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Client Alert

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# The JOBS Act, Part Deux: Frequently Asked Questions About Title II of the JOBS Act

Title II of the JOBS Act directed the SEC to (1) modify Regulation D under the Securities Act of 1933 to remove prohibitions on "general solicitation" in connection with Rule 506 offerings to accredited investors and (2) expressly permit general solicitation in connection with Rule 144A offerings. By a 4-to-1 vote on August 29, 2012, the SEC proposed rule changes to implement Title II.[1]

This *Client Alert* briefly summarizes the SEC's Title II proposals relating to general solicitation and provides answers to some of the most frequently asked questions about how we believe the revised rules would work in practice, assuming they are adopted as proposed.

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## Rule 506 and Rule 144A Pre-JOBS Act

Companies seeking to raise capital through the sale of securities in the United States must either register the securities offering with the SEC under the Securities Act or rely on an exemption from Securities Act registration. Rules 506 and 144A are the most commonly used exemptions from this registration requirement. Rule 506 allows offerings to an unlimited number of accredited investors (and up to 35 others) without regard to transaction size. If the conditions of Rule 506 are met, the transaction is deemed not to be a public offering within the meaning of Securities Act Section 4(a)(2) (formerly Section 4(2)). Rule 144A allows for unregistered resales of securities to certain large institutional investors known as qualified institutional buyers, or QIBs.

Under current law, the availability of the Rule 506 safe harbor is subject to the condition that neither the issuer nor anyone acting on its behalf uses any form of general solicitation or general advertising to offer or sell the securities. General solicitations are also currently avoided in Rule 144A offerings. Since the first step in a typical Rule 144A offering is a sale under Section 4(a)(2) to one or more investment banks acting as initial purchasers and the second step is a series of immediate resales by the initial purchasers to QIBs under Rule 144A, general solicitation in connection with a Rule 144A resale could taint the private placement to the initial purchasers in the first step of the Rule 144A transaction.

Loss of a registration safe harbor is potentially serious. No one wants to violate Securities Act Section 5, which would give investors a right of rescission or "put" remedy. This harsh result has led to very restrictive publicity practices in private offerings in order to minimize the risk that the offering would fail to qualify as exempt from registration.

## The SEC's Proposed Rules Under Title II of the JOBS Act

Title II of the JOBS Act, which instructs the SEC to eliminate the prohibition on general solicitation in certain offerings, significantly changes the rules of the game. Under the rules proposed by the SEC on August 29, 2012 to implement Title II of the JOBS Act:

- **General solicitation would be expressly permitted in Rule 144A transactions**. Revised Rule 144A(d)(1) would require simply that securities must be *sold* — not *offered and sold*, as under current Rule 144A — only to QIBs or to purchasers that the seller and any person acting on behalf of the seller reasonably believe to be QIBs. As a result, Rule 144A would be expressly available even where general solicitation had occurred — accidentally or intentionally — so long as the persons actually purchasing the securities in the offering were (or were reasonably believed to be) QIBs.
- **Proposed Rule 506(c) would permit general solicitation in offerings to accredited investors**. Proposed new Rule 506(c) would permit the use of general solicitation in private placements if:
  - all purchasers are accredited investors or the issuer reasonably believes that they are accredited investors at the time of the sale;[2]
  - the issuer takes "reasonable steps to verify" that purchasers (note, again, that *offerees* are disregarded) are accredited investors; and
  - all other requirements of Rules 501 (definitions), 502(a) (integration) and 502(d) (resale restrictions) are met.
- **Reasonable steps determination left flexible**. Under proposed Rule 506(c), whether an issuer has taken "reasonable steps to verify" accredited investor status depends on the facts and circumstances. The SEC suggested some relevant factors (discussed in more detail below), but decided not to require any specific verification methods or provide any examples at this time.

## FAQs: How Would These Proposed Rules Work in Practice?

**1) Q: How will we determine if an issuer has taken reasonable steps to verify that our purchasers are accredited investors?**

A: The SEC's proposal states that "whether the steps taken are 'reasonable' would be an objective determination, based on the particular facts and circumstances of each transaction."[3] We expect that market participants will develop standard representations and warranties to serve as a foundation for this determination and to support typical third-party legal opinions that the transaction is not subject to registration under the Securities Act.

The SEC suggested that some relevant factors to consider would include:

- *The nature of the purchaser and the type of accredited investor that the purchaser claims to be*. The status of certain investors as accredited will be easier to verify than others, with natural persons being more difficult than institutions.
- *The amount and type of information that the issuer has about the purchaser*. According to the SEC, the "more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa." In addition, if the issuer has actual knowledge that the purchaser is an accredited investor, then no additional steps would

be necessary. Part of the "reasonableness" analysis turns on how reliable the information is, so, for instance, a questionnaire response would be less reliable than official tax reporting information or a public filing with the SEC.

