SEC Proposes JOBS Act Amendments To Rule 506 And Rule 144A To Remove Ban On General Solicitation

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On August 29, 2012, the Securities and Exchange Commission released proposed amendments to Rules 506 and 144A in order to remove the prohibition on general solicitation and general advertising in Rule 506 and 144A offerings, as directed by the recently enacted JOBS Act. The SEC says it will accept comments on the proposed rules for 30 days.

The JOBS Act directed the SEC to create a new exemption under Rule 506 in order to allow an issuer relying on Rule 506 to offer securities through general solicitation or general advertising so long as the issuer takes "reasonable steps" to verify that all of the purchasers are accredited investors. Similarly, the JOBS Act directed the SEC to provide that sellers relying on Rule 144A may offer securities through general solicitation or general advertising so long as the seller "reasonably believes" that all of the purchasers are qualified institutional investors (QIBs).

Rule 506

In order to implement the changes to Rule 506, the SEC has proposed to add a new subsection (c), while leaving the rest of the existing Rule 506 intact. Under the new Rule 506(c), an issuer may use general solicitation or general advertising to offer and sell securities, provided that the following conditions are met:

- the issuer takes reasonable steps to verify that all purchasers are accredited investors
- all purchasers are accredited investors, or the issuer reasonably believes they are, at the time of the sale of securities; and
- all terms and conditions of Rule 501 (definitions) and Rules 502(a) (integration) and 502(d) (restrictions on resale) are satisfied.

To the dismay of many, the SEC declined to establish what specifically will constitute "reasonable steps," instead indicating that each transaction would be judged based on the facts and circumstances. Some of the factors that an issuer must consider when determining the reasonableness of the steps taken to verify accredited investor status include the nature of the purchaser, the amount and type of information that the issuer has about the purchaser, and the nature of the offering. While the proposed rules do not mandate the exact steps an issuer must take, it is clear that an issuer relying on Rule 506(c) will need to undertake some affirmative action to verify accredited investor status. It is unlikely that a representation from a purchaser regarding its status as an accredited investor will be sufficient.

The proposed rules preserve the current Rule 506(b), thereby apparently allowing issuers to continue to conduct Rule 506 offerings without taking "reasonable steps" to verify a purchaser's accredited investor status, so long as no general solicitation or general advertising is involved in the offering. Currently, an issuer claiming an exemption from registration under Rule 506 must file a Form D and must indicate that it is relying on Rule 506 under Item 6 of the form. In order to distinguish between an offering relying on Rule 506(b) and an offering relying on Rule 506(c), the SEC has proposed amending Item 6 of Form D to eliminate the 506 checkbox, and in its place include both a 506(b) and a 506(c) checkbox.

Although eliminating the prohibition on general solicitation and general advertising in connection with Rule 506 offerings may create new opportunities for companies seeking capital, any issuer relying on the new Rule 506(c) should be cautious because Section 4(a)(2) – the new designation of former Section 4(2), the classic "private placement" exemption – will not be available as a fallback. Under the current Rule 506, if an issuer attempts to rely on Rule 506 but fails to meet all of the elements, the offering may still be exempt from registration

under Section 4(a)(2), which exempts offerings that do not involve any public offering. In contrast, an offering made using general solicitation that does not qualify under new Rule 506(c) because of a failure to satisfy the accredited investor test will not be exempt from registration under Section 4(a)(2), at least not as that section has been interpreted by courts and practitioners for 79 years.

Rule 144A

The SEC has proposed to amend Rule 144A by removing any reference to "offer" or "offeree" in subsection (d)(1), which will effectively permit general solicitation and advertising in connection with Rule 144A offerings. Any seller relying on Rule 144A, whether they conduct the offering through general solicitation or not, will continue to have to reasonably believe that all purchasers are QIBs. The SEC has not proposed any changes to subsections (d)(1)(i)-(iv) of Rule 144A, which is a non-exclusive list of methods of establishing whether a purchaser is a QIB.

Some Possible Problems

Many practitioners feel that the SEC should have provided a real safe harbor about what constitutes a "reasonable basis" for believing that an investor is accredited. Without that certainty, issuers may not be willing to take a chance with their interpretation, which could limit use of 506(c), except in situations that are absolutely clear. Correspondingly, legal counsel are unlikely to be willing to give clean securities opinions on Rule 506(c) transactions because compliance with the rule will be a "facts and circumstances" test. Additionally, will courts accept that idea that selling to accredited investors in a Rule 506(c) transaction calls for a different, and tougher, standard than in a Rule 506(b) transaction? Will an unintended effect of the JOBS Act be to require a reasonable basis in Rule 506(b) transactions as well, and will this curtail the use that subsection?

Last, but surely not least, consumer groups worry that permitting general solicitation will result in a proliferation of fraudulent offerings by less than scrupulous issuers who will take an expansive view what is meant by a "reasonable basis" for believing that an investor is accredited. Their fear is that shoddy securities will find their way to barely vetted, unsophisticated investors.

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