

# LEGAL UPDATE

October 2012 By: Bertrand C. Fry, Stephen M. Goodman and Michael T. Campoli

## **THE PATH OPENS FOR ADVERTISING IN RULE 506 AND RULE 144A OFFERINGS: SEC PROPOSES RULES EFFECTING THE JOBS ACT'S ELIMINATION OF THE GENERAL SOLICITATION BAN IN PRIVATE OFFERINGS**

Adhering to a mandate set forth in Section 201(a)(1) of the Jumpstart Our Business Startups Act (the "JOBS Act"),<sup>1</sup> the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") on August 29, 2012 proposed rules<sup>2</sup> to eliminate the prohibition against "general solicitation" and "general advertising"<sup>3</sup> in certain offerings of securities conducted pursuant to Rule 506 of Regulation D ("Regulation D") promulgated under the Securities Act of 1933, as amended (the "Securities Act"). The proposed rules would also amend Rule 144(d)(1) promulgated under the Securities Act to provide that securities may be offered pursuant to Rule 144A to persons that do not satisfy that rule's definition of "qualified institutional buyer" ("QIB") so long as such securities are sold only to persons that are, or that the seller (or any person acting on its behalf) reasonably believes are, QIBs.

The SEC is expected to adopt final rules in this regard after the comment period for the proposed rules closes on October 5, 2012. However, as noted at the conclusion of this update, the proposed rules may yet be significantly modified or supplemented, depending on the SEC's response to comments such as those of state securities regulators.

### **PROPOSED RULE 506(C)**

The SEC's proposed new Rule 506(c) would permit an issuer to market its securities in an offering conducted pursuant to Rule 506 of Regulation D through a general solicitation, so long as:

- the issuer takes reasonable steps to verify that the offerees that ultimately purchase its securities in the offering are "accredited investors" as defined in Rule 501(a)<sup>4</sup>;

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<sup>1</sup> Jumpstart Our Business Startups Act, H.R. 3606, 112<sup>th</sup> Congress (2011). The SEC adhered to this mandate in substance but not in timeliness. As was repeatedly noted in the August 29, 2012 open meeting in which the Commission voted (4-1) to propose this rule, the SEC was required by the JOBS Act to issue rules amending Rule 506 of Regulation D under the Securities Act by July 4, 2012 (*i.e.*, not later than 90 days after the enactment of the JOBS Act on April 5, 2012).

<sup>2</sup> Release No. 33-9354 (August 29, 2012) (the "Proposing Release").

<sup>3</sup> Although the terms "general solicitation" and "general advertising" are not defined in Regulation D, Rule 502(c) promulgated under the Securities Act does provide a non-exclusive list of examples of general solicitation and general advertising, including advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising. The SEC has also confirmed that other uses of publicly available media, such as unrestricted websites, also constitute general solicitation and general advertising.

<sup>4</sup> The definition of "accredited investor" includes "any person... who the issuer reasonably believes comes within any of the [enumerated] categories." The new verification requirement is not intended to preclude reliance on this subjective prong of the definition of "accredited investor."

- all purchasers are accredited investors at the time of purchasing the securities (because each purchaser either objectively meets, or is reasonably believed by the issuer to meet, the criteria specified in one of the enumerated categories of accredited investor listed in Rule 501(a)); and
- all of the terms and conditions of Rules 501, 502(a), and 502(d) are satisfied.

Notwithstanding the adoption of Rule 506(c), Rule 506(b) of Regulation D would remain available for issuers that prefer to offer their securities in reliance on Rule 506 without the use of general solicitation. Although issuers that opt to rely on Rule 506(b) would have to confine their marketing efforts to avoid a general solicitation,<sup>5</sup> they could rely on current practice, such as requiring investors to check a box on an “accredited investor” questionnaire, to verify that the purchasers of their securities are accredited investors, and would still be permitted to sell privately to a limited number of non-accredited investors who meet the “sophistication” requirements set out in Rule 506(b).<sup>6</sup>

## VERIFICATION STEPS

In determining whether an issuer marketing its securities through a general solicitation has used “reasonable steps to verify” the accredited-investor status of the purchasers, new Rule 506(c) would apply an “objective”, “facts and circumstances” standard. In taking this approach, the SEC has avoided creating a set of rigid rules that could become fossilized into issuers’ private placement procedures and has sought to leave enough flexibility to accommodate innovation both in marketing techniques and in modes through which marketing might take place. According to the Proposing Release, in crafting a procedure for verifying a purchaser’s accredited-investor status, an issuer should take into account a number of factors. The implication is that an issuer may have different procedures that apply to different types of purchasers and to different offerings. The SEC’s examples of factors to be taken into account are:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information the issuer has about the purchaser;
- the nature of the offering (*e.g.*, the manner in which the particular purchaser’s investment was solicited); and
- the terms of the offering (*e.g.*, the required minimum investment amount).

