SEC adopts final amendments to permit general solicitation or general advertising in private placement transactions under Rule 506 and Rule 144A

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On 5 April 2012, President Obama signed into law the US Jumpstart Our Business Startups Act (**JOBS Act**). The JOBS Act was intended to facilitate capital raising activities by easing the securities law burdens to which growing private companies and smaller US public companies are subject. The JOBS Act amended certain provisions of the US Securities Act of 1933, as amended (**Securities Act**), and directed the US Securities and Exchange Commission (**SEC**) to revise its rules under the Securities Act to give effect to the JOBS Act. On 10 July 2013, the SEC held an open meeting at which it adopted amendments to implement Section 201(a) of the JOBS Act relating to the use of "general solicitation or general advertising" in certain US private placement transactions. The amendments are set forth in SEC Release No. 33-9415 (**Adopting Release**) and can be viewed here: *http://www.sec.gov/rules/final/2013/33-9415.pdf*. In a separate release, the SEC also adopted amendments disqualifying securities offerings involving certain "felons and other 'bad actors'" from reliance on Rule 506 (**Rule 506**) of Regulation D (**Regulation D**) under the Securities Act. The amendments are set forth in SEC Release No. 33-9414 and can be viewed here: *http://www.sec.gov/rules/final/2013/33-9414.pdf*. The amendments will become effective 60 days after publication of the respective releases in the US Federal Register, likely in mid-September.

Background

Section 201(a) of the JOBS Act directed the SEC to amend Rule 506 to allow general solicitation or general advertising in connection with private offers or sales of securities under that rule, so long as all purchases of securities are made solely by accredited investors. To address concerns that broadening the circumstances in which general solicitation may be used might expose small investors to fraudulent offering conduct, the JOBS Act mandates that issuers use methods prescribed by the SEC to verify that the purchasers under Rule 506 qualify as accredited investors.

Rule 506 is one of several "safe harbor" exemptions under Regulation D from the registration requirements of the Securities Act for transactions "not involving any public offering" in the United States. Under existing Rule 506 (which will be renumbered Rule 506(b) as a result of the amendments), a company may sell securities to an unlimited number of "accredited investors" and up to 35 non-accredited investors, subject to a number of requirements, including the issuer and any person acting on its behalf not offering or selling securities

Contacts

John Basnage
Partner
john.basnage@hoganlovells.com
+44 20 7296 2766

Maegen Morrison
Partner
maegen.morrison@hoganlovells.com
+44 20 7296 5064

Peter Kohl
Partner
peter.kohl@hoganlovells.com
+44 20 7296 5644

through any form of general solicitation or general advertising. Although Rule 506 does not define general solicitation or general advertising, it is understood to include advertisements published in newspapers and magazines, communications broadcast over television, radio and unrestricted websites and seminars where attendees have been invited by general solicitation or general advertising.

Section 201(a) of the JOBS Act also directed the SEC to amend Rule 144A under the Securities Act (**Rule 144A**) to permit securities to be *offered* to persons other than "qualified institutional buyers", as defined in Rule 144A (**QIBs**), including by means of general solicitation or general advertising, so long as only QIBs (or persons reasonably believed by the seller to be QIBs) *purchase* the securities.

Rule 144A is a "safe harbor" exemption from the registration requirements of the Securities Act for resales of certain restricted securities to QIBs. Rule 144A is used to place securities with US institutional investors by non-US issuers in a substantial number of global offerings. Although existing Rule 144A does not expressly prohibit general solicitation or general advertising, *offers* of securities under existing Rule 144A are limited to QIBs, with the result that transaction participants are in effect precluded from engaging in general solicitation or general advertising.