- *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*. Fewer verification steps would be required for purchasers solicited from pre-screened accredited investors as compared to those solicited from the general public. The terms of the offering could also serve as a screening method (*e.g.*, a high minimum investment requirement that only accredited investors could reasonably be expected to meet).[4]

**2) Q: Will it be reasonable to rely on a third-party service to screen potential investors for accredited investor status?**

A: Yes, if there is a reasonable basis for believing that the service is reliable. We think it's only a matter of time until independent verification services emerge to verify accredited investor status. Certain third-party services already provide a list of QIBs, which many market participants use to establish the required reasonable belief for Rule 144A offerings.[5]

**3) Q: Will we be able to engage in general solicitation if we wish to preserve the flexibility to sell to some non-accredited investors in our Rule 506 offering?**

A: No. Proposed Rule 506(c) does not modify the Rule 506 requirements relating to private placements to non-accredited investors. As a result, an issuer wishing to sell to non-accredited investors in its offering would not be able to engage in general solicitation. New Rule 506(c) is available for "sales only to accredited investors of unlimited amount using general solicitation."

**4) Q: Do we need to file a Form D to claim the benefit of new Rule 506(c)?**

A: No. The Proposing Release makes clear that while filing a Form D is a requirement of Rule 503(a) of Regulation D, it is not a condition to the availability of any of the Regulation D exemptions, including Rule 506(c).

**5) Q: Will general solicitation be permitted in a traditional Section 4(a)(2) private placement?**

A: No. The Proposing Release makes clear that Title II has no effect on traditional Section 4(a)(2) offerings.

**6) Q: Will general solicitation be permitted in connection with "Section 4(1½)" private resales?**

A: Consistent with the SEC's position on Section 4(a)(2), the SEC Staff has indicated that so-called Section 4(1½) private resales are not affected by Rule 506(c). We nonetheless believe that permitting general solicitation in Section 4(1½) private resales in situations where all the purchasers are accredited investors and the requirements of Rule 506(c) are met (other than its limitation to transactions by issuers) is consistent with the legal theory that gave rise to the secondary market in private offerings. The Section 4(1½) exemption relies on the interplay between Section 4(a)(2) on the one hand, and Sections 4(a)(1) and (a)(3) on the other. It is based on the notion that if the requirements of Section 4(a)(2) are otherwise met with respect to a private secondary market resale of a restricted security, the fact that a resale transaction occurs further down the chain of title (*i.e.*, does not involve the *issuer* as a counterparty) is not a reason to deny it the exempt status that would have been available had the issuer been the seller

in the transaction. What's good enough for the issuer, in our view, should be good enough for subsequent holders in the chain of title.

We believe this logic should apply with equal force to Rule 506(c), which, after all, is a safe harbor under Section 4(a)(2). In other words, in an otherwise Rule 506(c)-compliant transaction, a secondary market reseller should enjoy an exemption from registration notwithstanding the occurence of general solicitation. If this is not permitted, the only channel available for resales of a security originally sold under Rule 506(c) would seem to be Rule 144A. We see no policy basis for such a limitation.

**7) Q: Will a public company that is planning to offer convertible bonds or high yield notes in a Rule 506(c) or 144A offering be able to discuss the upcoming offering on an earnings call?**

A: Yes. Assuming the bonds are sold only to accredited investors and resold only to QIBs, general solicitation will be permitted.

**8) Q: Will a company be able to conduct a non-deal road show and shortly thereafter engage in a Rule 506(c) or 144A offering?**

A: Yes. So long as only accredited investors and QIBs purchase securities in the offering, there should no longer be a worry that a non-deal road show could amount to general solicitation (regardless of how the attendees were solicited). Of course, gun-jumping concerns remain in the context of registered offerings. As a result, pre-deal publicity limitations in advance of public offerings may need to be more restrictive than those in connection with Rule 506(c) or 144A private offerings. And since Rule 10b-5 applies to all material misstatements and omissions made in connection with a sale of securities, the contents of non-deal road show presentations (whether followed by either a public or a private offering) will continue to require careful vetting, particularly where there is only a short amount of time between the non-deal road show and the launch of the offering.

**9) Q: Will a company be able to conduct a Rule 506(c) or 144A offering using general solicitation and concurrently offer securities to the public in a registered transaction?**

A: In our view, yes. In 2007, the SEC made clear that the filing of a registration statement is not *per se* general solicitation and that companies should analyze whether a concurrent private placement is itself a valid private transaction:

> This analysis should not focus exclusively on the nature of the investors, such as whether they are "qualified institutional buyers" as defined in Securities Act Rule 144A or institutional accredited investors, or the number of such investors participating in the offering; instead, companies and their counsel should analyze whether the offering is exempt under Section 4(2) on its own, including whether securities were offered and sold to the private placement investors through the means of a general solicitation in the form of the registration statement.[6]

As a result of Title II, general solicitation will no longer be a feature of the private placement analysis in the case of a Rule 506(c) or 144A offering. It follows that a company should be able to conduct a public offering and concurrently conduct an otherwise valid Rule 506(c) or 144A offering, without losing the applicable Section 4(a)(2) exemption even if the securities were offered to the private investors by means of general solicitation.

