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Proposed SEC Rules on General Solicitation Will Fundamentally Change Private Capital Raising

The SEC proposed rule changes last week that will, when finalized, permit general solicitation and general advertising in connection with certain unregistered securities offerings. These new rules will represent one of the most fundamental changes to the regulation of private capital raising in decades. The changes were proposed to implement the requirements of the Jumpstart Our Business Startups (JOBS) Act.

Regulation D currently provides in Rule 506 a safe harbor from the registration requirements of the Securities Act of 1933 for certain offerings of securities that do not involve a "public offering" under section 4(a)(2) of that Act[1]. Since its adoption, one of the conditions to use of the Rule 506 safe harbor – and to any offering under a private placement exemption – has been that the offer not involve any general solicitation or general advertising (for purposes of this memo, "general solicitation"). As proposed, a new provision of Rule 506 – called Rule 506(c) – will extend the safe harbor to an offering that involves a general solicitation, provided that:

- the issuer takes "reasonable steps" to verify that the purchasers qualify as accredited investors, and
- each purchaser is an accredited investor, either through meeting one of the listed criteria under the accredited investor definition[2], or because the issuer reasonably believes that the purchaser meets one or more of those criteria at the time of sale.

Offerings under new Rule 506(c) also must continue to comply with the other requirements of Regulation D, including the issuer's taking reasonable care to assure that the purchasers are not underwriters through investment representations, legends and disclosure as to the restricted nature of the securities being sold.

While many issuers will no doubt continue to raise private capital quietly through networks of established contacts or through intermediaries, the new rule will open the doors for companies seeking capital, especially early-stage companies, to promote their securities offerings widely so long as they take reasonable steps to assure that all purchasers qualify as accredited investors. While making it easier for companies to raise capital, the new rules also raise legitimate questions whether it will also make it easier for promoters of fraudulent schemes or abusive practices to reach a wider audience. Regardless, the traditional distinction between public and private offerings can now be more accurately thought of as a distinction between registered and unregistered offerings, either of which will soon be permitted to be marketed to the public.

Reasonable Steps

The proposed new rule imposes additional verification requirements upon an issuer that wishes to use general solicitation in a Rule 506 offering. The SEC declined to define what is meant by "reasonable steps" in the proposed rule, noting that any enumerated set of steps, even if presented as a non-exhaustive list, may prove to be ill-suited and more onerous than is needed in some circumstances, while being not rigorous enough in others. Rather, whether steps taken by an issuer are "reasonable" will be an objective test based on the facts and circumstances of each transaction. The proposing release does suggest a number of factors that could be relevant in

1. The JOBS Act amended the Securities Act so that the general private placement exemption, long contained in section 4(2) of that Act, was renumbered as section 4(a)(2). Generally, Rule 506 currently permits offers and sales to an unlimited number of accredited investors, and up to 35 non-accredited investors. If any non-accredited investors purchase securities, however, substantial disclosure and information requirements apply.

2. Among other criteria, natural persons can be accredited investors either with net worth of $1 million, individually or with the person's spouse, excluding the person's primary residence, or with individual income over $200,000 in the last two years ($300,000 with a spouse) and an expectation of reaching the same level in the current year. Other standards apply to entities. See Rule 501(a).

determining the reasonableness of steps taken to verify an investor's status, such as:

- *The nature of the purchaser and the type of accredited investor the person claims to be*. For example, some categories under the accredited investor definition (such as registered broker-dealers) are easily confirmed with publicly available resources. Likewise, an executive officer or director of an issuer is, by definition, accredited.
- *The amount and type of information that the issuer has about a purchaser*. The more information an issuer has already about a purchaser, the fewer steps it would need to take. An issuer might rely on publicly available information, such as where a natural person is a named executive officer of an SEC registrant whose annual compensation is presented in his or her employer's proxy statement, or where a 501(c)(3) organization's total assets are disclosed in a publicly available tax return. It might rely on copies of a Form W-2 for a natural person to verify income. There may also be cases where it is appropriate to rely on third-party certifications or even published data on average compensation in an industry for certain levels of employee.
- *The nature and terms of the offering*. An issuer that solicits investors through a widespread advertisement or website would need to take more rigorous steps than one that solicits from a pre-screened list maintained by a reliable third party. Merely relying on representations from the investors would likely not be enough, especially where the solicitation is widespread. But a high minimum investment amount, combined with representations that it is not financed through borrowing, may also be considered as a factor, where the minimum amount is such that only accredited investors would be likely to meet it.

