FS Regulatory Brief

The SEC proposes new rules to allow issuers making private offerings to advertise

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Introduction

The "*Jumpstart Our Business Startups Act*" ("JOBS Act"), enacted in early April of 2012, required the SEC to lift the prohibitions on general solicitation and to allow issuers to advertise private offerings, as long as all purchasers of such interests are accredited investors (as already required).

Since then, issuers making private offerings of securities, including investment advisers to hedge funds, private equity funds, and other privately offered alternative asset funds, have been anxiously awaiting the SEC's new rules implementing the law.

On August 29, the SEC proposed new rules to implement the JOBS Act. While the SEC had previously indicated that it would issue an interim *final* rule allowing advertising immediately, it decided to issue a *proposed* rule in order to ensure that all major industry participants have the opportunity to comment on the proposed changes. Although some Commissioners took issue with the decision to add the step of a proposed rule to a rule-making process that had already extended past the 90-day window mandated by Congress, the proposed rules were approved by a 4-1 vote. The SEC also indicated that it will continue to study Regulation D.

Proposed amendment to Rule 506 of Regulation D

The SEC's proposed rule would permit the use of general solicitation when offering or selling private securities under Rule 506 of Regulation D, provided that the following conditions are satisfied:

- All purchasers of securities sold in any offering under new Rule 506(c) are accredited investors, either because the purchaser qualifies as an accredited investor under one of the Rule 501 tests or because the issuer, at the time of the sale of securities, reasonably believes the purchaser qualifies as an accredited investor;
- The issuer "shall take reasonable steps to verify that purchasers of securities sold in any offering under Rule 506(c) are accredited investors;" and
- Sales of such private securities must comply with the definition of "accredited investor" in Rule 501 and provisions in Rule 502 governing timing of offers and limiting resale.

In order to provide flexibility to issuers, the Commission declined to set forth specific steps that issuers would need to take to verify that the investor is accredited. Instead, the Commission laid out a "facts and circumstances" framework for an issuer's determination of investor accreditation.

Rule 144A of the Securities Act was also amended to allow general solicitation of securities that are sold to qualified institutional buyers ("QIBs"), as long as those securities are only sold to a QIB or a purchaser that the seller reasonably believes is a QIB.

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If adopted, the new rules will allow private fund advisers – for the first time – to advertise, e.g., at conferences and other forums, on the web, in print, radio and other media. Many private fund advisers have said that they felt constrained from talking about their firm or the fund's strategies in semi-public forums, for fear of being seen to have made a public solicitation. While allowing issuers to advertise, the proposed rules retain the prohibition on making sales to other than qualified investors, and require issuers relying on the exemption to take reasonable steps to verify that purchasers are accredited.

It is important to note that the new framework for general solicitation is in addition to, and does not supplant, the existing framework of Rule 506(b). Advisers may continue to operate in accordance with the previous rule regime, including the guidance previously set out by the Commission staff in no-action and interpretive letters regarding pre-existing substantive relationships between advisers and investors. Form D will be amended to allow advisers to indicate a reliance on the previous framework by checking box 506(b) or reliance on the new rule by checking box 506(c).

Reasonable determination of accredited investor status

The SEC stated that an investor's accredited status should be determined based on consideration of a number of factors. The Commission highlighted three factors:

- The **nature of the purchaser** and the type of accredited investor that purchaser claims to be;
- The **amount and type of information** that the issuer has about the purchaser; and
- 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.[1]

Each of these factors is described below.

The nature of the purchaser

Under existing rules, the accredited investor standard can be met by meeting one of eight tests that apply to both companies and individuals (existing rules regarding who is an accredited investor have not changed). Some of the standards require only organizational status, such as a registered broker-dealer or investment company. Others require a combination of status and amount of total assets, such as state benefit plans or 501(c)(3) charities that have assets in excess of $5 million. Finally, individual persons qualify solely based on an economic test of either net worth (in excess of $1 million excluding one's primary residence) or annual income (in excess of $200,000 for each of the last two years, or $300,000 for married couples, with a reasonable expectation of reaching that level in the year of investment).

The Commission stated that reasonable steps of verification would vary depending on the type of accredited investor, ranging from simply confirming the registration of broker-dealers on a publicly available database, to a more intensive process of data collection for individual persons.

Investor information

The Commission stated that the "more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take" to verify the purchaser's accredited investor status, and vice versa, when an issuer has minimal information about an investor, it will need to take more steps to verify the investor's status. Public documents filed with government agencies that provide information presumptively vetted and confirmed by a series of institutional controls are seen by the Commission as more reliable and providing a higher level of comfort than documents prepared by a third party but provided privately, such as an individual's W-2 form. Similarly, such private third party documentation is more reliable and can be given more weight than representations of accredited investor status by a third party,

[1] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release No. 33-9354, August 29, 2012, p. 14 (emphasis added).

such as an investor's accountant or attorney, who would have a reasonable basis of knowledge to make such a determination.

Similar to any diligence exercise, the Commission is acknowledging that information already provided in the public domain through published documentation or regulatory filings can more easily stand on its own accord, absent other areas of concern, and requiring that the accreditation verification process take a deeper dive when evaluating representations by individuals.

Nature and terms of the offering

The level of diligence required for a new investor can also vary based on how the investment itself is offered and the terms required for such investment. Investments offered to a pre-screened list of accredited investors would require less scrutiny than those offered through a publicly available website, for example, as the pre-screened list has already undergone some level of scrutiny while the website investors would be unknown. Investment terms that require an investment amount greater than the accredited minimum, such as the $1 million for individuals already utilized by many private funds, also removes some uncertainty about potential investors. So long as the adviser confirms that the investor is not financing the investment, such minimum investment amount could be taken into consideration when verifying accredited investor status

Records of investor verifications

Issuers bear the burden of proof that they were entitled to claim an exemption under Rule 506. Thus, advisers should develop, document, and follow policies and procedures addressing accredited investor verification. Relevant records of this process should be retained and responsibility for such record retention should also be reflected in the adviser's books and records matrix.

As advisers consider what their marketing/investor relations activities and operations might look like under this proposed rule, they should pay careful attention to establishing reasonable verification procedures. For the offering to be exempt, the issuer must have performed reasonable verification of the investor's status, and must reasonably believe that the investor is accredited at the time of the sale.

All three factors set forth by the Commission should be considered: the nature of the purchaser; the amount and type of information that the issuer has about the purchaser; and the nature and terms of the offering. The actual amount of diligence an investment adviser conducts regarding an investor's accreditation should be determined in a tiered fashion based on the type of investor, the reliability of that investor's supporting information, and the investment terms.

Issuers will also want to leverage the existing processes they use to determine and to document investor accreditation. While liberalizing the advertising rules, the SEC is likely to expect that issuers using general solicitation will take a very disciplined and careful approach to verifying investors' accredited status before effecting a sale.

Next steps

The SEC is seeking comments on the proposed rules for 30 days.

Of note, Commissioner Walter asked for comment on whether issuers should be required to file Form D as a condition of using the exemption. She indicated that such a requirement would help curb the trend of issuers failing to file Form D, would provide additional information from which to analyze the impact of the proposed rule change, and delineate the private offerings properly conducted with general solicitations from those that have not qualified for exemptions and have a higher likelihood for fraud.

Commissioner Gallagher stated that he hoped a final rule could be issued before the end of 2012, but also acknowledged that it was possible the final rule release may not happen until early 2013.

Additional information

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