John W. White
+1-212-474-1732
jwhite@cravath.com

Kris F. Heinzelman
+1-212-474-1336
kris.heinzelman@cravath.com

William P. Rogers, Jr.
+1-212-474-1270
wrogers@cravath.com

David Mercado
+44-20-7453-1060
dmercado@cravath.com

Stephen L. Burns
+1-212-474-1146
sburns@cravath.com

William J. Whelan III
+1-212-474-1644
wwhelan@cravath.com

Philip J. Boeckman
+44-20-7453-1020
pboeckman@cravath.com

William V. Fogg
+1-212-474-1131
wfogg@cravath.com

Andrew J. Pitts
+1-212-474-1620
apitts@cravath.com

George A. Stephanakis
+44-20-7453-1040
gstephanakis@cravath.com

LizabethAnn R. Eisen
+1-212-474-1930
lizann.eisen@cravath.com

Joel F. Herold
+1-212-474-1350
jherold@cravath.com

Erik R. Tavzel
+1-212-474-1796
etavzel@cravath.com

Craig F. Arcella
+1-212-474-1024
carcella@cravath.com

Alyssa K. Caples
+44-20-7453-1090
acaples@cravath.com

Joseph D. Zavaglia
+1-212-474-1724
jzavaglia@cravath.com

SEC Proposes Rule on General Solicitation in Certain Unregistered Securities Offerings

September 20, 2012

On August 29, 2012, the Securities and Exchange Commission (the "SEC") issued a release proposing rules ending the prohibition against general solicitation and general advertising in certain securities offerings pursuant to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (the "Securities Act").[1] The proposed rules were issued in response to directives contained in the "Jumpstart Our Business Startups Act" (the "JOBS Act"), which was signed into law on April 5, 2012.[2]

The proposed rules would:

- Add new Rule 506(c) permitting the use of general solicitation and general advertising in unregistered offerings of securities made in reliance on Rule 506 so long as all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are in fact accredited investors.

- Amend Form D (required to be filed in any Regulation D offering) to accommodate offerings under new Rule 506(c).

- Amend Rule 144A to eliminate references to "offer" and "offeree", so that, while securities may only be sold to Qualified Institutional Buyers ("QIBs") or to purchasers reasonably believed to be QIBs in an offering pursuant to Rule 144A, there would no longer be any restriction on *offering* securities pursuant to this rule to investors that are not QIBs. The effect of this change would be to permit general solicitation and general advertising in unregistered offerings of securities made in reliance on Rule 144A.

In addition to setting forth the language of the proposed rules, the release proposes a framework for evaluating what would constitute "reasonable steps to verify that purchasers of the securities are accredited investors" for purposes of new Rule 506(c). Furthermore, the release sets forth the SEC's position on two potential issues of concern related to section 201(a) of the JOBS Act. First, whether offerings pursuant to new Rule 506(c) or amended Rule 144A would be integrated with offshore offerings made in compliance with Regulation S under the Securities Act. Second, whether general solicitation or general advertising under new Rule 506(c) would disqualify privately offered funds from eligibility for certain exemptions under the Investment Company Act of 1940 (the "Investment Company Act").

This memorandum outlines the proposed rules and other guidance contained in the release. The SEC is soliciting comments from the public and all comments must be received by the SEC on or before October 5, 2012. Please see the SEC website and the release for more information on how to submit comments.

---

[1] SEC Release No. 33-9354.

[2] The JOBS Act requires that the SEC "revise" existing Rules 506 and 144A no later than 90 days after the enactment of that act. That deadline expired in early July without rulemaking. Although many anticipated that the SEC would issue an interim final rule, thus permitting the general solicitation and general advertising liberalizations contemplated by the JOBS Act to commence while the rule revisions were still subject to comment, the SEC ultimately issued only proposed rules.