Nicola Evans
Partner
nicola.evans@hoganlovells.com
+44 20 7296 2861

Nigel Read
Partner
nigel.read@hoganlovells.com
+44 20 7296 5121

Jaime Huertas
Associate
jaime.huertas@hoganlovells.com
+44 20 7296 2351

Visit us at
www.hoganlovells.com

It should be noted that the JOBS Act does not extend relief to private placement transactions that do not satisfy the requirements of Rule 506, for instance private placements under Section 4(a)(2) of the Securities Act or the so-called "Section 4(1½)" exemption that is used in block trades and accelerated book building transactions in circumstances in which Rule 144A is not available. Nor does the JOBS Act eliminate restrictions on the use of "directed selling efforts" in transactions conducted outside of the United States pursuant to Regulation S under the Securities Act (**Regulation S**). Directed selling efforts include activities undertaken for the purpose of, or that could reasonably be expected to have the effect of, condition the market in the United States for the securities being offered and may be implied by activities that would also constitute general solicitation or general advertising. Finally, the securities laws of the several states of the United States may prohibit the use of activities that constitute general solicitation or general advertising. While US federal securities law pre-empt state regulation of offerings conducted pursuant to Rule 506, no such pre-emption exists for transactions conducted in reliance on Rule 144A (unless the securities are being issued by a company that files reports with the SEC under the US Securities Exchange Act of 1934, as amended (**Exchange Act**)) or Section 4(a)(2).

The SEC's amendments

The SEC has retained the existing exemption under Rule 506 and renumbered it Rule 506(b). To implement Section 201(a) under the JOBS Act, it has supplemented this with a new Rule 506(c) that permits an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, provided that all purchasers of the securities are "accredited investors" and the issuer takes reasonable steps to verify that such purchasers are accredited investors. Rule 506(c) also includes a non-exclusive list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons. The SEC's amendments to Rule 144A provide that securities may be *offered* pursuant to Rule 144A to persons other than QIBs, provided that the securities are *sold* only to persons that the seller and any person acting on

behalf of the seller reasonably believe are QIBs.

Pursuant to a separate release, to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (**Dodd-Frank Act**), the SEC amended Rule 506 to disqualify issuers and other market participants from relying on Rule 506 if "felons and other 'bad actors'" are participating in the Rule 506 offering.

Rule 506

The SEC's new Rule 506(c) will permit a company to use general solicitation or general advertising in connection with a private placement under Regulation D so long as:

- the company complies with other applicable conditions of Regulation D, namely Rule 501 (which defines "accredited investor"), Rule 502(a) (relating to integration of offerings) and Rule 502(d) (relating to limitations on resales of securities placed in reliance on Rule 506);
- all purchasers are accredited investors or the company reasonably believes that the purchasers are accredited investor; and
- the company takes "reasonable steps to verify" that all purchasers are accredited investors.

The requirement that the issuer (or those acting on its behalf) take reasonable steps to verify the purchasers are accredited investors is separate from the requirement that all purchasers are, in fact, accredited investors and must be satisfied even if all purchasers happen to be accredited investors.

In its proposing release, the SEC stated that the reasonableness of steps to be taken would be subject to "an objective determination based on the particular facts and circumstances of the transaction", including, for instance, (a) the nature of the purchaser, (b) the amount and type of information that the issuer has about the purchaser and (c) the nature of the offering. The SEC noted that the reasonableness of steps undertaken to verify the status of investors depends on all aspects of the transaction, including the minimum amount of investment, if any, the breadth of and means of marketing undertaken and whether there is an existing relationship with investors.

In the Adopting Release, the SEC confirmed that a principles-based approach to verification of an accredited investor's status will apply. However, in response to comments to proposed amendments seeking additional guidance, the SEC has provided four non-exclusive methods for verifying the accredited investor status for *natural persons* that participate in an offering under Rule 506(c). These include (a) reliance on two years of US Internal Revenue Service forms that report income, along with a representation that the investor expects to have income sufficient to be an accredited investor in the current year, (b) bank and brokerage statements, certificates of deposit, tax assessments, appraisal reports, consumer reports and similar items addressing the investor's assets, along with a representation from the investor that all liabilities necessary to make a determination of net worth have been disclosed, (c) reports from a US registered broker-dealer, investment adviser, attorney or CPA confirming that it has taken reasonable steps to verify that the investor is an accredited investor and (d) for an investor that has previously invested as accredited investor in the issuer's securities on the basis Rule 506, a certificate from the investors that s/he continues to qualify as an accredited investor. These methods are in many cases more extensive than those that were customarily undertaken in connection with verifying the status of investors under existing Rule 506 and it is unclear to what extent these methods will be adopted. It is also uncertain to what extent, on what terms and at what cost third parties will be willing to certify an investor's accredited status.

