SEC Proposes Amendments to Permit General Solicitation in Securities Offerings

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Amendments to Rules 506 and 144A required by the JOBS Act

On August 29, 2012 the SEC proposed amendments to Rules 506 and 144A under the Securities Act of 1933 that would permit general solicitation and general advertising in securities offerings under these exemptions from securities registration. The proposal implements a provision of the JOBS Act that requires the SEC to amend these rules. The exemptions from registration under these rules are available to both publicly traded and private companies, both domestic and foreign.

Background

Prior to the amendments called for by the JOBS Act, Rule 506 permitted a company to offer and sell, in a private placement, an unlimited amount of securities to an unlimited number of accredited investors and to no more than 35 non-accredited investors who satisfied certain "sophistication" requirements (which could be met with the help of an advisor). The availability of this exemption from registration was subject to a number of conditions, including the absence of general solicitation and general advertising.

Rule 144A by its terms is limited to resales, but has been used to facilitate capital-raising by having the issuer sell its securities in a private placement to one or more financial intermediaries who immediately resell the securities under Rule 144A. Although the Rule does not expressly prohibit general solicitation, it requires that offers be made only to Qualified Institutional Buyers (QIBs), which has a similar solicitation-limiting effect.

The JOBS Act sought to make it easier for companies to raise capital by allowing them to broadly advertise their unregistered securities offerings to attract investors, provided that actual purchases are limited to investors who qualify to invest under the applicable private offering exemption.

Proposed Amendments to Rule 506

To implement the change mandated by the JOBS Act, the SEC is proposing to divide Rule 506 into two alternative exemptions. Rule 506(b) will continue the current exemption, which permits purchases by non-accredited investors and prohibits general solicitation. A new Rule 506(c) will permit the use of general solicitation, subject to the following additional conditions:

- All purchasers of the securities (regardless of the status of the offerees) must be accredited investors. (The definition of "accredited investor" in Rule 501 includes persons the issuer reasonably believes qualify as such. The proposing release confirms that this standard will also apply to offerings under new Rule 506(c).)

- The issuer must take reasonable steps to verify that all purchasers are accredited investors.

Except for these differences between the two Rule 506 exemptions, the current requirements applicable to Rule 506 offerings which are set forth in Rules 501 and 502 and other applicable provisions of Regulation D continue to apply to both types of Rule 506 offerings. (The requirement in Rule 502 to provide specified information if any purchaser in the offering is a non-accredited investor by its terms would not apply to the new Rule 506(c) exemption, which is limited to accredited investor purchasers.)

While the JOBS Act required that issuers take "reasonable steps" to verify that all purchasers in an offering using general solicitation are accredited investors, it left it to the SEC to determine the "methods" to be used by issuers in making the verification. In its proposed rule, the SEC declined to mandate a particular verification process or even to identify a set of "safe harbor" procedures that would be deemed to be "reasonable." Instead, the proposing release identified the following factors that issuers need to consider in determining whether their verification process is "reasonable."

- **Nature of the Purchaser**. Reasonable verification steps would differ depending on the category of accredited investor in which the purchaser falls. For example, less would be required where the purchaser's accredited investor qualification is determined solely by status (e.g. a registered broker-dealer or registered investment company), somewhat more where its qualification is determined by a combination of status and assets (e.g. a corporation with total assets over $5 million), with the greatest level of verification required for natural persons (where accredited investor status is based on either income or net worth).

- **Information about the Purchaser**. The proposing release indicates that issuers could review or rely on the following types of information, which, depending on the circumstances, may or may not be sufficient verification in and of themselves:

  - Publicly available information in regulatory filings, such as an executive's compensation as reported in his/her employer's proxy statement filed with the SEC, or a tax exempt organization's assets as reported in its Form 990 filed with the IRS.

  - Third-party information that is reasonably reliable, such as an individual's Form W-2 or publicly available trade publications providing compensation information about the individual.

  - Verification of the person's status as an accredited investor by a third party (such as a broker-dealer, attorney, or accountant) if the issuer has a reasonable basis for relying on this source. The proposing release anticipates that in the future vendors will emerge to fulfill this function.

- **Nature of the Offering.** An issuer that solicits purchasers through media accessible by the general public or by widely disseminated email or social media solicitations would need to take greater measures to verify accredited investor status than an issuer that limits its solicitations to pre-screened investors. Where the solicitation is made available to the general public, purchaser questionnaires and self-certifications would be insufficient verification.

- **Terms of the Offering.** If the minimum investment is sufficiently high that only accredited investors could reasonably be expected to meet it, the additional verification required would be limited. The proposing release indicates that in this situation it may be sufficient for the issuer to verify that the investment is not being financed by the issuer or a third party.

Regardless of the steps taken to verify accredited investor status, issuers would be required to retain records documenting the steps taken. Whether those steps were "reasonable" would be subject to SEC challenge in hindsight.

Proposed Amendments to Rule 144A

To implement the change mandated by the JOBS Act, the SEC is proposing to amend Rule 144A to eliminate the requirement that securities only be offered to QIBs (or to persons reasonably believed to be QIBs). As a result, offerings under the Rule would be able to be made by general solicitation, so long as purchasers were limited to QIBs and persons that the seller (and any person acting on the seller's behalf) reasonably believes to be QIBs.

Under existing Rule 144A, QIBs are defined generally as specified institutions that own and invest on a discretionary basis at least $100 million in securities (with special rules for banks and broker-dealers). The Rule already provides a non-exclusive list of methods which can be used to determine whether a prospective purchaser satisfies the definition. These include (i) the purchaser's most recent publicly available financial statements or other information filed with a governmental or self-regulatory body, (ii) information appearing in a recognized securities manual, and (iii) certification by an executive officer of the purchaser.

Integration with Offshore Offerings

Under current law, an issuer may make an offering of securities outside the United States under Regulation S concurrently with an unregistered offering within the United States under Rule 506 or Rule 144A. An essential element of Regulation S is that there can be no "directed selling efforts" in the United States - a concept broadly defined as activity with the purpose or effect of conditioning the market in the US for the securities being offered abroad. In response to comments, the SEC proposing release has addressed the question of whether general solicitation activities undertaken as part of a Rule 506 or 144A offering would constitute directed selling efforts which would preclude the availability of Regulation S.

While not eliminating the Regulation S requirement that there be no directed selling efforts within the United States, the proposing release reaffirms the SEC's historical position that offshore offerings under Regulation S will not be integrated with domestic offerings made in compliance with an exemption from Securities Act registration. Accordingly, the release asserts that the use of general solicitation under amended Rules 506 and 144A would not preclude the availability of Regulation S for a concurrent offshore offering.

For more information about the proposed amendments to Rules 506 and 144A and other SEC rulemaking, or about Hughes Hubbard's Securities and Capital Markets Practice Group, please contact any of the following attorneys:

Gary Simon, Co-Chair
(212) 837-6770
simon@hugheshubbard.com

Ted Latty, Co-Chair
(213) 613-2808
latty@hugheshubbard.com

Ellen Friedenberg
(212) 837-6465
frieden@hugheshubbard.com

Gloria Nusbacher
(212) 837-6719
nusbache@hugheshubbard.com

Chuck Samuelson
(212) 837-6454
samuelso@hugheshubbard.com

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Hughes Hubbard & Reed LLP
One Battery Park Plaza | New York, New York 10004-1482 | 212-837-6000