In practice, the first two factors will likely overlap, as a purchaser’s claim to be an accredited investor of a particular type will in some cases point to the sources of information available to verify that claim. For example, the SEC notes that a reasonable step to verify an entity’s accredited-investor status if it reports that it is a registered broker-dealer (and thus an accredited investor in reliance on Rule 501(a)(1)) would be to locate and note such purchaser’s record on FINRA’s BrokerCheck Web site. In contrast, natural person purchasers pose particular difficulties, as the information required to establish net worth (which requires measuring both assets and liabilities), or to establish prior year’s annual income and a “reasonable expectation of reaching the same income level in the current year”, could require access to sensitive personal documentation. In any case, issuers that conduct offerings in reliance on Rule 506(c) should specifically elicit from each prospective purchaser precisely which prong of the “accredited investor” test it satisfies (and if the purchaser claims to satisfy Rule 501(a)(1), which covers several different types of entities, whether such purchaser is a bank, savings and loan institution, broker-dealer, insurance company, business development company or other type of entity described in the rule).

The SEC clearly believes that the rigor required in order for verification procedures to be considered reasonable is inversely related to how indiscriminately the offering is broadcast. At one end of the spectrum one finds a

<sup>5</sup> Issuers relying on Rule 506(b) to privately offer their securities would continue to be required to comply with the SEC’s guidance regarding such offerings, including its guidance regarding pre-existing substantive relationships with the offerees. See footnote 40 of the Proposing Release.

<sup>6</sup> Currently the number of non-accredited investors who may participate in a Rule 506(b) offering is 35.

“website accessible to the general public” and “a widely disseminated email or social media solicitation”, which would require more significant verification procedures than the other end of the spectrum, where one finds “a database of pre-screened accredited investors created and maintained by a ... registered broker-dealer.” Interestingly, in a footnote to the Proposing Release the SEC notes that “[i]f an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer would not have to take any [verification] steps at all.”<sup>7</sup> However, issuers seeking to rely on the guidance in this footnote may nevertheless want to create some form of records to support their claim of “actual knowledge”.<sup>8</sup> In general, the SEC’s discussion of these first two factors suggests that an issuer should aim to base its verification of accredited-investor status on documents that are publicly available through reliable sources or that are produced by third-parties on which the issuer can reasonably rely.

An issuer that imposes a required minimum investment will have a very strong basis for relaxing its verification procedures under the last factor cited by the SEC. In the Proposing Release, the SEC observes that even where the issuer “knows little about the potential purchaser... but the terms of the offering require a high minimum investment amount, then it may be reasonable for the issuer to take no steps to verify accredited investor status other than to confirm that the purchaser’s cash investment is not being financed by the issuer or by a third party, absent any facts that may indicate that the purchaser is not an accredited investor.” If the rules are adopted in their proposed form, the presence of a high required minimum investment amount would appear to enable issuers to rely on Rule 506(c) with minimal verification methods focused only on the source of the purchaser’s investment funds. Consequently, where practicable, issuers should consider adopting high minimum investment amounts for their offerings and should expressly state these requirements in their offering materials. However, this aspect of the proposed rules is likely to be closely scrutinized by the SEC, and in the Proposing Release, the SEC specifically solicits input about whether issuers that impose high required minimum investment amounts<sup>9</sup> for their offerings should nonetheless verify other features of prospective purchasers or the investment beyond the above-mentioned confirmation that there has been no third-party financing.

Regardless of the steps that an issuer takes to verify that a purchaser is accredited, it is important that the issuer – which, as noted above, has the burden of showing that it is entitled to rely on any exemption from the registration requirements of Section 5 of the Securities Act that it may claim – retains adequate records that document such steps.

## FORM D

In the Proposing Release, the SEC proposes to revise Form D, which is currently required by Rule 503 of Regulation D to be filed by all issuers offering securities in reliance on Rule 504, 505 or 506 of Regulation D. Under the proposal, issuers claiming an exemption under Rule 506(c) would be required to specifically indicate their reliance on this exemption by checking a new box to be added in Item 6 of Form D. The SEC believes that this additional information will assist them in their efforts to monitor the use of general solicitation in Rule 506(c) offerings and help them look into the practices that would develop to satisfy the accredited investor verification requirement.