It is likely, however, that transaction participants seeking to rely on Rule 506(c) will undertake a high degree of caution in determining whether a person is an "accredited investor", as a mistaken characterization could lead to an allegation that the offering cannot be conducted in reliance on Rule 506(c), and any use of general solicitation or general advertising would also render Section 4(a)(2) unavailable as a back-up exemption. It should also be noted that the SEC's amendments do not limit the scope of US anti-fraud provisions, including Rule 10b-5 under the Exchange Act. Expanding the use of general solicitation may increase the risk of running

afoul of these provisions.

Rule 144A

The SEC has adopted amendments that will eliminate references to "offer" and "offeree" in Rule 144A(d)(1), with the effect that sellers and their agents offering securities in reliance on Rule 144A may offer such securities to persons that are not QIBs, including by means of general solicitation or general advertising, so long as the purchasers are QIBs or persons reasonably believed to be QIBs by the seller and anyone acting on its behalf. However, the SEC's amendments do not pre-empt state regulation of Rule 144A transactions where securities are being issued by a company that does not file reports with the SEC under the Exchange Act, as would be the case in a substantial proportion of Rule 144A transactions undertaken by foreign private issuers outside of the United States. In such circumstances, US state securities laws that prohibit advertising in connection with securities transactions may apply and could prevent offering participants from seeking investors through the use of general solicitation in such states.

Private Funds

The SEC has confirmed that private funds, such as hedge funds, venture capital funds and private equity funds, will be permitted to conduct general solicitation or general advertising to offer and sell their interests without registration under the Securities Act in reliance on Rule 506(c). Notwithstanding requests from parties commenting on its proposed amendments, the SEC declined to limit such fund's use of Rule 506(c). It noted, however, that these funds are subject to Rule 206(4)-8 under the US Investment Advisers Act of 1940, as amended, which prohibits as fraudulent activities the making of "any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or otherwise engag[ing] in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle". In other words, while such funds may engage in general solicitation under Rule 506(c), as with others relying on the rule, concerns about potential liability under Rule 10b-5 may limit the extent to which they do so.

Integration with Regulation S

The SEC has reiterated its position that concurrent offerings conducted in accordance with Regulation S outside of the United States will not be integrated with domestic unregistered securities that are conducted in compliance with Rule 506 or Rule 144A. The SEC appears to be of the view that general solicitation conducted in the United States may be permissible with respect to securities placed with US investors under Rule 506(c) or Rule 144A, at the same time as "directed selling efforts" would be impermissible with respect to securities placed simultaneously outside the United States in reliance on Regulation S. Many activities that constitute general solicitation or general advertising may in fact also constitute directed selling efforts. As securities are frequently offered concurrently within and outside the United States in offering by non-US companies that are managed as a single global offering, it is unclear in practice to what extent the continuing restrictions on the use of directed selling efforts by issuers, underwriters and persons acting on their behalf will limit the use of general solicitation or general advertising in such global offerings.

Bad Actor Provisions

In accordance with Section 926 of the Dodd-Frank Act, the SEC also adopted amendments to Regulation D in the form of a new Rule 506(d), that will make Rule 506(b) and Rule 506(c) unavailable for securities offerings where the issuer or certain persons related to the issuer are convicted of felonies or certain misdemeanors or become subject to certain convictions, orders, judgments, decrees, suspensions, expulsions or bars on or after the date on which Rule 506(d) comes into effect. These persons include any director, executive officer, other officer participating in the offering, general partner, any beneficial owner holding more than 20% of the issuer's outstanding voting securities, any investment manager of an issuer that is a pooled investment fund and any person that will be paid remuneration for the solicitation of purchasers, among others. In addition, the issuer must disclose to each purchaser a description in writing of any matters that would have triggered

disqualification under Rule 506(d), but occurred before the time of its effectiveness.