

CAPITAL MARKETS ALERT

September 2012

SEC Proposes Rules to Eliminate Prohibitions on General Solicitation and Advertising in Response to JOBS Act Mandate

As part of the Jumpstart Our Business Startups Act (JOBS Act), Congress directed the Securities and Exchange Commission (SEC) to adopt rules to permit general solicitation or general advertising in offerings made under Rule 506 of Regulation D so long as all purchasers are “accredited investors.” The elimination of this prohibition is a radical departure from current rules governing private placements and is aimed at providing issuers with greater access to the capital markets. Congress conditioned an issuer’s ability to use general solicitation and general advertising on the issuer taking “reasonable steps” to verify that purchasers of the securities are in fact accredited investors, “using such methods as determined by the Commission.” The SEC stated in its release that it is not proposing to adopt uniform verification methods because it believes such an approach would be impractical and potentially ineffective. Instead, issuers will have flexibility in determining how best to verify an investor’s status, taking into account the facts and circumstances of the investor and the offering.

The proposed rule would be implemented through the addition of a new Rule 506(c) that would provide that general solicitation or general advertising may be used if all purchasers of securities sold in any offering are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors. In addition, the general terms and conditions of Rule 501 and Rule 502(a) and (d) (relating to integration and limitations on resale) must also be satisfied. Although the new rules assign issuers a gate keeping function, the SEC made clear that the standard remains a “reasonable belief” standard rather than an absolute one and that the safe harbor would be available if a purchaser was not an accredited investor so long as the issuer took reasonable steps to verify the investor’s status. Because an issuer seeking to rely on the exemption bears the burden of proof, issuers should maintain documentation of the steps taken to verify investor status.

While continuing to solicit comments on various approaches to verification, the SEC indicated in the proposing release that what is “reasonable” to verify investor status will vary depending on the facts and circumstances, 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, including the manner in which the investor was solicited to participate and whether there is a minimum investment amount.

For example, the SEC indicated that the steps that might be reasonable to document an investor’s status as an investment company would likely be different than the steps required to verify the status of an investor that is a natural person given an individual’s privacy concerns. The SEC also indicated that an issuer that solicits investors through a public website or social media would likely need to take greater measures than an issuer that solicits investors from a pre-screened database maintained by a reliable third party. In the former case, the SEC indicated that it does not believe reasonable steps will have been taken if the issuer’s only verification is requiring the investor to check a box on a questionnaire. In contrast, the SEC indicated that an issuer could rely on a third party screener “provided that the issuer has a reasonable basis to rely on such third-party verification.”

The SEC indicated it does not propose to provide a non-exclusive list of methods to satisfy the verification requirement. However, the proposing release does provide insight into methods considered reasonable by the SEC, including the SEC's statement that it anticipates many of the practices currently used by issuers conducting Rule 506 offerings would satisfy the verification requirement under new Rule 506(c).

In addition to requiring the amendment of Rule 506, the JOBS Act directed the SEC to amend Rule 144A to permit offers under Rule 144A to persons other than "qualified institutional buyers" (QIBs) provided sales are only made to persons the seller reasonably believes to be QIBs. While Rule 144A does not contain an express prohibition on general solicitation or advertising, it does provide that offers may be made only to QIBs, which has the same effect. The proposed rules would eliminate the reference to "offered" and "offeree" in Rule 144A(d)(1).

Unlike many aspects of the JOBS Act, the revisions to Rule 506 and Rule 144A will not be effective until the SEC's final rules become effective. Rule 506 and Rule 144A therefore remain unchanged at present and issuers should continue to comply with Rule 506's prohibition on general solicitation and advertising. The new rules will also not affect offers and sales under other provisions of Regulation D or in reliance on

Section 4(2) of the Securities Act of 1933. Issuers may continue to make sales to up to 35 unaccredited investors under Rule 506 provided they do not utilize new Rule 506(c). The SEC also make clear its belief that utilizing general solicitation under new Rule 506(c) would not constitute "directed selling efforts" under Regulation S and that a domestic offering under Regulation D, as amended by the proposed rules, would not be integrated with a concurrent off-shore offering made in compliance with Regulation S.

The proposing release made clear the SEC's belief that privately offered funds, such as private equity funds, venture capital funds and hedge funds, may utilize general solicitation under new Rule 506(c) without losing their exclusion under Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act.

Lastly, the proposed rules would require issuers to check a new box on Form D indicating whether the offering was conducted pursuant to new Rule 506(c). Because a Form D is not submitted until after sales are made, the SEC will not receive notice in advance of an offering made by means of general solicitation, as was recommended by some commentators. The disclosure will, however, serve the purpose of allowing the SEC to continue to monitor the development of this market.

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