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SEC Issues Proposed Rules Under JOBS Act Eliminating Prohibition of General Advertising for Private Offerings

Introduction

The Jumpstart Our Business Startups Act (the "JOBS Act"), signed by President Barack Obama on April 5, 2012, directs the U.S. Securities and Exchange Commission (the "SEC") to adopt rules implementing several provisions of the law affecting offerings of securities (including by private equity and hedge funds) exempt from registration under the federal securities laws. On August 29, 2012, the SEC issued proposed rules that would implement the JOBS Act's elimination of the ban on general solicitation or general advertising in connection with offerings made pursuant to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933, as amended (the "Securities Act").

We address below in question and answer format the implications of the SEC's proposed rules, which will remain subject to public comment until October 5, 2012.

Q: What are the requirements for a Rule 506 offering under the SEC's proposed rules?

A: Under the existing safe harbor exemptions of Regulation D, a private fund or other issuer relying on Rule 506 may offer and sell securities to "accredited investors," but may not engage in any general solicitation or general advertising in doing so. The proposed rules would create new Rule 506(c), which would provide an additional exemption from registration even for offerings marketed using general solicitation or general advertising, provided that:

- the issuer take reasonable steps to verify that the purchasers of the securities are accredited investors; and
- all of the ultimate purchasers of the securities are accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors, or the issuer reasonably believes that they do, at the time of sale.

The proposed rules do not change the definition of "accredited investor" in Rule 501 of Regulation D, and do not eliminate the integration requirement of Rule 502(a) or the restrictions on resale contained in Rule 502(d).

Q: Would the proposed rules change any SEC filing requirements for offerings made under proposed Rule 506(c)?

A: The proposed rules would amend Form D, which issuers must file with the SEC within 15 days after the first sale of securities in the offering. The revised form would add a separate box for issuers to check if they are relying on Rule 506(c). In its proposing release, the SEC clarified that proposed Rule 506(c) would not require that a Form D be filed in advance of any general solicitation or advertising.

Q: Can statements be made to the press and other media (including television) about a particular offering of a private fund or other issuer? Will the content of advertisements and public statements be subject to regulation?

A: Under the current prohibition on general solicitation and general advertising in Rule 506, certain internet websites, mailings, statements made to correct inaccurate reports or even inadvertent public statements made by principals of the issuer have risked disqualifying offerings from an exemption from registration. The proposed rules would eliminate the prohibition without any explicit restrictions on the form or content of communications made to investors in connection with a Rule 506(c) or Rule 144A offering. Advertisements, articles, email solicitations and other communications made by means of television, print, radio or online media would all be acceptable forms of general advertising and general solicitation.

Issuers should note, however, that regardless of the scope of the SEC's final rules, advertisements and solicitations by issuers will remain subject to the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Securities Exchange Act of 1934, Section 17(a) of the Securities Act and, for investment advisers, Section 206 of the Investment Advisers Act of 1940. These provisions prohibit false or misleading statements or other fraudulent conduct in connection with the offer or sale of securities, including in connection with the presentation of historical investment performance.

The following table highlights key differences between existing Rule 506(b) and proposed Rule 506(c).

Current Rule 506(b) Offerings	Proposed Rule 506(c) Offerings
No general solicitation or general advertising.	**General solicitation and general advertising are permitted, provided that all purchasers are accredited investors.**
Generally, an issuer may approach prospective investors only if there is a substantive pre-existing relationship.	Issuers would be permitted to approach prospective investors even without a substantive pre-existing relationship.
No advertisements, articles, notices or other communications published in any newspaper, magazine or similar media (including the internet) or broadcast over television or radio.	Advertisements, articles, notices or other communications would be permitted. Proposed Rule 506(c) does not include specific content restrictions, but any such communications would be subject to the general anti-fraud provisions of federal securities laws and the Investment Advisers Act.
No public seminars or meetings.	Public seminars and meetings would be permitted.

Q: Would an issuer need to take any additional steps under the proposed rules to verify that participants in an offering are all "accredited investors"?

A: In most cases, yes. Proposed Rule 506(c) permits "general solicitation or general advertising," provided the issuer "takes reasonable steps to verify" that its securities are ultimately sold only to accredited investors.

The SEC's proposed rules do not require issuers to use specified methods of verification. In its rulemaking proposal, the SEC noted that a prescriptive rule, or even a non-exclusive list of specified methods, could be overly burdensome in certain cases, and ineffective in others. The

SEC further provided that in determining the reasonableness of steps taken to verify investor status, issuers should consider various objective facts and circumstances of each transaction, including the representations of a potential investor, the amount and type of information that the issuer has about each potential investor, the approach used to solicit investors and the terms of the offering, such as a minimum investment amount.

The table below lists examples of certain verification methods, and the circumstances under which each could potentially suffice as "reasonable steps."

