September 2012

SEC JOBS Act Implementation

SEC Proposes Rules Relating to General Solicitation and General Advertising for Rule 506 and Rule 144A Offerings

On August 29, 2012, the Securities and Exchange Commission ("SEC") proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"), as required by Section 201(a) of the Jumpstart Our Business Startups Act ("JOBS Act"). The proposed amendments will permit certain unregistered exempt offerings of securities using general solicitation and general advertising. A copy of the SEC's proposing release is available here.

Background

Section 201(a) of the JOBS Act requires the SEC to revise its rules to remove the prohibition against general solicitation and general advertising in private offerings under Rule 506 of Regulation D, provided that all purchasers of the securities are accredited investors. The JOBS Act stipulates that the new rules must require the issuer to take reasonable steps to verify that purchasers are accredited investors, using methods to be determined by the SEC. In addition, the JOBS Act amended Section 4 of the Securities Act to provide that offerings made in compliance with Rule 506 will not be deemed public offerings as a result of general advertising or solicitation. The JOBS Act also requires the SEC to revise Rule 144A under the Securities Act to provide that securities sold pursuant to that rule may be offered to persons other than qualified institutional buyers, including by way of general solicitation and general advertising, so long as the only purchasers in the offering are persons that the seller has a reasonable belief are qualified institutional buyers. The JOBS Act deadline for the SEC rulemaking under Section 201(a) was July 4, 2012. The SEC solicited comments on the JOBS Act shortly after its enactment on April 5, 2012, and received more than 50 comment letters relating to Section 201(a). For additional information on the JOBS Act, please see our prior memorandum available here.

Rule 506

Rule 506 is a non-exclusive safe harbor permitting unregistered sales of securities to an unlimited number of accredited investors and a limited number of non-accredited investors subject to a number of conditions, including a condition that the issuer not offer or sell the securities through any form of "general solicitation." Examples of general solicitation include newspaper advertisements, communications by radio or television and seminars whose attendees have been invited by general solicitation.

Rather than eliminating or modifying the existing Rule 506 regime, the proposals would establish a second type of Rule 506 offering. While issuers may continue to offer their securities without using general solicitation consistent with prior practice under the existing provisions of Rule 506, issuers would also have the alternative of conducting offerings under a new Rule 506(c) using general solicitation. This new alternative safe harbor would require compliance with the following two additional conditions:

- all purchasers of securities sold in the offering must be accredited investors; and

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- the issuer must take reasonable steps to verify that the purchasers of securities sold in the offering are accredited investors.

Offerings relying on the proposed new Rule 506(c) safe harbor also must comply with the terms and conditions of Rules 501 and 502(a) and (d); however, Rule 501(b) (which requires specified information disclosures to non-accredited investors) and Rule 501(c) (which prohibits general solicitation and general advertising in connection with a Regulation D offering) would not apply to the new Rule 506(c) offerings.

The proposed amendments do not define what would constitute "reasonable steps to verify" the purchasers' accredited investor status and do not require specific verification methods. However, the SEC noted in the proposing release that an analysis of whether the steps taken are "reasonable" would be an objective determination based on the facts and circumstances of each transaction. The SEC identified several examples of factors to be considered by issuers in this analysis, 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; 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 the minimum investment amount.

This facts and circumstances approach and lack of guidance regarding specific permissible practices raises a number of questions. For example, many issuers currently rely on "check the box"-style investor questionnaires to assist in determining accredited investor status. The SEC noted that reliance on such a questionnaire, absent other information about the purchaser indicating accredited investor status, would not be reasonable in the context of a freely accessible website solicitation, widely disseminated email or social media solicitation. As a result, issuers intending to engage in a general solicitation and rely on such questionnaires would need to review their current practices to determine whether additional steps would need to be taken to rely on Rule 506(c) in its current proposed form. While the SEC did not specify what additional steps may be required, the SEC discussed the potential for reliance on reasonable third-party verification of accredited investor status.

The SEC did not propose to amend the definition of "accredited investor" although several comment letters recommended modifications to the definition. Thus, the reasonable belief standard in Rule 501(a) would remain unchanged. Nor did the SEC propose rules governing the content or manner of advertising for Rule 506(c) offerings or different treatment for any particular type of issuers, such as private funds.

While no specific recordkeeping requirements were proposed in the release, the SEC noted that any issuer claiming the exemption has the burden of showing that it is entitled to the exemption and that it would be important for issuers to retain adequate records. Consequently, issuers should review their practices relating to recordkeeping to determine whether they are appropriate.

An issuer would not lose the benefit of the Rule 506(c) exemption if a non-accredited investor purchases securities in the offering so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that the purchaser was an accredited investor.

