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SEC Proposes to Permit General Solicitation in Private Offerings

Proposed rule amendments permit general solicitation and general advertising in Rule 506 and Rule 144A offerings but raise challenges for verification of accredited investor status of Rule 506 purchasers.

On August 29, the Securities and Exchange Commission (SEC) issued a release[1] proposing rule amendments designed to satisfy the legislative mandate of Sections 201(a)(1) and 201(a)(2) of the Jumpstart Our Business Startups Act (JOBS Act), which are focused on permitting general solicitation and general advertising (collectively, general solicitation) in offerings under Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (Securities Act), respectively. These amendments would enable issuers to utilize offering methods that previously have not been permitted in the private offering context.

Rule 506 is a "safe harbor" rule that, if its conditions are satisfied, provides for the exemption from registration of the offer and sale of securities based on Section 4(a)(2) of the Securities Act, which exempts transactions by an issuer not involving any public offering. Currently, an issuer or any person acting on the issuer's behalf cannot engage in general solicitation in connection with a Rule 506 offering. Rule 144A is a "safe harbor" rule that, if its conditions are met, provides for the exemption from registration of resales of restricted securities based on Section 4(a)(1) of the Securities Act, which exempts transactions by persons other than an issuer, underwriter, or dealer. Under current Rule 144A, offers and sales must be limited to qualified institutional buyers (QIBs) or to persons the seller and any person acting on behalf of the seller reasonably believe are QIBs. This limitation has the practical effect of prohibiting general solicitation.

Section 201(a)(1) of the JOBS Act requires that the SEC amend Rule 506 to permit general solicitation in Rule 506 offerings, provided that all purchasers are accredited investors. Section 201(a)(2) requires the SEC to adopt amendments to Rule 144A to permit offers, including offers by means of general solicitation, to persons other than QIBs, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Significantly, Section 201(a)(1) also mandates that rules promulgated by the SEC require the issuer to take "reasonable steps to verify" that all purchasers of securities in a Rule 506 offering involving general solicitation are accredited investors. In contrast, a verification requirement does not apply with respect to determining that a purchaser in a Rule 144A offering subject to general solicitation is a QIB.

The Proposed Amendments to Rule 506 and Rule 144A

The rule amendments proposed by the SEC principally are designed to implement the JOBS Act's statutory mandate. Proposed new Rule 506(c) provides an exemption from registration for offerings that meet some of the conditions traditionally applicable to Rule 506 offerings, but Rule 506(c) offerings need not meet conditions prohibiting general solicitation and requiring dissemination of specified information in offerings to persons other than accredited investors, provided that all purchasers in the Rule 506(c) offering are accredited investors. In addition, Rule 506(c) would require that the "issuer . . . take reasonable steps to verify that purchasers of securities sold in any offering under [the proposed Rule 506(c) exemption] are accredited investors." Rule 144A,

1. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9354 (Aug. 29, 2012), *available at* http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

as proposed to be amended, would no longer restrict offers to QIBs or to persons that the issuer or persons acting on the issuer's behalf reasonably believe are QIBs. The QIB requirements would apply only to sales under Rule 144A. Because Rule 144A does not expressly prohibit general solicitation, the proposed amendment would effectively enable general solicitation in Rule 144A offerings.

Verification Requirement Under the Proposed Rule 506(c) Exemption

Most of the SEC's release addresses the verification requirement with respect to accredited investors under new Rule 506(c). The SEC did not propose to require any specified methods of verification, or even provide a nonexclusive list of specified methods of verification. Instead, the SEC provided general guidance as to what constitutes "reasonable steps to verify." Although the SEC stated that it "anticipate[s] that many practices currently used by issuers in connection with existing Rule 506 offerings would satisfy the verification requirement," the SEC's guidance is limited and does not provide much tangible information regarding the verification steps it would deem reasonable, subject to certain obvious exceptions.

The SEC stated that whether steps are reasonable would be based on a number of factors issuers "would consider." The SEC then addressed what it characterized as "some examples" of these factors, namely the nature of the purchaser and the type of accredited investor the purchaser claims to be, information about the purchaser, and the nature and terms of the offering.

