SEC Issues Proposal to Eliminate General Solicitation Ban as Mandated by the JOBS Act

September 4, 2012

On August 29, 2012, the Securities and Exchange Commission (the "**SEC**") issued a **proposal** to permit widespread advertising and other forms of "general solicitation" in private offerings made in reliance on Rule 506 of Regulation D or Rule 144A of the Securities Act of 1933 (the "**Securities Act**"), so long as the purchasers in the offering are accredited investors ("**AIs**") (in Rule 506 offerings) or qualified institutional buyers ("**QIBs**") (in Rule 144A offerings). The proposal is mandated by Section 201(a) of the Jumpstart Our Business Startups Act (the "**JOBS Act**") but, unlike other portions of the JOBS Act, the proposal would apply to all issuers, not just emerging growth companies.

Current Restrictions and JOBS Act Mandate

Rule 506 of Regulation D is a non-exclusive safe harbor that permits the sale of securities in private placements to AIs, or to purchasers who the issuer reasonably believes are AIs at the time of sale, as well as up to 35 other purchasers (including non-AIs), subject to certain conditions. These conditions forbid an issuer or a person acting on its behalf from using any form of general solicitation or general advertising in the offer or sale of securities under Rule 506.

Likewise, Rule 144A is a non-exclusive safe harbor that allows the resale of unregistered securities to QIBs. One of Rule 144A's prerequisites is that the securities be "*offered* or sold" only to QIBs (emphasis added). This precludes the marketing of the securities to a population that may include non-QIBs, even if the Rule 144A resales are made only to QIBs.

The JOBS Act directed the SEC to amend Rule 506 and Rule 144A, by July 4, 2012, to permit general solicitation or general advertising in Rule 506 and Rule 144A offerings, provided the only purchasers of the securities are AIs and QIBs, respectively.

Proposal to Allow Advertising in Rule 506 Offerings to AIs with Reasonable Verification

The proposal would permit issuers and their designees to advertise in connection with Rule 506 offerings as long as the issuer takes "reasonable steps" to verify that the purchasers of the securities are AIs. The proposal notes the importance of documenting and retaining records related to these steps. The proposal would not eliminate the ability of an issuer to sell securities in accordance with the conditions currently in Rule 506. Therefore, an issuer that does not utilize general solicitation in a Rule 506 offering would not be required to verify the accredited investor status of purchasers but would be required to "reasonably believe," at the time of the sale, that a purchaser is an AI, as is currently required.

Reasonable verification. The proposal does not list specific measures that an issuer must take to verify a purchaser's accredited investor status or otherwise provide a bright line test for making this "reasonable" assessment. Instead, the proposal explains that whether an issuer's verification efforts are reasonable would be an objective determination, based on the particular facts and circumstances of each transaction. The proposal does, however, suggest that an issuer consider the following factors:

- ***The nature of the purchaser***. The proposal acknowledges that an issuer will likely use different methods to verify a natural person's and an entity's accredited investor status and will further differentiate these procedures based on the applicable accredited investor test. For example, the proposal highlights comments suggesting that issuers may find it more difficult to verify accredited investor status based on a net worth test versus an annual

income test. The proposal also implies that an issuer might turn to FINRA's BrokerCheck website to verify that an entity meets the registered broker-dealer test.

- ***Information that the issuer has about the purchaser***. The proposal implies that an issuer may take fewer steps to verify a potential purchaser's status as an AI if the issuer has ample information supporting this classification. For example, if the potential purchaser is an executive officer of a public company, an issuer might be satisfied by looking at the purchaser's annual compensation as disclosed in that company's Exchange Act filings. An issuer could also review a 501(c)(3) organization's publicly available IRS filings. The proposal also acknowledges that issuers could, in certain circumstances, rely upon evidence from third parties, such as representations from a broker-dealer, attorney or accountant.
- ***Nature and terms of the offering***. The proposal also suggests the issuer consider the manner in which the purchaser was solicited and the terms of the offering. Here, not surprisingly, the proposal asserts that an issuer that solicits new investors through a public website or a broadly available form of social media "would likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party, such as a registered broker-dealer." The proposal states that, in the case of the former, the SEC would not deem an issuer to have taken reasonable steps to verify AI 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." In addition, the proposal allows an issuer to take into account "the ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only AIs could reasonably be expected to meet it, with a direct cash investment that is not financed by the issuer or by any other third party."

Like any framework, the proposal's outline of factors issuers should consider in determining what constitutes "reasonable verification" of investor eligibility is likely to, at least in the near-term, lead to varying views on what steps should be taken to satisfy the rule's requirements. We expect commenters will weigh-in on the utility of this framework and urge you to contact us or the SEC directly to express your views.

