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SEC Proposes Rule Amendments to Permit General Solicitation in Rule 506 and 144A Offerings, Including Offerings by Hedge Funds and Other Private Funds

Introduction

On August 29, 2012, the Securities and Exchange Commission proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (the "Securities Act") to eliminate prohibitions against the use of general solicitation in private offerings conducted in reliance on those rules. The amendments are required by Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"), which was signed into law earlier this year. Offerings under Rule 506 and Rule 144A are widely used to raise capital, and the proposed amendments could have significant implications for market participants. According to the SEC, in 2011 issuers raised $895 billion and $168 billion in Rule 506 and Rule 144A offerings, respectively, compared to $984 billion raised in registered offerings. The proposed amendments would significantly expand the permissible methods of marketing these types of offerings, enabling public and private operating companies, investment funds (including hedge funds, venture capital funds, private equity funds and other private investment vehicles) and other issuers to use print, broadcast and outdoor advertisements, internet advertisements, websites without password protection and other forms of public communication to attract investors, so long as all investors who actually purchase securities in the offering are accredited investors.

To view the complete text of the proposing release (Release No. 33-9354), click here.

Proposed Rule 506 Amendments

Rule 506 is a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act, which exempts certain securities offerings that do not involve a public offering from the registration requirements of the Securities Act. Specifically, Rule 506 permits issuers to offer and sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors" (as defined in Rule 501 of Regulation D) and up to 35 non-accredited investors that meet certain "sophistication" requirements. The Rule 506 safe harbor is currently applicable only to securities offerings in which neither the issuer nor anyone acting on its behalf engages in any form of "general solicitation or general advertising." The term "general solicitation and general advertising" (which is referred to in this advisory as "general solicitation") is not defined in the SEC's rules, but includes advertisements in newspapers, communications broadcast over television, radio or unrestricted websites, and seminars whose attendees have been invited by one of the foregoing means.

To implement Section 201(a) of the JOBS Act, the SEC has proposed to amend Rule 506 by adding new Rule 506(c), which would provide that the restriction against general solicitation (contained in Rule 502(c)) does not apply to offers and sales of securities made pursuant to Rule 506 provided that (i) the issuer takes "reasonable steps to verify" that the purchasers are accredited investors, and (ii) all purchasers of the securities in the offering are accredited investors.

Reasonable Steps to Verify Accredited Investor Status

The SEC's proposing release does not specify the methods necessary to demonstrate that an issuer has taken reasonable steps to verify accredited investor status. Instead, the SEC has proposed a more flexible approach to analyzing whether steps taken are "reasonable," indicating that such analysis would depend on the particular facts and circumstances of each transaction. The proposal does identify factors to be considered in determining the reasonableness of steps taken to verify accredited investor status, including the following:

- **The nature of the purchaser and the type of accredited investor that the purchaser claims to be.** The steps required to verify accredited investor status will vary depending upon the type of accredited investor that a purchaser claims to be. For example, a purchaser's status as a registered broker-dealer could be verified by reference to FINRA's BrokerCheck website, while verifying that a natural person satisfies applicable net worth or income tests would require other means of verification.
- **The amount and type of information that the issuer has about the purchaser.** The amount and type of information an issuer has about a purchaser would be a significant factor in determining what additional steps would be necessary to verify accredited investor status. For example, an issuer could review publicly available information in SEC filings (such as executive compensation disclosure), Form 990s filed by 501(c)(3) organizations with the Internal Revenue Service, or third-party information that provides reasonably reliable evidence of accredited investor status, such as copies of W-2s, trade publications that disclose annual compensation for certain levels of employees or partners at a particular purchaser's workplace at the purchaser's level of seniority, or third-party information provided by an attorney, accountant or broker-dealer (provided that the issuer has a reasonable basis to rely on such third party).
- **The nature of the offering, such as the manner in which the purchaser was solicited, and the terms of the offer, such as the minimum investment amount.** The nature of the offering, including the means of soliciting purchasers, may be relevant to determining the reasonableness of steps taken to verify accredited investor status. An issuer soliciting purchasers through a website generally accessible to the public, for example, would likely be obligated to take greater measures to verify accredited investor status than an issuer soliciting purchasers through a pre-screened database of accredited investors. The SEC noted that, in the case of solicitations by means of an unrestricted website, merely checking a box on a questionnaire, absent additional information, would likely not be a reasonable means of verifying accredited investor status. In addition, a high minimum investment requirement that would likely only be satisfied by an accredited investor could be taken into consideration.