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<sup>7</sup> See footnote 51 of the Proposing Release.

<sup>8</sup> An issuer claiming an exemption from the registration requirements of Section 5 of the Securities Act has the burden of showing that it is entitled to that exemption.

<sup>9</sup> Without specifically endorsing it, the SEC seems likely to regard a minimum of \$1 million to be a “sufficiently high” minimum investment amount to justify the use of these more limited verification procedures. See footnote 54 of the Proposing Release. In addition, the comment letter submitted by the Managed Funds Association in response to the Proposing Release suggests that the SEC adopt a safe harbor in this regard where the private issuer adopts a minimum investment of \$500,000 for individuals and \$2.5 million for entities. This approach is based on analogy to the “qualified client” test under the Investment Advisers Act. See the Pryor Cashman Legal Update, “Changes in the ‘Qualified Client’ Test: Challenges for Investment Advisers Charging Performance Fees”, dated May 3, 2012.

Although the SEC's proposals do not change the deadline for filing a Form D (i.e., no later than 15 calendar days after the first sale of securities in the offering), Commissioners Louis A. Aguilar and Elisse B. Walter stated in their remarks regarding the proposed rules that they would have preferred that the filing of the Form D be a condition to using the Rule 506(c) exemption. In expressing this preference, Commissioners Aguilar and Walter acknowledged the role of Form D filings in the SEC's efforts to combat fraud and noted that compliance with the Form D filing requirement is inconsistent across covered issuers. In addition, Commissioner Aguilar suggested that the information required to be provided on Form D be modestly expanded to include basic items such as the issuer's Internet website address, the names of any controlling persons, and the size of the issuer. It is unclear whether the SEC will include any of these suggestions in the final rules.<sup>10</sup>

#### **RULE 144A(D)(1) AMENDMENTS**

In accordance with the mandate set forth in Section 201(a)(2) of the JOBS Act, the SEC has proposed to amend Rule 144A(d)(1) to eliminate the references to "offer" and "offeree" contained therein. As a result, Rule 144A, which currently requires that offerees be, or that such offerees are reasonably believed by the seller to be, QIBs, would thereafter require only that the securities sold pursuant to Rule 144A be sold to a QIB or to a purchaser that the seller (and any person acting on behalf of the seller) reasonably believes is a QIB. If adopted, the amended Rule 144A would permit resales of securities pursuant to Rule 144A to be marketed broadly, including by general solicitation, provided that the offerees that ultimately purchase such securities meet the QIB condition. Due to the high standards necessary to qualify as a QIB, the limited number of QIBs, and the manner in which Rule 144A offerings are generally conducted, it is unlikely that the SEC's proposal will have a significant impact on the use of Rule 144A.

#### **STATE LAW CONSIDERATIONS**

Securities issued in offerings conducted in reliance on Rule 506 – including, if adopted, Rule 506(c) – are considered "covered securities" under state "Blue Sky" laws.<sup>11</sup> In general, requirements that issuers register offerings of securities under state laws are pre-empted by federal law with respect to "covered securities". Thus, issuers that issue securities in Rule 506 offerings are not required to register such securities under state laws, although such offerings may still be required to comply with state notice filing requirements and the payment of applicable fees unless an exemption therefrom is available.

However, the proposed changes to Rule 506 may disrupt the balance which was previously struck with respect to "covered securities". State securities regulators, both individually and through the North American Securities Administrators Association ("NASAA") have been vocal regarding what they perceive as the dangers and inadequacies of allowing general solicitation and advertising of "private" offerings.<sup>12</sup> An October 3, 2012, comment letter from NASAA<sup>13</sup> points out that the exemption from registration at the state level is available only if an offering "actually complies with Rule 506." The letter points out that the ambiguity surrounding the

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<sup>10</sup> Commissioner Aguilar also advocated in his remarks for additional steps to decrease the vulnerability of investors in offerings conducted under Rule 506(c), including amending the definition of "accredited investor" to require consideration of the investor's financial sophistication.

<sup>11</sup> Some comment letters submitted in response to the Proposing Release note that there is some ambiguity as to whether securities issued in offerings conducted in reliance on Rule 506 are "covered securities" due to the fact that the blue sky exemption in the current version of Section 18(b)(4)(E) of the Securities Act does not properly refer to re-designated Section 4(a)(2) of the Securities Act (which provides an exemption for current Rule 506 and proposed Rule 506(b) offerings) or new Section 4(b) of the Securities Act (which provides an exemption for offerings made under proposed Rule 506(c)). See the comment letter submitted by the Law Offices of Eric I. Michelman on September 27, 2012. We anticipate that the SEC will resolve this ambiguity in the final rules.