Determination of "Reasonable Steps" Sufficient for Verification of Accredited Investor Status	
Source of information regarding investor status	**Additional "reasonable steps" required?**
Investor questionnaires in subscription documents.	Investor questionnaires may not always suffice, particularly if investors were solicited through a website accessible to the general public or a widely-disseminated email or social media solicitation. Additional steps, such as those outlined below, would likely be required.
Minimum investment amount.	If an investor is able to satisfy a minimum investment amount requirement that only accredited investors could reasonably be expected to meet, in most cases an issuer would need only to verify that the investor is able to meet the requirement upon becoming a participant in the offering without financing from the issuer or a third party.
Verification of investor status by a third party.	If the issuer has a reasonable basis to rely on verification from a third party such as a broker-dealer, attorney or accountant, such verification alone may constitute sufficient reasonable steps in some cases.
Publicly available information.	If, for example, an individual investor is a named executive officer of a company that has disclosed the investor's compensation for the last three consecutive fiscal years in public filings, in many cases no additional steps would be required.
Actual knowledge.	If an issuer has actual knowledge that a purchaser is an accredited investor, no additional steps would be necessary.

In issuing the proposed rules, the SEC clarified that the existing "reasonable belief" standard in the definition of "accredited investor" remains unchanged by the JOBS Act, despite the new requirement under Rule 506(c) for issuers to take reasonable steps to verify investor status. If it is ultimately determined that a purchaser was not an accredited investor, an offering may still remain exempt from registration under Rule 506(c) provided that the issuer took reasonable steps to verify the purchaser's status and had a reasonable belief that such purchaser was an accredited investor at the time of sale.

Regardless of the steps taken, the SEC's proposing release emphasizes that issuers should keep adequate records documenting any verification procedures. As with other federal securities laws, the burden of proof would fall on the issuer seeking an exemption.

Given the potential for general advertisements to reach less sophisticated investors, the SEC staff has indicated that public comment in this area of rulemaking is especially encouraged.

Q: If an issuer does not engage in general solicitation or general advertising, can it still make an exempt offering under Rule 506 without becoming subject to the new verification requirement?

A: Yes. The SEC's proposed rules create new Rule 506(c), permitting general solicitation and general advertising, while leaving existing Rule 506(b) in place. Issuers wishing to make exempt offerings without engaging in general solicitation or general advertising can still claim the exemption under Rule 506(b), and would not be subject to the requirement to take "reasonable steps" to verify accredited investor status.

Claiming an exemption from registration under existing Rule 506(b) may be preferable for issuers wishing to take advantage of the ability to sell interests to up to 35 non-accredited investors, which would not be permissible under proposed Rule 506(c). (It is important to note that issuers wishing to sell interests to non-accredited investors must take into account the implications of this approach, which, as a practical matter, is not commonly used.)

The SEC has also clarified that where an issuer has pre-existing substantive relationships with all offerees, it would likely be able to claim the exemption under Rule 506(b) and would not need to comply with the additional verification requirements of Rule 506(c).

Q: How do the proposed rules change the requirements for Rule 144A offerinsg?

A: Currently, Rule 144A provides an exemption for resales of securities where the securities are offered and sold only to "qualified institutional buyers" ("QIBs"). The proposed amendment would eliminate the reference to "offer" and would require only that the securities be sold to QIBs or to purchasers that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Under the proposed amendment, resales of securities pursuant to Rule 144A could be conducted using general solicitation, so long as the purchasers are limited in this manner.

Q: How does the change in Regulation D intersect with other securities laws, such as Section 3(c)(7) or Section 3(c)(1) of the Investment Company Act? If an offering is advertised, is it considered a "public offering" under the Investment Company Act?

A: Importantly, the JOBS Act explicitly provides that general advertising or general solicitation under proposed Rule 506(c) will not constitute a "public offering" for purposes of the federal securities laws. Investment funds relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") thus can take advantage of the ability to attract investor interest by means of broad-based advertising, without becoming subject, due to the use of general advertising or general solicitation, to the Investment Company Act's registration requirement for funds making a "public offering."

Q: If an issuer makes a domestic offering under Rule 506 or Rule 144A and a contemporaneous offshore offering under Regulation S, can that issuer advertise the domestic offering without violating the prohibition of "directed selling efforts" for the Regulation S offering?

A: Yes. In prior no-action letters, the SEC has clarified that permissible activities in connection with registered or exempt offerings in the United States do not constitute directed selling efforts in a contemporaneous Regulation S offering. In light of the proposed elimination of the ban on general solicitation for certain Regulation D and Rule 144A offerings, commentators had requested confirmation that the SEC would continue to take this position if the proposed rules are adopted.

In its rulemaking proposal, the SEC has confirmed that general solicitation or advertising in connection with an offering under Rule 506(c) or Rule 144A, as proposed to be amended, would not constitute directed selling efforts for concurrent offshore offerings conducted in compliance with Regulation S, and would not result in the integration of such domestic and offshore offerings.