While the proposing release indicates that practices currently used by issuers in connection with Rule 506 offerings, such as obtaining completed investor questionnaires, may, in certain circumstances, satisfy the verification requirement proposed for offerings pursuant to Rule 506(c), it is not clear that such practices would satisfy such requirement in offerings that are marketed by means of broad-based general solicitation.

Sales Only to Purchasers Who Are Accredited Investors

In addition to the verification methods described above, under the proposed amendments securities sold in reliance on new Rule 506(c) could only be sold to purchasers who qualify as accredited investors. Accredited investors are investors that the issuer "reasonably believes" fall within one of the categories enumerated in Rule 502. The SEC clarified that the proposed amendments would not modify the "reasonable belief" standard for determining accredited investor status. Therefore, as a practical matter, this second requirement that all purchasers of the securities in the offering be accredited investors is subsumed by, and is not in addition to, the first requirement that the issuer take reasonable steps to verify that the purchasers are accredited investors.

Form D

The proposed amendments would also modify Form D to add a separate field or check box for issuers to indicate whether they are claiming an exemption under Rule 506(c). According to the SEC, such information is intended to allow the SEC to monitor the use of Rule 506(c) and to assess the efficacy of verification practices. This addition is consistent with other recent amendments to Form D that added check boxes for issuers to indicate which subsections of Regulation D they are relying on for their exemptions from registration under the Securities Act, as well as which subsections of Section 3(c) of the Investment Company Act of 1940 (the "Investment Company Act") they are relying on for their exclusions from regulation under the Investment Company Act.

Privately Offered Funds

Hedge funds, venture capital funds, private equity funds and other investment vehicles ("Private Funds") that wish to operate without the restrictions applicable to public mutual funds and commodity pools typically offer and sell their securities in private placements without registration under the Securities Act in reliance on the Rule 506 safe harbor in order to qualify for exemptions and exclusions from such other regulation.

While the JOBS Act required the SEC to amend the Rule 506 safe harbor to allow issuers to engage in general solicitations without being deemed engaged in a public offering, it did not specifically address or require amendments to the other laws and regulations that apply to many Private Funds and their advisers, including the Investment Company Act, the Commodity Exchange Act (the "CEA"), the Investment Advisers Act of 1940 (the "Investment Advisers Act") or state regulation of investment advisers.

Private Funds that invest or trade in securities generally rely on exclusions from the definition of "investment company" under the Investment Company Act set forth in Section 3(c)(1) or Section 3(c)(7). Section 3(c)(1) of the Investment Company Act, generally speaking, excludes issuers the securities of which are held by fewer than 100 beneficial owners and which are not making and do not propose to make a public offering. Section 3(c)(7) of the Investment Company Act, generally speaking, excludes issuers the securities of which are held exclusively by qualified purchasers and which are not making and do not propose to make a public offering. Engaging in a public offering of their securities would preclude funds from relying on either of those exclusions.

Though the JOBS Act did not specifically address Private Funds, the SEC indicated in the proposing release that it interprets Section 201(b) of the JOBS Act as permitting Private Funds to engage in general solicitations under amended Rule 506 without losing their exclusions from the Investment Company Act. See "Practical Implications of the Proposed Amendments – Private Funds" below.

Rule 506 Offerings without General Solicitation

The proposal would continue to make available the traditional safe harbor under Rule 506 for offerings that do not involve any general solicitation and otherwise satisfy existing requirements. Issuers engaging in Rule 506 offerings without general solicitation would not be subject to the new requirement to take reasonable steps to verify the accredited investor status of purchasers and would be permitted to sell to up to 35 non-accredited investors who satisfy existing "sophistication" requirements.