<sup>12</sup> The Ohio Division of Securities went so far as to claim that the proposed changes create a category of "exempt public offerings". See Comments of Andrea L. Seidt, Commissioner, Ohio Division of Securities, July 3, 2012, available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-38.pdf>.

<sup>13</sup> Available at <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-to-SEC-re-Rule-506.pdf>.

“reasonable steps” for verifying accredited investor status renders it difficult for state administrators to determine if the issuer has in fact “complied” with the Rule, leaving open the possibility that the states may step up their efforts to investigate such compliance. The letter also forcefully requests additional changes<sup>14</sup> to be made to the proposed rules to simplify state anti-fraud enforcement efforts, such as requiring a revised Form D (including proposed additional information) to be filed *prior* to the use of any general advertising and subjecting the content of such advertising to guidelines similar to those for sales material used in connection with public offerings.<sup>15</sup> Thus, if such changes were adopted, the final rules regarding general solicitation could ultimately result in unanticipated changes to other aspects of Rule 506 practice.

Even if the SEC fails to adopt the specific changes requested by NASAA, issuers should note that many of the exemptions from existing state notice filing requirements are only available if the offering is conducted without the use of general solicitation or general advertising. Offerings conducted in reliance on proposed Rule 506(c) would not be eligible for these exemptions. In such cases, issuers should consult with counsel to ensure either that an exemption from state notice filing requirements is available for their offerings, or that all required notice filings are timely made.

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*The foregoing is merely a discussion of the SEC’s proposed rules eliminating the ban on general solicitation in offerings conducted pursuant to Rule 506 of Regulation D. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Bertrand C. Fry at 212-326-0134 or [bfry@pryorcashman.com](mailto:bfry@pryorcashman.com), Stephen M. Goodman at 212-326-0146 or [sgoodman@pryorcashman.com](mailto:sgoodman@pryorcashman.com), or Michael T. Campoli at 212-326-0468 or [mcampoli@pryorcashman.com](mailto:mcampoli@pryorcashman.com).*

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<sup>14</sup> Many of the requested changes were sought in an earlier NASAA letter to the SEC, available at <http://sec.gov/comments/jobs-title-ii/jobstitleii-40.pdf>.

<sup>15</sup> See “CF Disclosure Guidance: Topic No. 3 (Staff Observations in the Review of Promotional and Sales Material Submitted Pursuant to Securities Act Industry Guide 5),” available at <http://www.sec.gov/divisions/corpfm/guidance/cfguidance-topic3.htm>.

## ABOUT THE AUTHORS



### **BERTRAND C. FRY**

Partner

Direct Tel: 212-326-0134

Direct Fax: 212-710-6320

[bfry@pryorcashman.com](mailto:bfry@pryorcashman.com)

Bertrand Fry is a partner in Pryor Cashman's Corporate Group and is co-head of the firm's Investment Management Group. Bert has nearly twenty years of general corporate and transactional experience that includes extensive experience with alternative investment vehicles. In addition to having launched and advised a diverse array of U.S. and non-U.S. investment products, including vehicles engaged in macro, distressed, private equity, venture capital, and real estate investing, debt origination, and quantitative trading of securities and futures, his practice has included, among other things, structuring and advising investment managers and advisers, private company mergers & acquisitions, and joint ventures.

Bert is particularly well attuned to the business needs of his clients, based on more than a decade of in-house experience at the D. E. Shaw group, where Bert was a Senior Vice President and served for a period as Acting General Counsel. During his tenure there, the D. E. Shaw group included several SEC-registered investment advisers and, at its apex, managed approximately \$40 billion across various strategies and multiple funds. Bert also launched and advised a wide range of hedge funds, funds of funds, and their managers as a member of the London office of Dechert LLP.

Bert earned his J.D., with honors, from The University of Texas at Austin School of Law, where he was also an articles editor for the Texas Law Review and received the Outstanding Second-Year Member Award from the Texas Law Review, the Gilbert I. Low Endowed Presidential Scholarship in Law, and Highest Achievement in Contracts.