BACKGROUND

Rule 506 of Regulation D is a non-exclusive safe harbor promulgated under section 4(a)(2)[3] of the Securities Act that exempts offerings by an issuer "not involving any public offering" from the registration requirements of the Securities Act. Under existing Rule 506, an issuer may offer and sell securities in an unlimited dollar amount to an unlimited number of accredited investors and no more than 35 non-accredited investors who satisfy certain eligibility requirements. Because Rule 506 provides a safe harbor for issuers, the rule typically is relied upon for primary offerings that are either placed directly by the issuer or through a financial intermediary acting on an agency basis. In order to comply with the "not involving any public offering" requirement of the safe harbor, an issuer currently is not permitted to offer or sell securities by any form of general solicitation or general advertising (including any advertisement, article or notice in any newspaper, magazine or similar media or broadcast over television and radio, or any seminar or meeting whose attendees were invited by any general solicitation or general advertising). This prohibition is set forth in Rule 502(c) of Regulation D. Section 201(a) of the JOBS Act requires the SEC to modify Rule 506 so that the restriction on general solicitation and general advertising will not apply to private placements made under Rule 506, provided that all purchasers are accredited investors.[4] Notably, the JOBS Act does not require the SEC to extend this relief to private placements that do not satisfy the requirements of Rule 506 but still qualify as private placements under section 4(a)(2) of the Securities Act.

Rule 144A is a non-exclusive safe harbor that exempts resales of restricted securities to QIBs from the registration requirements of the Securities Act. Frequently such resales follow an initial placement of the securities by the issuer to one or more financial intermediaries in an offering that is exempt from the registration requirements of the Securities Act under section 4(a)(2). This initial placement followed by an immediate resale has become a very common structure for underwritten primary offerings of debt securities. In order to rely on Rule 144A, a seller currently is only permitted to make offers and sales to QIBs or investors who are reasonably believed to be QIBs. The JOBS Act requires the SEC to modify Rule 144A to permit a seller to *offer* securities to a non-QIB, including by means of general solicitation or general advertising. However, *sales* under the modified Rule 144A will still be restricted to QIBs or purchasers whom the seller reasonably believes to be QIBs.

PROPOSED AMENDMENT TO RULE 506

To implement section 201(a) of the JOBS Act, the SEC proposes to add a new Rule 506(c) to Regulation D. New Rule 506(c) would permit the use of general solicitation and general advertising by an issuer or persons acting on its behalf to offer and sell securities under Rule 506 so long as (1) all purchasers are accredited investors and (2) the issuer takes reasonable steps to verify that the purchasers are accredited investors. Offerings pursuant to Rule 506(c) would still be subject to other Regulation D requirements, including the rules on integration and limitations on resale (*i.e.*, securities sold in reliance on Rule 506(c) would be "restricted" securities for purposes of Rule 144). Under the proposed rule revisions, existing Rule 506(b) would be revised and retained as a separate safe harbor. Offerings pursuant to "new" Rule 506(b) would be subject to the same requirements as offerings under current Rule 506. Any such offering would continue to be subject to the Rule 502(c) prohibition against general solicitation and general advertising. In the release, the SEC suggests that "new" Rule 506(b) would remain a valuable tool for issuers that do not wish to engage in general solicitation or general advertising (and be subject to the enhanced accredited investor verification requirements associated therewith) or wish to offer and sell securities to non-accredited investors.

The Reasonable Steps to Verify Requirement: Background

Perhaps the most significant issue arising out of the proposed implementation of JOBS Act section 201(a) is how the SEC will implement the requirement to take reasonable steps to verify accredited investor status. Prior to the release of the proposed rules, the SEC received significant commentary on the "reasonable steps" requirement, and the release summarizes several themes set forth in those comments. According to the release, many commentators were concerned that "unduly prescriptive or burdensome rules" with respect to verification would make issuers reluctant to utilize the exemption and access the capital markets, causing economic harm, or would be contrary to the stated goals of the JOBS Act. Other commentators stated that the desired verification steps were already part of customary practice, and recommended that the SEC resist imposing any additional requirements. At the other end of the spectrum, some commentators called for a higher standard due to the perceived greater

[3] Formerly section 4(2).

[4] "Accredited Investor" is defined in Regulation D. This term includes the enumerated categories of investors in Rule 501(a), as well as any person the issuer reasonably believes comes within one of the enumerated categories.

likelihood of fraud that could come with eliminating restrictions on general solicitation and general advertising. They called for the SEC to adopt specific steps that would be required to be taken by issuers in order to verify accredited investor status.

According to the release, other suggestions included:

- Accepting the representation of an investor that it is an accredited investor;
- Requiring the production of documentary evidence;
- Relying on third-party firms for verification;
- Relying on letters from third parties with knowledge of an investor's status; and
- Permitting a combination of certification by the investor and a minimum investment amount.