Notwithstanding the ability under Rule 506 to sell to up to 35 non-accredited investors, many issuers choose not to sell securities to non-accredited investors because their inclusion in Rule 506 offerings may trigger heightened disclosure requirements under Rule 502. Moreover, a private fund may not be permitted to admit any non-accredited investors if (1) it relies on Section 3(c)(7) of the Investment Company Act, which requires its securities to be held exclusively by qualified purchasers, generally a higher standard than accredited investors; (2) it is advised by an SEC-registered investment adviser and charges performance fees in reliance on Investment Advisers Act Rule 205-3, which requires its securities to be held exclusively by qualified clients, generally a higher standard than accredited investors; or (3) it is a commodity pool and its commodity pool operator (CPO) relies on an exemption from registration with the Commodity Futures Trading Commission such as the one contained in CFTC Rule 4.13(a)(3), which generally requires its securities to be held exclusively by accredited investors.

Proposed Rule 144A Amendments

Rule 144A is a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales of certain "restricted securities," which are securities acquired from an issuer or an affiliate of an issuer in a chain of transactions not involving a public offering, to persons reasonably believed to be qualified institutional buyers (QIBs). While Rule 144A applies to "resales," in practice it is used for primary offerings in which the issuer sells securities to one or more financial intermediaries (commonly referred to as "initial purchasers") in a private transaction, followed by the immediate resale of such securities pursuant to Rule 144A. Although Rule 144A does not expressly prohibit general solicitation, sellers (such as initial purchasers and other intermediaries) relying on Rule 144A may only offer securities to QIBs, which yields the same result. The proposed amendment would eliminate references to "offer" and "offeree" in Rule 144A(d)(1), thereby permitting sellers in Rule 144A offerings to offer securities to persons other than QIBs, including by means of general solicitation, provided that the securities are only sold to purchasers that are QIBs or that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

Integration with Offshore Offerings

According to the SEC, some market participants have expressed concerns that offshore offerings conducted in reliance on Regulation S, which among other things prohibits "directed selling efforts" in the United States, might be integrated with offerings conducted under amended Rule 506. The SEC's proposal clarifies the SEC's view that offshore securities offerings under Regulation S would not be integrated with domestic unregistered offerings conducted under amended Rule 506 or Rule 144A by means of general solicitation and general advertising.

Practical Implications of the Proposed Amendments

General

The proposed amendments would have a variety of implications for issuers and investors alike. When using general solicitation, issuers may be able to reach a greater number of investors, thus increasing their access to capital and potentially reducing their cost of capital. To the extent issuers are able to reach investors directly, the ability to use general solicitation may also mitigate the need to use intermediaries, potentially reducing the costs of private offerings for issuers.

The proposed amendments may also mitigate certain concerns about communications with the public while conducting Rule 506 and Rule 144A offerings. Under existing rules, a public communication or an inadvertent leak of information about a private offering may require an issuer to delay or terminate the offering to the extent such information constitutes a general solicitation. Under the proposed rules, disclosure or other communications would not render the issuer ineligible to rely on the applicable safe harbor. In the context of Private Funds, responses to press inquiries and other public communications that constitute a general solicitation would not, by themselves, compromise the fund's ability to raise capital in reliance on Rule 506 or jeopardize exclusions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, although they may jeopardize exemptions under the Investment Advisers Act, the CEA and state law, as more fully discussed below.

From an investor perspective, liberalized communications by issuers could lead to a larger, more readily identifiable pool of potential investment opportunities. In particular, allowing Private Funds to communicate more freely with the public could allow accredited investors to gather information about Private Funds at relatively lower costs, potentially increasing investment opportunities. To the extent Private Funds determine to make more information available to the public, asymmetrical information between Private Funds and registered investment companies may be reduced and investors may be more likely to invest in Private Funds that provide such information.