Nature of the Purchaser and Type of Accredited Investor the Purchaser Claims to Be

Not surprisingly, the SEC noted that, for entities such as registered broker-dealers, very little effort would be required to verify accredited investor status; in the case of a broker-dealer, merely checking the broker-dealer's status on FINRA's Broker Check website would be sufficient. Of course, such a cut-and-dried approach is not always available, and the SEC noted that the nature of the reasonable steps an issuer would take to verify accredited investor status "would likely vary depending on the type of accredited investor that the purchaser claims to be." Verification is more challenging with regard to natural persons, and the SEC acknowledged that taking reasonable steps to verify such persons' accredited investor status "poses greater practical difficulties as compared to other categories of accredited investors, and these practical difficulties likely would be exacerbated by natural persons' privacy concerns about the disclosure of personal financial information."

Under Regulation D's definition of "accredited investor," a natural person is an accredited investor if his or her net worth, exclusive of the person's primary residence, exceeds $1 million (subject to limited exclusions in calculating liabilities with respect to certain indebtedness secured by the person's primary residence). In addition, a person is an accredited investor if he or she had an individual income in excess of $200,000 in each of the two most recent years or joint income with his or her spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. As described below, while verification that a potential purchaser satisfies the income test could be achieved through the purchaser's presentation of a Form W-2, providing verification of net worth will present more of a challenge.

Information About the Purchaser

Despite its acknowledgment of the difficulties in verifying the status of natural persons as accredited investors, the SEC indicated its unwillingness to countenance a process where the verification would be based solely on at least some forms of purchaser representations. The SEC stated, "[W]e do not believe that an issuer would have taken reasonable steps to verify accredited investor status if it required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status." As the examples provided by the SEC regarding acceptable forms of verification involve publicly available information or information obtained from third-party sources, there may be some question as to whether more comprehensive information provided by the purchaser, such as a detailed balance sheet, would satisfy the "other information" requirement.

An issuer's inability to rely on such information could present a particular challenge in the context of verifying a natural person's net worth. The income test applicable to natural persons and the assets test applicable to corporations, partnerships, Massachusetts or similar business trusts, or 501(c)(3) organizations could be verified through, for example, a Form W-2 (for purposes of the income test) or a bank statement or brokerage account statement (for purposes of the assets test). However, these types of verification will not be sufficient for the net

worth test because that test requires not only assets but also liabilities to be taken into account. How does an issuer know that it has verified all of a natural person's outstanding liabilities if it cannot rely exclusively on the representations of the prospective purchaser? As described below, the SEC has suggested that verification by a third party, such as a broker-dealer, attorney, or accountant, may suffice if the issuer has a reasonable basis to rely on the verification. But the "reasonable basis" element of this alternative raises other concerns for an issuer. Therefore, we are hopeful that the SEC will provide additional guidance clarifying that, in this context, an issuer's procurement of comprehensive information provided by the purchaser would constitute a "reasonable step."

The SEC's list of possible sources of verification of accredited investor status range from the obvious to the curious and include the following:

- Publicly available information, for example:
  - For a Section 501(c)(3) organization, the organization's Form 990 series return disclosing the organization's total assets.
  - If the purchaser is a named executive officer of a company having a class of securities registered under the Securities Exchange Act of 1934, proxy statement disclosure of the person's compensation.
- Third-party information providing "reasonably reliable evidence," such as the following:
  - For a natural person, copies of the person's Form W-2.
  - "[T]he purchaser works in a field where industry and trade publications disclose average annual compensation for certain levels of employees or purchasers, and specific information about the average compensation earned at the purchaser's workplace by persons at the level of the purchaser's seniority is publically available."
  - Verification by a third party, such as a broker-dealer, attorney, or accountant, "provided that the issuer has a reasonable basis to rely on such third-party verification." The SEC did not provide any guidance on what constitutes a "reasonable basis" for such reliance. (In a footnote, the SEC speculated that perhaps verification services may develop, particularly for Web-based Rule 506 offering portals that include offerings for multiple issuers. The SEC noted that such services "as opposed to the issuer itself, could obtain appropriate documentation or otherwise verify accredited investor status.")