However, in the release, the SEC rejected all of these prescriptive approaches. It did state that many practices currently used by issuers probably would satisfy the verification requirement under the proposed rule but declined to establish specific rules for verification. According to the release, the SEC believes that requiring specific methods of verification would be "impractical and potentially ineffective in light of the numerous ways in which a purchaser can qualify as an accredited investor, as well as the potentially wide range of verification issues that may arise." According to the SEC, these types of requirements could be too burdensome in some cases and ineffectual in others.

The SEC also rejected the idea of creating a non-exclusive list of specified methods for satisfying the reasonable steps to verify requirement. According to the release, the SEC believes that verification methods on such a list might be inadequate in some cases, and at the same time might be viewed as required by market participants. A more flexible method would, the SEC states, allow issuers to select the most cost-effective verification methods for individual offerings.

The Reasonable Steps to Verify Requirement: Proposed SEC Approach

In the release, the SEC proposes that the determination of whether steps taken to verify accredited investor status are reasonable be an objective one, "based on the particular facts and circumstances of each transaction." Though the SEC does not provide an exhaustive list of what factors would be included in this objective test, it lists and discusses the following three factors:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be.

  In the release, the SEC states that it recognizes that reasonable steps to verify whether a purchaser is an accredited investor would vary depending on the type of accredited investor the purchaser claims to be. As an example, the SEC suggests that verifying the accredited investor status of a purported registered broker-dealer would require different steps than verifying the accredited investor status of a natural person because status as a registered broker-dealer can be relatively easily verified by reliable publicly available information whereas a natural person's status as an accredited investor (which depends on net worth or income) might not be ascertainable solely from publicly available information and any verification would implicate potential privacy concerns.

- The amount and type of information that the issuer has about the purchaser.

  In the release, the SEC suggests that it is likely that an issuer that has a substantial amount of information about a particular investor would be required to take fewer verification steps while an issuer that has very little information about an investor would likely have to take more. The SEC suggests that an issuer could rely on publicly available information about an investor, such as what is available in filings with government entities, or reasonably reliable third-party information (*e.g.*, if the investor provides copies of his or her income tax documents or information about the average earnings of individuals in the investor's sector and class of employment is available through industry publications).

- The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

  In the release, the SEC suggests that the means through which investors are solicited also may be relevant in determining the accredited investor status of the purchaser. For example, whether investors are solicited through a generally accessible

website or whether investors are selected from a list of pre-screened accredited investors may affect the reasonableness of particular verification methods. Despite the SEC's apparent reluctance to prescribe specific steps in the area of verification, the release does state the SEC's belief that a "check the box" verification as to accredited investor status in the context of widely disseminated email or social media solicitation would not satisfy the reasonable steps to verify requirement. In addition, in the case of natural persons, the terms of the offering, including whether there is a high minimum investment amount, could also influence the reasonableness determination, although an issuer would still need to satisfy itself that the investor's investment was not financed by a third party.

In the release, the SEC suggests that an issuer should, based on its own assessment of these factors, determine what steps would be reasonable to take to verify the status of an investor in the context of a particular offering. According to the SEC, the "factors are interconnected, and the information gained by looking at these factors would help an issuer assess the reasonable likelihood that a potential purchaser is an accredited investor, which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status." The release is clear that regardless of the steps taken, it will be important for issuers to document the steps taken to verify the accredited investor status of any purchaser as the burden of proof to establish an exemption from registration requirements is on the issuer.

The Reasonable Steps to Verify Requirement: Related Issues

In the release, the SEC also addresses the concern raised by some commentators that the requirement for an issuer to take reasonable steps to verify accredited investor status in the context of a Rule 506 offering that includes general solicitation or general advertising would preclude an issuer from relying on the "reasonable belief" standard that is a component of the definition of accredited investor. In the release, the SEC states its belief that section 201(a) of the JOBS Act does not indicate a congressional intent to remove the protection of the existing reasonable belief aspect of the definition of accredited investor. Accordingly, in a transaction made in reliance on "new" Rule 506(b) (which would continue to be subject to the prohibition on general solicitation and general advertising found in Rule 502(c)), the reasonable verification requirements of Rule 506(c) would not apply. Furthermore, if Rule 506(c) is adopted, according to the release, an issuer could still rely on the Rule 506(c) exemption even if the investor had misrepresented itself and did not belong to any of the enumerated categories of accredited investor, as long as it took reasonable verification steps and had a reasonable belief that the investor belonged to one of the enumerated categories.