Private Funds

While the proposing release would permit a Private Fund to engage in a general solicitation under amended Rule 506 without losing its exclusion under the Investment Company Act, managers of private funds must consider the potential impact offering fund interests through general solicitation may have on the availability of exemptions the managers rely on under other applicable law and regulation.

Foreign Private Advisers. Although Congress in 2010 repealed the registration exemption widely used by so-called private advisers that had fewer than 15 clients in the preceding 12 months and did not hold themselves out to the public as investment advisers, certain foreign private advisers relying on a narrower exemption from registration as investment advisers under Section 202(a)(30) of the Investment Advisers Act are still prohibited from holding themselves out generally to the public in the United States as investment advisers. Historically, including the name of an investment adviser in an offering document for a private fund did not constitute holding the investment adviser out to the public as an investment adviser, because the offering document was not publicly disseminated. However, if the private fund engages in a general solicitation, this may no longer hold true.

CFTC Rule 4.13(a)(3) Exemption. A Private Fund that may invest in commodity interests (now including many kinds of swaps under the Dodd-Frank Wall Street Reform and Consumer Protection Act) is considered a commodity pool under the CEA. Under the CEA, commodity pool operators (CPOs) and commodity trading advisors (CTAs) must register with the Commodity Futures Trading

Commission unless an exemption from registration is available. Many CPOs rely on CFTC Rule 4.13(a)(3) for their exemption, which requires, among other things, that interests in the pool are both (i) privately offered and (ii) sold without marketing to the public. It is not clear that engaging in a general solicitation in connection with a private offering in reliance on Rule 506(c) would still meet the requirement of Rule 4.13(a)(3) that the interests be sold without marketing to the public, potentially jeopardizing the Rule 4.13(a)(3) exemption. The Managed Funds Association (MFA) has written a letter to the CFTC requesting that it harmonize Rule 4.13(a)(3) with proposed Rule 506(c), but the CFTC has not yet responded. To view the MFA letter, click here.

CFTC Rule 4.7 Exemption. CPOs who are registered with the CFTC may claim an exemption under CFTC Rule 4.7 from many of the CFTC's disclosure and recordkeeping requirements with respect to certain commodity pools. This exemption may be claimed by a registered CPO "who offers or sells participations in a pool solely to qualified eligible persons in an offering which qualifies for exemption from the registration requirements of the Securities Act pursuant to section 4(2) of that Act . . ." Proposed Rule 506(c) is being promulgated under Section 4(2). As currently drafted, in order to qualify for this exemption, a registered CPO must limit both sales and offers to qualified eligible persons. As seen with current Rule 144A, which restricts both sales and offers to QIBs, a restriction on making offers to ineligible investors effectively precludes the use of general solicitation. The MFA has highlighted this issue as well in its letter to the CFTC requesting harmonization, but it has not yet received a response.

CFTC Rule 4.14(a)(5). CFTC Rule 4.14(a)(5) exempts a CTA from registration if it is also a CPO, but (i) it is exempt from registration as a CPO and (ii) its commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so exempt. However, as discussed above, if it cannot rely on the CFTC Rule 4.13(a)(3) exemption from registration as a CPO, it will not be able to rely on the corresponding CFTC Rule 4.14(a)(5) exemption from registration as a CTA.

State Blue Sky Law. There are investment advisers that are not required to be registered with the SEC that are also not registered with the states in which they operate in reliance on state exemptions from registration that contain, as components thereof, the prohibition against holding oneself out generally to the public as an investment adviser. As discussed above, historically, including the name of an investment adviser in an offering document for a private fund did not constitute holding the investment adviser out to the public as an investment adviser, because the offering document was not publicly disseminated. However, if the private fund engages in a general solicitation, this may no longer hold true.

Comment Period

The proposed amendments are open to public comment until October 5, 2012. The proposal raises a number of questions for which the SEC is actively seeking comment from market participants.

If you have questions or need additional information, please contact one of the attorneys listed below.

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