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SEC Proposes to Eliminate the Prohibition Against General Solicitations in Certain Private Offerings

On August 29, 2012, the SEC released proposed amendments that, if enacted, would remove the ban on general solicitation and general advertising in connection with private placements under Rule 506 of Regulation D and Rule 144A under the Securities Act.[1] These new amendments would satisfy the requirement contained in Section 201(a) of the Jumpstart Our Business Startups Act, or the "JOBS Act," that the SEC remove these prohibitions. We summarize some of the highlights and potential implications of this proposal below.

The Proposed Changes

- Offers and sales conducted pursuant to a new clause (c) of Rule 506 of Regulation D would not have to comply with the ban on general solicitations and general advertising under Rule 502(c), provided that all of the purchasers of the offered securities are Accredited Investors,[2] or "AIs," and the issuer takes "reasonable steps to verify" that purchasers are Accredited Investors. According to the release: "[W]hether the steps taken are 'reasonable' would be an objective determination, based on the particular facts and circumstances of each transaction."

- The SEC declines to prescribe specific steps that an issuer would have to take to "verify" Accredited Investor status or even provide a non-exclusive list of verification methods that would guide issuers. The release states that the intent is to provide issuers with maximum flexibility to adopt the most cost-effective verification method given the facts and circumstances of a particular offering. However, the release goes on to acknowledge that this approach could have costs of its own, including that issuers may adopt more burdensome verification methods than is now the case given the proposed standard's lack of specificity. The SEC asks for comments on this issue, and we expect that many commentators will ask the SEC to provide clarity on this point in order to avoid a move towards more burdensome practices.

- The release does provide a non-exclusive list of three factors that an issuer could consider when determining whether particular verification methods are reasonable.

  – The first is the type of AI the investor claims to be, with some types (such as broker/dealers) naturally lending themselves to easier verification than others (such as individuals).

  – The second is the type of information the issuer already has about an investor, including publicly available information and information provided by third parties.

1 The proposed amendments are contained in SEC Release No. 33-9354, which can be found at this link: http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

2 "Accredited Investor" is defined in Rule 501(a) under the Securities Act.

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  - The third is the nature and terms of the offering itself, such as how it is marketed and the minimum investment size. The release states that highly public offerings, such as through websites or mass emails would require more stringent verification, making explicit that issuers in such offerings could not merely rely on representations from the investor in a questionnaire or form. On the other hand, a minimum investment size that only an AI could reasonably be expected to meet could be used as evidence of the investors' status.

  The release makes clear that the foregoing factors would be both non-exclusive and interconnected, with factors indicating a higher level of verification able to offset those indicating a lower level and vice versa.

- The SEC proposes keeping the prohibition on general solicitation or general advertising in connection with sales to up to 35 non-Accredited Investors in offerings pursuant to the existing exemption in Rule 506(b)(2). Therefore, issuers that want to sell securities to non-Accredited Investors would retain the option to proceed with an offering under the rules in effect today.

- Current rules require an issuer to report any sales it makes under Regulation D on Form D. The proposed rules would revise the check boxes in Form D to require an issuer to state whether it is relying on Rule 506(b) or 506(c) in conducting its offering. It is not clear how this would apply to an issuer that chooses to "play it safe" and both avoid a general solicitation while also selling only to AIs. Such an issuer may have to check only one of the two boxes, even though its offering would qualify for both.

- The release notes that certain privately offered funds (such as hedge funds, venture capital funds and private equity funds) rely on exclusions under the Investment Company Act[3] that would not be available to them if they make a public offering of their securities. According to the release, it is the SEC's position that the effect of Section 201(b) of the JOBS Act is to permit these privately offered funds to make a general solicitation as part of an offering without losing these exclusions under the Investment Company Act.