Form D. The proposal would also amend Form D, which is the notice that issuers must file with the SEC when they sell securities pursuant to Regulation D, to add a separate box for issuers to check if they are using general solicitation in connection with a Rule 506 offering. According to the proposal, this additional information would, among other things, assist the SEC in monitoring the use of general solicitation in Rule 506 offerings and the size of this offering market.

Private Funds. Notably, the SEC did not propose any additional restrictions on general advertising by private funds, such as mutual fund-like performance-advertising content standards. The SEC also confirmed in the proposal that a private fund relying on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "**Investment Company Act**") for exemption from registration as an investment company would be permitted to engage in a general solicitation under amended Rule 506 without losing either exemption under the Investment Company Act even though such exemptions currently prohibit, among other things, the "public offering" of a private fund's securities. The SEC, however, declined the request of certain commenters to revise the definition of "accredited investor" to include all persons who are "knowledgeable employees" for purposes of the Investment Company Act.

Rule 144A Offerings to QIBs

The proposal would also amend Rule 144A(d) to allow sellers to broadly offer and advertise securities to be sold under Rule 144A so long as the purchasers of the securities are QIBs. Unlike in advertised Rule 506 offerings, a seller of securities under Rule 144A would not be obligated take "reasonable steps" to

verify that a purchaser of the securities is a QIB but would need to "reasonably believe" that the purchaser is a QIB, as is currently required. This means that sellers publicly soliciting investors in a Rule 144A offering would not technically be obliged to undertake any additional procedures than they do today to confirm that purchasers in the offering are indeed QIBs.

Commissioners' Views and What's Next

Although all of the Commissioners except Commissioner Aguilar voted to issue the proposal, Commissioners Paredes and Gallagher expressed strong dissatisfaction with the process behind the proposal, asserting that because the SEC has already missed the JOBS Act's statutorily imposed July 4th deadline for lifting the ban on general solicitation, the Commission should have issued an interim final rule to expedite implementation of the rule rather than a proposal. Commissioner Walter indicated that she was disappointed that the proposal did not contain more mechanisms to mitigate investor protection concerns, such as a legend requirement, and hoped that commenters would suggest improvements to the final rule in this regard. Commissioner Aguilar voiced similar investor protection worries in voting against the proposal.

Comments on the proposal will be due by October 5, 2012 (within 30 days of publication in the Federal Register, which is scheduled to occur on September 5, 2012). Although the SEC has been urged by members of Congress to move swiftly to adopt final rules, and certain Commissioners are clearly anxious to do so, it is unclear how quickly the SEC will act to finalize the rules once the proposal's comment period has expired. Until the SEC issues final rules, offering participants relying on Rule 506 and Rule 144A remain subject to the current prohibitions on general solicitation and general advertising under those rules. (For a set of Q&As that we prepared with a group of law firms that reflect our current understanding of the rules in place prior to the SEC's adoption of final rules, please **follow this link**). Once the SEC issues final rules to lift the current ban on general solicitation and general advertising, issuers would theoretically be able to find investors for Rule 506 or Rule 144A offerings using newspaper, Internet or TV ads or other forms of advertising, so long as the purchasers are AIs or QIBs, as applicable. We do not expect that this type of solicitation will occur on a widespread basis, however, at least in the near term. We do expect to see the following practical consequences once final rules are adopted:

- The initial purchasers or placement agents would be able to be named in press releases for a private offering conducted in reliance on Rule 506 or Rule 144A.
- An issuer conducting a public offering would be able to conduct a concurrent private placement without concerns about publicity restrictions. In response to commenter concerns, the SEC has also confirmed in the proposal that the use of general solicitation in an offering or sale of securities under Rule 506 or Rule 144A does not impair an issuer's ability to conduct a concurrent offshore offering under Regulation S. Accordingly, issuers would have new flexibility to raise capital on a registered basis, a private basis or both.
- An issuer that is a private fund relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act would be able to engage in general solicitation without losing its exemption from registration under the Investment Company Act.

Chairman Schapiro and the staff also acknowledged that broader private offering reform may be called for, and they plan to focus on this in the coming months, but they did not have the capacity to undertake this larger exercise congruently with the proposal discussed above.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Capital Markets

Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Michael Kaplan	**212 450 4111**	**michael.kaplan@davispolk.com**
Richard J. Sandler	**212 450 4224**	**richard.sandler@davispolk.com**
Richard D. Truesdell, Jr.	**212 450 4674**	**richard.truesdell@davispolk.com**
Janice Brunner	**212 450 4211**	**janice.brunner@davispolk.com**

Investment Management

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Yukako Kawata	**212 450 4896**	**yukako.kawata@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Danforth Townley	**212 450 4240**	**danforth.townley@davispolk.com**

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