**STEPHEN M. GOODMAN**

Partner

Direct Tel: 212-326-0146

Direct Fax: 212-798-6340

sgoodman@pryorcashman.com

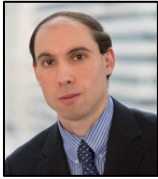
Stephen M. Goodman is co-head of the Mergers and Acquisitions Practice at Pryor Cashman LLP. He has extensive experience representing technology-based companies in public offerings; private placements; limited liability company, partnership and joint venture agreements; and complex arrangements for the acquisition, sale, development and commercialization of patents, copyrights and trademarks, in particular for drug compounds and formulations, software and other technology.

Mr. Goodman has also written on topics ranging from export controls relating to biotechnology research to raising seed capital for entrepreneurial companies and has lectured on various aspects of pharmaceutical/biotech collaboration agreements.

Mr. Goodman has been responsible for negotiating and documenting the following representative transactions:

- On behalf of a multi-national professional publishing company, acquisitions of the stock or assets of more than thirty targets, in transactions ranging in value up to \$1 billion, including acquisitions involving counsel in multiple jurisdictions, auction transactions and several involving friendly tender offers for the stock of publicly-traded companies
- On behalf of a development stage biotechnology company, a private financing of \$8.4 million to advance a client's two lead drug programs and a "double-dummy" reverse merger a second biotechnology company, creating a single company with multiple drug programs which has been purchased by a public pharmaceutical company for more than \$100 million
- On behalf of an early pioneer in internet music delivery, two private preferred equity financings, the second led by a major hedge fund
- On behalf of a company developing compounds believed to have wound-healing and other regenerative properties, acquisition of a portfolio of patents for certain compounds together with clinical trial data filed with regulatory agencies related to these compounds
- On behalf of a public company in the field of monoclonal antibody research, an initial and a secondary public offering
- On behalf of a company in the field of RNAi therapeutics, acquisition of an entire division of a company engaged in RNAi research for influenza
- On behalf of a warehousing logistics software company, a set of master documents for licensing and maintaining the company's software
- On behalf of a company offering menu-driven iPod applications for foreign language translation, a license to utilize voice recognition software to enhance the utility of its programs
- Multiple licenses for the use of university or research institute technology, including a license for exclusive worldwide rights to patents and patent applications covering a naturally occurring peptide and its derivatives in the fields of obesity, appetite suppression, reducing food intake, inducing weight loss and inducing satiety and another for a compound with potential for treating various conditions of the central nervous system, including addiction
- A Feasibility Study, Option and License Agreement for the development of a client's lead drug candidate for moderate-to-severe pain
- Agreements with major textbook publishers for conversion of print or electronic textbooks into interactive formats utilizing client's proprietary software and coding

Mr. Goodman is frequently called upon by the press to comment upon corporate, life science and other newsworthy matters. Mr. Goodman is a 1977 graduate of New York University School of Law, where he was Order of the Coif and Articles Editor of the Annual Survey of American Law.



**MICHAEL T. CAMPOLI**

Partner

Direct Tel: 212-326-0468

Direct Fax: 212-798-6361

[mcampoli@pryorcashman.com](mailto:mcampoli@pryorcashman.com)

Michael Campoli devotes his practice to counseling public and private companies on a broad range of corporate matters, including securities law compliance, corporate formation and governance, mergers and acquisitions, public and private debt and equity financing transactions, and limited liability company and partnership counseling.

Mr. Campoli's work at Pryor Cashman has included the representation of:

- Marina Biotech, Inc. (NASDAQ: MRNA) as outside general counsel in connection with its equity and debt financings, M&A initiatives and Securities Exchange Act reporting requirements
- Javelin Pharmaceuticals, Inc. (NYSE Amex: JAV) as outside general counsel in connection with its equity financings and Securities Exchange Act reporting requirements
- Henry Schein, Inc. (NASDAQ: HSIC) in connection with the acquisition of various private companies in the medical equipment and software industries
- Cowen and Company, LLC, Rodman & Renshaw, LLC and Global Hunter Securities, LLC in connection with various underwritten public offerings for domestic and foreign issuers
- Briad Restaurant Group in its prevailing tender offer for Main Street Restaurant Group, Inc., the largest T.G.I. Friday's franchisee
- The Kushner Companies in connection with its acquisition of the office building located at 666 Fifth Avenue, New York, New York
- A private telecommunications company in connection with the issuance of secured notes to the Rural Utilities Service of the U.S. Department of Agriculture and the concurrent placement of preferred stock to venture capital investors

Mr. Campoli is a 2000 graduate of New York University School of Law and a 1997 graduate of Columbia College.