The Impact of Rule 506(c) on Certain Exemptions from the Investment Company Act

Certain privately offered funds, including hedge funds and private equity funds, rely on Rule 506 to offer and sell interests in the funds without registration of such interests under the Securities Act. Furthermore, in order to avoid being subject to the regulatory provisions of the Investment Company Act, such funds rely on exclusions from that act. Section 3(c)(1) of the Investment Company Act provides that an issuer will not be considered an investment company if its outstanding securities are beneficially owned by 100 or fewer persons and if it is not making and does not propose to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act provides an exemption for issuers the outstanding securities of which are owned exclusively by qualified purchasers (as defined in the Investment Company Act) and which is not making or proposing to make a public offering of its securities. In the release, the SEC states its view that a transaction under proposed Rule 506(c) would not constitute a public offering for the purposes of these exemptions, and, accordingly, an issuer will not be precluded from relying on these Investment Company Act exemptions if it relies upon proposed Rule 506(c), including the use of general solicitation and general advertising, to offer and sell fund interests.

Proposed Change to Form D

Currently, all issuers offering or selling securities pursuant to Regulation D must file a notice of sale on Form D with the SEC for each new offering of securities. The proposed change adds a separate check box for offerings pursuant to proposed Rule 506(c). The SEC is proposing this change in order to better monitor the use of general solicitation and general advertising in proposed Rule 506(c) offerings and the size of the market for these offerings.

PROPOSED AMENDMENT TO RULE 144A

The SEC proposes to amend Rule 144A so that securities sold pursuant to that rule may be offered to non-QIBS, as long as such securities are only sold to QIBs or purchasers reasonably believed to be QIBs. This rule change would allow issuers and financial intermediaries to offer the securities through general solicitation and general advertising, as mandated by section 201(a) of the Act. The proposed amendment would not introduce any incremental verification requirements with respect to the requirement that sales be made only to QIBs or purchasers reasonably believed to be QIBs. Consistent with the guidance in the

release that general solicitation or general advertising in reliance on Rule 506(c) would not constitute a public offering for purposes of the section 3(c)(1) and section 3(c)(7) exemptions from the Investment Company Act, the release indicates that general solicitation or general advertising in the context of Rule 144A resales by a financial intermediary would not constitute a public offering that would impair an issuer's ability to rely on section 4(a)(2) of the Securities Act[5] for the initial sale of such securities to the financial intermediary.

INTEGRATION OF OFFSHORE OFFERINGS WITH OFFERINGS UNDER THE PROPOSED RULES

Regulation S provides issuer and resale safe harbor exemptions from the registration requirements of the Securities Act for offers and sales of securities outside the United States. The Regulation S safe harbors are available when the securities are sold in an offshore transaction and, among other requirements, there are no "directed selling efforts" in the United States. Directed selling efforts are activities that may condition the United States market for the securities sold pursuant to Regulation S. Often, offerings using the Regulation S safe harbor and offerings pursuant to Rule 506 or Rule 144A are undertaken concurrently. In the release, the SEC addresses concerns raised by some commentators that offerings under Regulation S might be integrated with (and therefore tainted by) concurrent offerings under Rule 506(c) and amended Rule 144A, because any general solicitation and general advertising in the Rule 506(c) or Rule 144A offering might be considered impermissible "directed selling efforts" in respect of the securities offered and sold pursuant to Regulation S.

In the release, the SEC refers to the original adopting release for Regulation S, which stated that transactions made in compliance with Regulation S will not be integrated with exempt domestic offerings, and states its belief that this view would continue to apply to offerings under proposed Rule 506(c) and proposed amended Rule 144A, despite the presence of general solicitation and general advertising activities aimed at the U.S. market. Although posited as an integration issue rather than an interpretation of the meaning of directed selling efforts, the release expresses a clear view that general solicitation or general advertising activities aimed at the U.S. market in a Rule 506(c) or Rule 144A offering will not preclude reliance on Regulation S in a parallel non-U.S. offering. However, if an issuer undertakes a stand-alone Regulation S offering, the prohibition against directed selling efforts would preclude the sorts of general solicitation activities in the U.S. that would be permitted in a concurrent Rule 506(c) or Rule 144A offering.

New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

www.cravath.com

[5] Section 4(a)(2) exempts "transactions by an issuer not involving any public offering."