Nature and Terms of the Offering

The SEC began its analysis here with the unsurprising observation that an issuer soliciting investors through a website generally available to the public "would likely be" obligated to take greater verification measures than an issuer who solicits new investors from a database of prescreened accredited investors "created and maintained by a reasonably reliable third party," such as a registered broker-dealer. The SEC then proceeded to focus its analysis on the view expressed by some commentators that a purchaser's ability to meet a high minimum investment amount "could be relevant to the issuer's evaluation of steps that would be reasonable" to verify a purchaser's status as an accredited investor. The SEC stated its belief that "there is merit to this view." (A large minimum investment was at one time sufficient to confer accredited investor status on a purchaser. As initially adopted, Regulation D included among the categories of persons who were accredited investors a natural person who purchases at least $150,000 of the securities being offered, where the total purchase price did not exceed 20% of the person's net worth at the time of sale, or joint net worth with the person's spouse, and where the consideration paid was within specified categories. This category was rescinded in 1988.) The SEC stated:

> [I]f an issuer knows little about [a natural person who is a] potential purchaser[,] . . . but the terms of the offering require a high minimum investment amount, then it may be reasonable for the issuer to take no steps . . . other than to confirm that the purchaser's cash investment is not being financed by the issuer or by a third party, absent any facts that indicate that the purchaser is not an accredited investor.

This statement certainly does not constitute an endorsement of a minimum investment, by itself, as being sufficient to reasonably verify accredited investor status. By requiring that an issuer confirm a negative, namely that the purchaser's cash investment is not being financed by the issuer or a third party, an issuer would appear

to be facing a significant challenge absent the SEC's willingness to countenance a purchaser's own representation that it did not obtain such financing from a third party (obviously, the issuer will know if it financed such a purpose). The SEC provided no guidance on this issue.

In summing up its analysis of the factors addressed above, the SEC articulated a two-step test:

1. Based on the information gained by looking at these factors, is it likely that a person qualifies as an accredited investor?
2. If so, the issuer would have to take fewer steps to verify accredited investor status, and vice versa.

In our view, this two-step test is illusory and can be collapsed into a single test: Is the totality of information obtained by an issuer sufficient to support a reasonable conclusion that the person is an accredited investor? If so, the issuer has taken reasonable steps to verify that the purchaser is an accredited investor. If not, the issuer has not taken such steps. In other words, we believe that the SEC ultimately may determine the reasonableness of the steps taken based on its view of the reasonableness of the conclusion reached by the issuer regarding a purchaser's accredited investor status. Such an analysis could be an invitation to the application of 20/20 hindsight.

"Reasonable Belief"

The SEC then engaged in a discussion of whether the "reasonable belief" standard continues to apply to the determination of accredited investors. Although the concept of "reasonable belief" is included in JOBS Act Section 201(a)(2) dealing with general solicitation in Rule 144A offerings, the concept is not included in Section 201(a)(1)'s requirement that all purchasers in a Rule 506 offering involving general solicitation must be accredited investors. Nevertheless, the SEC noted that the definition of "accredited investor" remains unchanged; that definition continues to include not only persons who come within the specified categories of accredited investors, but also persons the issuer reasonably believes come within the specified categories. As a result, the SEC concluded that the reasonable belief standard continues to apply to the determination of a person's accredited investor status. In reaching this conclusion, the SEC noted its belief that the difference in the JOBS Act's statutory language reflects the different manner in which the reasonable belief standard was included in Regulation D and Rule 144A as initially adopted, and not a congressional intent to eliminate the reasonable belief standard from Regulation D's definition of "accredited investor."

We believe the SEC's analysis is sound, as far as it goes. But what constitutes a "reasonable belief" in the context of a traditional Rule 506 offering, which has not been subject to a verification requirement, and what constitutes a "reasonable belief" in the context of an offering under the new Rule 506(c) exemption from registration, which contains the verification requirement, likely are meaningfully different.

