

JOBS Act Client Alert – Rules 506 of Regulation D and 144A

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The JOBS Act (the “Act”), signed into law on April 5, 2012, promises to have a significant impact on two popular exemptions to registration of securities under federal securities laws. Currently, any issuer intending to rely on either Rule 506 of Regulation D or Rule 144A cannot engage in any general solicitation or advertising to attract investors. The Act directs the SEC to remove this prohibition. In addition, the Act exempts certain persons who connect Rule 506 issuers to potential purchasers from registering as a broker or dealer. Much of the interpretation of these provisions is left up to the SEC, which has 90 days to publish final rules, and until the SEC publishes its rules, the current Rules 506 and 144A and related guidance should be followed. Regardless of whether the shift is subtle or dramatic, the changes to Rules 506 and 144A will certainly affect how private capital is raised in the future.

Background

Under federal securities laws, prior to the sale of any securities, the securities must either be registered with the SEC, or exempt from registration. One popular exemption for issuers is Rule 506 of Regulation D, which, subject to a number of conditions, allows an issuer to sell its securities to so-called “accredited investors” (AIs) in a private placement transaction. An AI is currently defined as a business entity with at least \$5 million in assets and individuals with a net worth of at least \$1 million (excluding the individual’s primary residence) or an annual income of at least \$200,000 (or \$300,000 together with the individual’s spouse). However, in order to qualify for a Rule 506 exemption, the securities cannot be sold through means of general solicitation or advertising to the public at large.

A second useful exemption is Rule 144A, which provides an exemption from registration for the resale, generally by underwriters or investment houses, of certain types of previously issued securities, provided that the securities are only offered or sold to “qualified institutional buyers,” or QIBs. A QIB includes entities that hold at least \$100 million in securities, and other categories of financially sophisticated entities enumerated in the Rule.

General Solicitation

The Act directs the SEC to amend Rule 506 and Rule 144A to provide as follows:

- *Rule 506.* An issuer relying on Rule 506 may now offer the securities through general solicitation or general advertising so long as the issuer takes “reasonable steps” to verify that all purchasers are accredited investors.
- *Rule 144A.* A seller relying on Rule 144A may now offer the securities, including through public solicitation or advertising, to persons other than QIBs, although the seller must still “reasonably believe” that all of the purchasers are QIBs.

However, the Act does not identify what “reasonable steps” a Rule 506 issuer must take, or what it means to “reasonably believe” that a purchaser is a QIB, instead leaving it up to the SEC to provide final rules within 90 days. Until such time, we do not recommend that an issuer or Rule 144A seller engage in general solicitation in connection with a Rule 506 or 144A transaction.

Effect on the Integration Doctrine. Another open question is whether a Rule 506 offering that is “marketed” by means of a general solicitation (as will be permissible under revised Rule 506 pursuant to the Act) will be deemed by the SEC to be part of a subsequent public offering, thereby rendering the unregistered Rule 506 private placement improper, and requiring registration of the entire offering. The SEC employs this doctrine, known as integration, in order to prevent issuers from improperly circumventing the registration process, but the SEC has made it clear that under some circumstances an issuer may indeed sell securities privately while in the process of registering a public offering. In 2007, the SEC released guidelines addressing the risk of integration of such concurrent offerings, and

emphasized that the analysis centers on the methods used to solicit investors. Generally, the SEC will not integrate the two offerings if the issuer does not solicit investors for the private placement through “general solicitation.” Given that general solicitation is now allowed in connection with Rule 506 offerings, this analysis no longer seems clear, and issuers will require further guidance from the SEC regarding integration.

Brokers-Dealers

The Act also creates a new exemption from broker-dealer registration for certain persons facilitating Rule 506 offerings. Specifically, a person does not have to register as a broker-dealer solely because: (1) the person maintains a platform or mechanism that permits the offer, sale, purchase or negotiation of securities in connection with a Rule 506 offering; (2) the person or its affiliates co-invest in the Rule 506 offering; or (3) the person provides ancillary services with respect to the Rule 506 offering. Ancillary services include due diligence services, so long as such services do not include investment advice for separate compensation, and furnishing standard investment documents, provided that the person does not negotiate the offering terms and the standard documents are not required to be used by issuers. Significantly, the person may not receive any compensation in connection with the sale of securities under Rule 506.

In recent years, various websites emerged to connect willing investors to companies seeking capital. Under the new exemption, these sites are now explicitly exempt from having to register as broker-dealers in connection with Rule 506 transactions originating on their site. The impact will likely be felt most strongly online, but the language of this exemption is broad enough to encompass other platforms for connecting sellers and purchasers as well. Although a person seeking exemption from broker-dealer registration under this provision cannot receive compensation in connection with the sale of securities, a website may be able to charge an access or membership fee that is not tied directly to the sale of securities. Until the SEC provides more guidance, it is unclear how or whether such a fee would render a person ineligible for the exemption.

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