**10) Q: What about gun-jumping concerns in the concurrent public/private scenario discussed above?**

A: Recall that Securities Act Section 4 provides an exemption from Section 5's various restrictions, and that Rule 506(c) and 144A transactions are exempt under Section 4. As a result, general solicitation in connection with a Rule 506(c) or 144A private offering should not be considered gun jumping, even if a company is concurrently offering its securities to the public in a transaction subject to Section 5. Concerns could nonetheless arise if the general solicitation inappropriately highlighted the public offering — for example, if the purported general solicitation for the private offering was in fact being used to solicit investors in the public offering who are not institutional accredited investors.

**11) Q: And what about integration in the concurrent public/private scenario?**

A: In the *Black Box* and *Squadron Ellenoff* no-action letters,[7] the SEC Staff reasoned that offerings to QIBs and up to three large institutional accredited investors would not be integrated with a concurrent public offering. In 2007, the SEC provided additional guidance on integration of concurrent public and private offerings that focused on how the private placement investors were solicited rather than who they are, taking a "how, not who" approach to this issue.[8] Since general solicitation will no longer be part of the "how" equation for a Rule 506(c) or 144A offering, we believe an otherwise valid Rule 506(c) or 144A offering can occur concurrently with a registered offering.

To be sure, market participants will need to work out procedures for appropriately conducting concurrent public and Rule 506(c) or 144A offerings. For example, deal teams will likely not want the marketing materials used in the Rule 506(c) or 144A offering to be considered free writing prospectuses in the concurrent public offering.

**12) Q: Will a company be able to discuss an upcoming Rule 506(c) or 144A offering with prospective investors at an industry conference?**

A: Yes, so long as all of the actual sales in that offering are made to accredited investors and QIBs in accordance with Rule 506(c) or 144A. We expect capital-raising discussions between issuers and prospective investors at industry conferences to become commonplace.

**13) Q: Will general solicitation be permissible in connection with a global offering involving a concurrent Regulation S offering outside the United States combined with a Rule 506(c) or 144A offering to US investors?**

A: Yes. In the Proposing Release, the SEC reiterated its longstanding position that offshore offerings under Securities Act Regulation S are not integrated with concurrent domestic offerings.[9] As a result, general solicitation in connection with Rule 506(c) or 144A transactions will not constitute "directed selling efforts" under Regulation S that would jeopardize a concurrent Regulation S offering.

**14) Q: How will Rule 506(c) or 144A offerings be treated under state blue sky laws?**

A: Section 18 of the Securities Act broadly preempts state securities law registration requirements for certain exempt transactions in covered securities, including Rule 506 offerings for all issuers and Rule 144A offerings by SEC-reporting issuers. The use of general solicitation should not affect the preemption of state securities registration requirements provided under Section

18 for these offerings. However, Rule 144A offerings for non-reporting issuers are not federally preempted pursuant to Section 18. Fortunately, each state provides an exemption from state securities registration requirements for offers and sales of securities made solely to QIBs, but those exemptions do not extend to offers made to non-QIBs. It remains an open question whether written offering materials used to offer (or deemed to be used to offer) securities to non-QIBs would be subject to a filing requirement in some states. We do not expect this technical point to be a concern in practice.

**15) Q: Will general solicitations be permissible in connection with an unregistered offering for a private investment fund under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940?**

A: Yes, so long as the offering also meets the requirements of Rule 506(c) or 144A. These transactions have historically been regarded as non-public offerings for purposes of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, and the use of general solicitation does not change this view.

**16) Q: Will a Section 3(c)(1) or 3(c)(7) fund be able to sponsor a golf tournament or similar publicity-generating event?**

A: Yes. Consistent with the answer to question 15 above, there should not be a concern with general solicitation in connection with branding initiatives by investment funds.

**17) Q: If there is no prohibition on general solicitation in Rule 506(c) or 144A offerings, can anyone now solicit potential purchasers in connection with private placements?**

A: No. Persons who solicit or find potential purchasers in securities offerings will still need to be registered as broker-dealers under the Securities Exchange Act of 1934 (and applicable state blue sky laws) or comply with an appropriate exemption from such registration requirements.[10]

**Endnotes**

[1] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9354 (August 29, 2012) (the "Proposing Release").

[2] Proposing Release at 12 n.37.

[3] *Id*. at 14.

[4] *Id*. at 14-20.

[5] *See, e.g.* SEC Division of Corporation Finance no-action letters to *Communicator Inc.* (Sept. 20, 2002) and *CommScan LLC* (Feb. 3, 1999).

[6] *Revisions of Limited Offering Exemptions in Regulation D*, SEC Release No. 33-8828 (Aug. 3, 2007) at 55-56.

[7] SEC Division of Corporation Finance no-action letters to *Black Box Incorporated* (June 26, 1990) and *Squadron Ellenoff, Pleasant & Lehrer* (Feb. 28, 1992).

[8] *See Revisions of Limited Offering Exemptions in Regulation D*, SEC Release No. 33-8828 (Aug. 3, 2007) at 55-56.

[9] Proposing Release at 39.

[10] *See, e.g.*, SEC Division of Investment Management no-action letter to *Lamp Technologies, Inc.* (May 29, 1997) at n.2.

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