Each of these factors would be analyzed objectively and in their totality to determine whether the steps an issuer takes to verify accredited investor status are reasonable.

Issuers raising capital through general solicitations under new Rule 506(c) will need to maintain adequate records demonstrating the steps they have taken to verify the purchasers' status, consistent with the general principle that issuers claiming an exemption from the registration requirements of the Securities Act have the burden of showing that they qualify for that exemption.

Rule 144A Offerings

Rule 144A is a non-exclusive safe harbor exemption from the registration requirements of the Securities Act, for the resale of securities to "qualified institutional buyers", or QIBs. As required by the JOBS Act, the proposed rules would permit general solicitation in connection with a Rule 144A offering, so long as the securities are sold only to a person that the seller and any person acting on behalf of the seller reasonably believe is a QIB.

Private Funds

Venture capital funds, private equity funds and hedge funds typically rely on one of two exclusions from the definition of "investment company" under the Investment Company Act of 1940 in order to avoid the burdensome registration requirements of that Act. Both of those exclusions are available only to an issuer which "is not making and does not … propose to make a public offering" of its securities[3].

Section 201(b) of the JOBS Act provided that offers and sales exempt under Rule 506, as revised to permit general solicitation, "shall not be deemed public offerings under Federal securities laws as a result of general solicitation or general advertising." The SEC's proposing release confirms its view that the effect of the JOBS Act is to permit a private fund to offer its limited partnership interests through a general solicitation under new Rule 506(c) without losing its Investment Company Act exclusion.

Changes to Form D

To assist the SEC in tracking the use of general solicitation in connection with unregistered offerings under the new rule, the SEC has proposed to amend Form D by adding a box to check for offerings that will rely on the new Rule 506(c). For now, at least, the filing of the Form D remains an independent requirement of Regulation D, but not a condition to the availability of the safe harbor.

Integration with Overseas Offerings

Regulation S, which provides a registration exemption for offers and sales of securities outside of the United States, requires that there not be any "directed selling efforts" in the United States. The proposing release confirms that general solicitation used in a Rule 506(c) offering will not be considered "directed selling efforts" that would jeopardize the Regulation S portion of the offering. This is consistent with the traditional SEC position that offshore transactions under Regulation S will not be integrated with either registered offerings in the United States or transactions exempt from registration in the United States.

Existing Rule 506 Remains Available

The proposal makes clear that issuers will continue to have the option of using Rule 506 as it currently

[3]. See sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.

exists. In other words, issuers that do not engage in general solicitation will not be required to demonstrate "reasonable steps" to verify that all purchasers are accredited investors, and they will be free to sell to non-accredited investors under the conditions of the rule. They will be able to continue to rely on the reasonable belief standard incorporated into the definition of accredited investor, which may in practice often be satisfied through investor questionnaires or similar steps.

Anti-Fraud Rules Still Apply

As with any offer and sale of securities, an offering under Rule 506(c) will be subject to the anti-fraud provisions of the securities laws, which among other things prohibit untrue statements of material facts (or omissions of material facts necessary to make the statements that are made not misleading) in connection with the offer or sale of the security. The exemption under Rule 506(c) is merely an exemption from the registration requirements of section 5 of the Securities Act, and not an exemption from the anti-fraud rules.

Blue Sky Preemption

Offers and sales under Rule 506 are preempted by section 18 of the Securities Act from substantive state securities (or "blue sky") regulation other than fee and notice filing requirements. Although the SEC's non-prescriptive approach to the "reasonable steps" requirement is welcome, it could provide plaintiffs who seek to assert state blue sky law claims by challenging compliance with Rule 506 another basis for such challenge.

No General Solicitation until Final Rules

The SEC has not met its JOBS Act deadline to have final rules on general solicitation in place, deeming it better to get the rules right than to issue them quickly. Instead of issuing interim final rules with immediate effect as originally planned, the Commission issued proposed rules with a relatively short 30-day comment period. Regardless of the delay, it is important to recognize that *until final rules are adopted and become effective, general solicitation in connection with Rule 506 offerings remains prohibited.*

This advisory is for guidance only and is not intended to be a substitute for specific legal advice. If you would like further information, please contact the Edwards Wildman Palmer LLP lawyer responsible for your matters or the lawyer listed below:

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