New Form D Check Box

Form D is a notice required to be filed with the SEC by issuers offering securities in reliance on an exemption from registration provided by Regulation D or by Section 4(a)(5) under the Securities Act. In conjunction with its amendment to Rule 506, the SEC proposed adding a separate check box for offerings relying on the new Rule 506(c) exemption (the current reference to "Rule 506" would be changed to "Rule 506(b)"). The SEC stated it proposed the change to assist its efforts to monitor general solicitation in Rule 506(c) offerings and to help it "look into the practices that would develop to satisfy the verification requirement."

Privately Offered Funds

Section 3(c)(1) of the Investment Company Act of 1940 excludes from the definition of an "investment company" any issuer whose outstanding securities (other than short-term paper) are beneficially owned by no more than 100 beneficial holders. Section 3(c)(7) excludes from the "investment company" definition any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers," as defined in that act. In either case, the exemption applies only to issuers that are not making and do not "presently" (in the case of Section 3(c)(1)) or "at that time" (in the case of Section 3(c)(7)) propose to make a public offering of their securities.

For privately offered funds that may wish to rely on the proposed Rule 506(c) exemption, a question arises as to whether use of general solicitation would constitute a public offering that would make unavailable the Sections 3(c)(1) and 3(c)(7) exemptions. The SEC answered the question in the negative, noting that Section 201(b) of the JOBS Act states that offers and sales exempt under Rule 506, as revised under JOBS Act Section 201(a), will not be deemed to be public offerings under the federal securities laws as a result of general solicitation.

Integration of Rule 506 and Rule 144A Offerings with Regulation S Offerings

Regulation S is a "safe harbor" rule that articulates conditions that, if satisfied, would result in offers and sales of securities being deemed to take place outside of the United States and, therefore, not subject to the registration requirements under the Securities Act. It has been common for issuers to conduct offerings in reliance on Regulation S concurrently with a private offering in the United States conducted in accordance with Rule 506 or Rule 144A. This practice developed as a result of language in Regulation S itself, as well as specific SEC guidance in the release adopting Regulation S,[2] which stated that "[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act," even if undertaken contemporaneously.

The use of general solicitation in Rule 506 or Rule 144A offerings raises a question regarding the continued ability to conduct those offerings concurrently with Regulation S offerings. Specifically, the question focuses on whether it remains possible to satisfy the Regulation S requirements that (1) securities sold without Securities Act registration must be sold in an offshore transaction and (2) there can be no directed selling efforts in the United States. In particular, commentators raised concerns regarding the impact of general solicitation on the "no directed selling efforts" requirement. Rather than specifically analyzing the interplay between general solicitation in Rule 506(c) and Rule 144A offerings and the "no directed selling efforts" requirement in Regulation S, the SEC simply reiterated that offshore offerings that are conducted in compliance with Regulation S would not be integrated with concurrent domestic unregistered offerings conducted in compliance with Rule 506 or Rule 144A, as proposed to be amended.

The application of this guidance is not entirely clear. We believe that, absent further guidance from the SEC, general solicitation in a Regulation S offering must be segregated from general solicitation in a U.S. offering such that the Regulation S solicitation will satisfy the "no directed selling efforts" requirement. With regard to Internet postings, taking steps such as providing separate uniform resource locators (URLs) containing information directed to specifically disparate audiences should be helpful. In the case of Internet postings in the context of a Regulation S offering, compliance with guidance provided by the SEC in Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services, Release No. 33-7516 (March 23, 1998), would be prudent.

The comment period for the proposed rule amendments is relatively short, expiring on October 5, 2012. This may be a response to some political pressure on the SEC to dispense with proposed amendments and proceed directly to adopting final rules, particularly because the July 4, 2012, deadline set forth in the JOBS Act for adopting such rules has already passed.

2. Offshore Offers and Sales, Release No. 33-6863 (Apr. 24, 1990).

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