities transactions among them (assuming such platforms otherwise comply with the new and existing rules) will be further legitimized.
- Companies with publicly traded securities will be able to effect widely-marketed private placements of their securities, which may change the manner in which "PIPE" transactions are effected.
- Private companies looking to go public may explore the relaxed private placement rules, together with the new provisions permitting companies to "test the waters" in connection with an IPO, to engage in simultaneous public and private offerings under "Black Box" (the SEC no-action letter that first permitted concurrent public and private offerings) or subsequent SEC interpretative guidance, provided that integration concerns are appropriately managed.

Until the SEC publishes final rules, companies must still adhere to existing rules that prohibit general solicitations in connection with private placements and effectively similar constraints in Rule 144A transactions.

Notes

1 Rule 502(c) of Regulation D sets forth manner of sale limitations for private placements exempt under Rules 504, 505 and 506 of Regulation D, including the current requirement that neither the issuer nor any person acting on the issuer's behalf sell securities by means of "general solicitation" or "general advertising." In its release proposing amendments to Rule 506, the SEC explained that its discussion of "general solicitation" is intended to refer to both general solicitation and general advertising.

2 Existing Rule 506(b)(1) specifies that an issuer seeking to rely on the exemption provided by Rule 506 must satisfy the conditions specified in Rule 502, which includes the prohibition on general solicitation set forth in Rule 502(c).

3 Rules 501 (definitions), 502(a) (integration of previous and subsequent offerings) and 502(d) (limitations on resale) would apply to any sale effected pursuant to new Rule 506(c).

4 Under Rule 503 of Regulation D, an issuer is required to file a Form D with the SEC for each new offering of securities made in reliance on an exemption provided by Regulation D, and such filing is required to be filed no later than 15 calendar days after the first sale of securities in the offering.

5 The authority of state securities regulatory authorities to bring enforcement actions based on fraud is preserved in Section 18(c) of the Securities Act.

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