Q: If an issuer engages in general solicitation or advertising for a Rule 506(c) offering, would that issuer need to register under state Blue Sky laws?

A: Issuers would not need to register under state "Blue Sky" laws as a consequence of using the exemption in proposed Rule 506(c), but may be subject to notice filing requirements depending on the state. Because securities issued in a Rule 506 offering are "covered securities" under state Blue Sky regulations, state registration requirements for such securities are preempted by federal law. The elimination of the ban on general solicitation and general advertising at the federal level does not affect preemption, and as such, issuers making Rule 506(c) offerings would still avoid state registration by submitting notice filings and paying fees in jurisdictions in which the securities are sold.

Under many state Blue Sky laws, issuers are often further exempt even from notice filing requirements in states with de minimis or other exemptions. Such exemptions, however, are often available only for securities offered without the use of general solicitation or advertising – which, under current law, necessarily includes all securities offered under the Rule 506 safe harbor provisions. Securities offered under proposed Rule 506(c) through general solicitation or advertising could no longer take advantage of these exemptions, and would trigger the requirement to make notice filings in the applicable states.

Determining whether a proposed Rule 506(c) offering triggers the notice filing requirement will likely involve additional diligence for issuers relying on these exemptions, with attention to the specific rules of each state. Some issuers may be able to rely on alternative exemptions for offerings made only to certain institutional investors, which are not conditioned on the prohibition of general solicitation or advertising. In order to take advantage of such alternative exemptions, if available, issuers must take care to ensure that any solicitation or advertising is narrow in scope and directed only at institutional investors.

In effect, qualifying for the exemption from Blue Sky notice filing requirements will prove difficult for issuers seeking to make widespread general solicitations or use advertisements in connection with a Rule 506(c) offering. Such issuers should consider the cost of notice filings and related filing fees, and should consult with local counsel or Blue Sky experts to ensure compliance in each jurisdiction.

Q: Would a fund manager still be exempt from registering as a commodity pool operator or a commodity trading advisor if an issuer engages in general solicitation or advertising?

A: The Commodities Futures Trading Commission (the "CFTC") promulgates rules governing the futures and options markets, including private funds trading in those markets as commodity pools. While commodity pool operators ("CPOs") are generally required to register with the CFTC and comply with its rules, certain exemptions are available under CFTC Regulation 4.7(b) and CFTC Regulation 4.13(a)(3) for CPOs who offer and accept investments only from accredited investors and other qualified persons without "marketing to the public."

CPOs seeking exemption under one of these CFTC rules and existing Rule 506(b) seldom risk complying with one while running afoul of the other, since neither the CFTC regulations nor Rule 506(b) allow exemption for offerings that are marketed to the public via general solicitation or general advertising. In light of proposed Rule 506(c), however, the CFTC has solicited public comments as it considers issuing new rules harmonizing its exemptions with those affected by the JOBS Act and the SEC's proposed rules. Unless and until such harmonizing rules are adopted, CPOs should continue to ensure compliance with the CFTC's existing rules even after the SEC adopts final rules permitting general solicitation and advertising. This means, for instance, that until the CFTC has acted to harmonize its rules, 3(c)(1) funds relying on CFTC Rule 4.13(a)(3) would not be able to take advantage of proposed Rule 506(c), if adopted.

Similarly, certain commodity trading advisors ("CTAs") rely on an exemption conditioned on their providing trading advice to no more than 15 persons, provided that they do not hold themselves out to the public as CTAs. Such CTAs should continue to ensure compliance with the conditions in Section 4(m) of the Commodity Exchange Act.

The following table summarizes the implications of proposed Rule 506(c) on the securities laws discussed above.

Effect on Compliance with Other Securities Laws	
Investment Company Act	General advertising or general solicitation under proposed Rule 506(c) would not constitute a "public offering" for purposes of the federal securities laws, including Section 7(d) of the Investment Company Act.
Regulation S Offerings	General solicitation or general advertising in connection with an offering under proposed Rule 506(c) would not constitute "directed selling efforts."
State Blue Sky Laws	Securities offered under proposed Rule 506(c) through general solicitation or general advertising would still be exempt from state registration, but may trigger the requirement to make notice filings in states with notice filing exemptions conditioned on a prohibition of general solicitation or advertising.
CFTC Regulations	The CFTC has not proposed new rules harmonizing its exemptions with those affected by the JOBS Act. CPOs and CTAs should continue to ensure compliance with the CFTC's existing rules, even after the SEC adopts final rules permitting general solicitation and advertising.

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The SEC will continue to solicit comments on the proposed rules discussed above until October 5, 2012. Issuers of exempt offerings should continue to comply with current law, and should not engage in general solicitation or general advertising, until the SEC's final rules are adopted. For a copy of the proposed rules and the SEC's accompanying release, see http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to:

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