- Rule 144A(d)(1) under the Securities Act currently requires that securities be "offered or sold" only to Qualified Institutional Buyers,[4] or "QIBs," or persons the issuer reasonably believes to be QIBs, in order for an offering to qualify for the exemption under Rule 144A. The proposed amendments would remove the reference to "offered," so the amended Rule 144A would only require that sales be made to QIBs, while offers could be made to anyone, including by general solicitation.

- With respect to offshore offerings under Regulation S, the release reiterates the SEC's position that offerings under Regulation S will not be integrated with domestic offerings. This means that any general solicitation or general advertising under a Regulation D or Rule 144A offering (as they are proposed to be amended) would not constitute "directed selling efforts" that would foul a simultaneous Regulation S offering.

Potential Implications

If the SEC adopts these proposals, they will affect in important ways how private offerings are conducted. Here are a few interesting potential implications we think may apply.

- We often receive questions from clients regarding whether company executives can speak at industry conferences or other events near the time of a private offering or during the roadshow. We think the new rules would enable executives to make such appearances without limiting their ability to mention that the company is engaged in a private offering or raising concerns about the status of attendees. We think it would still be important to make sure the information provided in these forums does not contradict or go beyond what is disclosed in the offering document.

- A private offering document should no longer have to be confidential (although many issuers may still want to treat it as confidential for competitive or other reasons). This means that issuers should be able to send private offering documents to investors without first verifying their status as an AI (because verification would only be required at the time of sale). Issuers should also be able to distribute the offering document more widely, including by email without concern about whether a potential investor forwards the email to others.

- Issuers often inquire about whether they may send a private offering document to customers or publish it on their website. If enacted, the new rules should permit an issuer to take these types of actions and might also permit an issuer to promote the offering in publications and advertisements. Further, a reporting company engaged in a private offering would likely have the freedom to publicly share information about that offering, including publishing the entire offering document and roadshow on its website or filing them on a Form 8-K or 6-K, rather than filing only those portions that contain previously undisclosed information.

- Agreements that issuers customarily enter into in connection with Rule 144A or Regulation D offerings may no longer have to include the standard representations about the absence of general solicitation or general advertising, but may need more robust provisions regarding the vetting of investors.

3 Principally under Section (3)(c)(1) and Section (3)(c)(7) under the Investment Company Act.

4 "QIB" is defined under Rule 144A(a)(1).

- One interesting question that arises from the release is whether the issuer in a Rule 144A offering may now have to file a Form D to address the initial sale to the initial purchasers. Previously, this sale was presumed to have occurred under Section 4(a)(2) of the Securities Act (previously Section 4(2)) because Rule 144A only covers the resale of securities. If a Rule 144A offering involves a general solicitation, Section 4(a)(2) might not be available to cover the initial sale, meaning the sale might have to be made under Regulation D with the attendant requirement to file a Form D.

- The expected removal of the prohibition on general solicitation raises a question of whether it will be easier for a company conducting an IPO to sell securities to investors in a private placement concurrent with the IPO. This practice is currently conducted under a policy-based exception pursuant to the "Black Box" no-action letter that permits such sales to QIBs and two or three large institutional Accredited Investors at the same time as an IPO. However, while the proposed rules would remove the prohibition on general solicitation, the SEC has not expressly addressed the question of whether a private placement conducted outside of the "Black Box" parameters (i.e., to a large number of AIs) would still run afoul of the SEC's rules regarding "integration" of public and private offerings. We therefore believe that absent further clarification from the SEC, issuers and underwriters would still have to continue to follow existing guidelines and practices with respect to the conduct of private placements concurrently with IPOs.

To avoid any potential confusion, we reiterate that these proposed amendments to Regulation D and Rule 144A are not yet in effect. Section 201(a) of the JOBS Act requires the SEC to have enacted these new rules by July 4, 2012. However, the SEC has stated that this was never a realistic deadline and has been proceeding at a more deliberate pace. Given the mandate contained in Section 201(a), there is every reason to expect that these proposed amendments, or a version close to them, will eventually be adopted. Until that time, however, the ban on general solicitation and general advertising under Regulation D and Rule 144A remains in effect.