

Securities Alert

Proposed JOBS Act Amendments to Regulation D: General Solicitation Will No Longer Be Prohibited

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For many years, smaller and mid-sized companies seeking to raise capital have relied upon Rule 506 under the Securities Act of 1933. However, Rule 506 did not permit issuers to offer or sell their securities using any form of general solicitation or advertising. Thanks to the Jumpstart Our Business Startups (JOBS) Act and amendments to Rule 506 proposed by the Securities and Exchange Commission on August 29, 2012, many issuers will soon be able to expand the circle of potential investors they reach by using general solicitation and advertising in Rule 506 offerings. This change presents an important opportunity for smaller and middle-market businesses.

Background

Securities offerings are regulated by both state and federal law. The federal Securities Act provides that, absent an exemption, no issuer or underwriter may offer securities unless a registration statement has been filed with the SEC and no sales of the securities may be made unless the registration statement has become effective. Most state securities laws also have registration or qualification provisions. The public offering process is time-consuming, very expensive, imposes significant ongoing compliance costs and imposes substantial potential liabilities on the issuer and its insiders.

For many years, smaller and middle-market companies have relied upon a safe harbor from the registration requirements available under Rule 506. As currently in effect, the Rule 506 requirements are as follows:

- The issuer reasonably believes that there are no more than 35 purchasers of securities who are not “accredited investors.”¹
- If the securities are offered to unaccredited investors, each unaccredited investor must have sufficient knowledge and experience in financial and business affairs and the investors must be provided with certain specified and detailed financial and business information.
- The issuer must file with the SEC a simple notice on Form D within 15 days after the first date any securities are sold.

¹ “Accredited investors” include, among others and with certain qualifications, institutional investors (banks, insurance companies, etc.); charities, trusts, corporations and other businesses with assets of more than \$5,000,000; individuals with assets (exclusive of the primary residence) of over \$1,000,000 or income for two years of more than \$200,000 (or \$300,000 filing jointly); and insiders of the issuer.

- Neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or advertising, including, without limitation, any advertisement published in any newspaper, magazine or similar medium.

In addition, state securities laws requiring the registration or qualification of securities offerings do not apply to Rule 506 offerings; states may impose, at most, requirements to file a copy of the federal Form D and pay a nominal fee. Using the Rule 506 exemption, then effectively pre-empts any separate state qualification requirements. In addition, many states have available limited offering exemptions, the requirements of which vary greatly from state to state, that may not require any filing or fee payment to such state.

Thus, Rule 506 permitted issuers an important way to raise capital without having to resort to the public offering process that is out of reach for most small and middle-market businesses. However, the scope of the issuer's reach to potential investors was greatly limited by the prohibition on general solicitation and advertising. The issuer's only means of reaching investors was to contact parties with whom they had existing business or personal relationships or to employ a broker, who would still not be permitted to engage in a broad solicitation.

The JOBS Act Amendments

On April 12, 2012, the JOBS Act became law. This Act had numerous provisions intended to facilitate funding of small and start-up businesses. One important feature was a requirement that the Securities and Exchange Commission amend Rule 506 within 90 days to eliminate the prohibition on general solicitation or advertising in offerings in which all purchasers of the securities are accredited investors. In addition, the SEC was directed to establish standards for determining the reasonable belief that one is an accredited investor.

On August 29, 2012, the Securities and Exchange Commission issued SEC Release No. 33-9354, "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings." The Release proposes, but does not yet adopt, the amendments to Rule 506 required by the JOBS Act. Following a 30-day comment period, the SEC may make changes to the proposed amendments before they become final. In light of the Congressional mandate in the JOBS Act, it is unlikely that the changes would be significant or that the SEC would fail to promulgate final amendments. We cannot estimate how much time it will take the SEC after the comment period ends to act on final amendments. And, pending the effectiveness of final amendments, we would counsel our clients to continue avoiding using any form of general solicitation or advertising.²

The proposed rules preserve the Rule 506 exemption in its existing form, but now refer to those offerings as Rule 506(b) offerings. Accordingly, issuers who do not wish

² In addition to it being our advice, a consortium of fourteen major securities law firms published a consensus report stating that issuers should consider the prohibition on general solicitation and advertising to fully apply pending the adoption of the final rule. 14 Law Firm Consensus Report, *The JOBS Act and General Solicitation: Impact of Private Offerings During the Period Prior to SEC Rulemaking*, ALI-ABA Topical Courses, The JOBS (Jumpstart Our Business Startup Act – A Revolution in Private Offerings) (April 23, 2012).

to engage in general solicitation or advertising may continue to rely upon Rule 506(b). Issuers using Rule 506(b) may still solicit unaccredited investors and needn't verify the purchaser's accredited investor status.

In addition, however the amendments create a new Rule 506(c). The proposed Rule 506(c) requirements are as follows:

- The issuer may only make sales to persons the issuer reasonably believes are accredited investors.
- The issuer must take reasonable steps to verify that the purchasers are accredited investors.
- The issuer must file with the SEC a Form D within 15 days after the first date any securities are sold.

The other Rule 506 requirements would not apply. Specifically, the issuer would be permitted to engage in general solicitation and general advertising and there would be no requirement to deliver any particular financial or business information to the potential investors.

Moreover, securities issued under proposed Rule 506(c) would continue to be federal "covered securities," effectively pre-empting any state securities regulation other than requirements to make a post-offering filing with the states of the Form D and pay a fee. This is significant, because state limited offering exemptions that do not require any filing or fee payment generally turn upon there being no general solicitation or advertising. While the limited offering exemptions will continue to be useful in Rule 506(b) offerings, the issuer will likely need to rely upon the covered securities exemption for Rule 506(c) offerings.

Verification of Accredited Investor Status

Unlike existing Rule 506, proposed Rule 506(c) would require that the issuer take "reasonable steps" to validate each purchaser's accredited investor status. The Release states that the SEC considered, and rejected, including any guidance on what steps would be sufficient or necessary, stating that the verification could vary greatly depending upon the facts and circumstances. The SEC did indicate that the following factors would affect the reasonableness of the verification process;

- The nature of the purchaser and type of accredited investor the purchaser claims to be (e.g., a large financial institution vs. an unknown individual).
- The amount and type of information the issuer has about the purchaser (e.g., information may be available publicly or from third parties).
- The nature of the offering (e.g., ability to satisfy a high minimum purchase requirement might be relevant).

In any event, some reasonable verification process will be important. In addition, it will be imperative to document that verification. The Release suggests that a pre-existing relationship may be sufficient and that the issuer should be entitled to rely upon

reasonably trustworthy outside sources. However, naked reliance upon a representation, warranty or investor questionnaire – as many issuers now do in Rule 506 offerings – clearly would not be sufficient.

Conclusion

In our experience, a large percentage of Rule 506 offerings made by issuers today are made exclusively to accredited investors. For these issuers, the ability to use general solicitation and advertising may be a revolutionary advance in their ability to raise capital. This flexibility and reach comes at a price – the issuers will be required to verify the purchaser’s accredited investor status and may lose the ability to rely upon a limited offering exemption in some states, potentially requiring some additional Form D filings and some additional blue sky fees. However, for most issuers who are not soliciting unaccredited investors, those costs are small in comparison to the benefits of being able to solicit and advertise.

Should you have any questions about Rule 506 or the proposed amendments, please contact us.

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