Form D

The SEC also proposes to amend Form D to require issuers to specify whether the offering was made without general solicitation or in reliance on the new alternative approach permitting general solicitation. Thus, the SEC will be able to monitor use of the safe harbor and related practices and potentially engage in additional rulemaking.

Rule 144A

Rule 144A is a non-exclusive safe harbor permitting resales of restricted securities to "qualified institutional buyers" ("QIBs") without registration under the Securities Act. While Rule 144A does not restrict general solicitation, the rule includes a condition that offers must be made only to QIBs. The practical impact of this condition is to limit offers to non-QIBs and is similar to a prohibition on general solicitation.

The SEC's proposed amendments to Rule 144A remove references to the words "offered" and "offeree." As amended, Rule 144A would require that the securities be sold only to QIBs or to a person that the seller and any person acting on behalf of the seller reasonably believe is a QIB. As a result, the practical impact is that Rule 144A offerings would be able to employ general solicitation.

Implications Under Other Securities Laws: Investment Company Act, Regulation S and Commodity Pool Issues

There are several other federal laws with exemptions conditioned on a prohibition on public offerings. These laws include regulation of investment companies under the Investment Company Act of 1940, as amended (the "Investment Company Act"); regulation of sales of securities to non-U.S. persons under Regulation S under the Securities Act; and commodity regulation by the Commodity Futures Trading Commission ("CFTC").

Investment Company Act: The SEC confirmed in the proposing release its view that the JOBS Act provision that offers and sales under Rule 506 will not be deemed public offerings will permit privately offered funds to make a general solicitation under new Rule 506(c) without losing either of the Section 3(c)(1) or 3(c)(7) exclusions under the Investment Company Act. These exclusions are currently not available to issuers that are making or proposing to make a public offering and are the exclusions most commonly relied upon by private funds. As a result, if the proposed rule is adopted in its current form, private funds would be permitted to conduct an offering using general solicitation in compliance with Rule 506(c) without losing the benefit of the Section 3(c)(1) or Section 3(c)(7) exclusions from investment company status.

Regulation S: The SEC did not propose any changes to Regulation S or its prohibition on "directed selling efforts" in the United States, which is often seen as similar to general solicitation. However, the SEC confirmed that an offshore offering that is conducted in compliance with Regulation S would not be integrated with a concurrent domestic unregistered offering that is conducted in compliance with Rule 506 or Rule 144A, as proposed to be amended.

Commodity Regulation: The number of private funds that may be considered commodity pools was expanded recently as a result of the Dodd-Frank Act's mandate subjecting "swaps" to commodity regulation. Certain private funds and their advisers may rely on the exemption from registration as a commodity pool operator in CFTC Section 4.13(a)(3) or provide more limited disclosures under CFTC Section 4.7(b) as long as interests in the pool are "offered and sold without marketing to the public in the United States" (among other conditions). Unless the SEC and CFTC exemptions are harmonized, private funds and their advisers seeking to rely on these CFTC regulations will need to consider the implications of any general solicitation on their CFTC exemptions.

Timetable

The proposed amendments have been presented with a limited comment period. The SEC previously solicited comments on the JOBS Act provisions and provided an opportunity for comment. In the statements made in connection with the new proposals, certain Commissioners noted concern that the JOBS Act rulemaking deadline had already passed or expressed a preference for posturing the proposals as interim temporary final rules rather than rule proposals requiring further implementation.

Consequently, we expect the SEC to feel some pressure to adopt final rules on a relatively short timetable. The SEC's deadline for submitting comments will be October 5, 2012, 30 days after publication in the Federal Register. The SEC specifically requested comment on a number of aspects of the proposals, including whether certain types of issuers should be subject to a different verification standard.

What To Do Now?

For now, the lack of specific SEC guidance regarding permissible practices for private offerings involving general solicitation and the lack of harmonization with CFTC exemptions raise a number of questions that may limit the utility of the proposed new exemption for many issuers, except in the context of an inadvertent failure to comply with the general solicitation condition for a private offering conducted using current practices. However, as a result of the short rulemaking timetable, issuers, investment advisers to private funds and other financial industry participants in private offerings should begin preparing now for the new private offering environment involving general solicitation by reviewing the related risks and opportunities, as well as their own internal policies and procedures for private offerings.

Additional Information

The Hunton & Williams LLP Capital Markets and Securities practice group has a long history of representing issuers, investors and underwriters in a wide range of public and private offerings of equity and debt securities. The Hunton & Williams Private Investment Funds practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the SEC's rulemaking to implement the JOBS Act's requirements as well as relevant trends in private offering and private investment fund regulation. We are available to assist in evaluating these issues, preparing to address the new rules and drafting proposed comments to the SEC regarding the proposals.

For additional information on financial industry recovery proposals, see our related memoranda, available on www.huntonfinancialindustryresourcecenter.com. For additional information on recent legislation and regulations relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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