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SEC Proposes Rule to Eliminate Ban on General Solicitation and Advertising

The changes would eliminate prohibitions against the use of general solicitation in private offerings conducted in reliance on those rules, as required by Section 201(a) of the Jumpstart Our Business Startups (JOBS) Act

On August 29, 2012, the Securities and Exchange Commission (the "SEC") proposed amendments to Rule 506 of Regulation D, as promulgated under the Securities Act of 1933 (the "Securities Act"), to implement Section 201(a)(1) of the Jumpstart Our Business Startups Act (the "JOBS Act"), which would eliminate the prohibition against general solicitation and general advertising as it applies to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors. (See Release No. 33-9354.)

The proposed amendments, if adopted as proposed, could greatly impact the marketing of private fund issuers such as hedge funds, venture capital funds, private equity funds and real estate funds.

Rule 506's Current Safe Harbor

Rule 506 is a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act, which exempts transactions by an issuer "not involving any public offering" from the registration requirements of Section 5 of the Securities Act. Currently, Rule 506 permits an issuer, without an effective registration statement filed under the Securities Act, to offer and sell securities to an unlimited number of "accredited investors" (as defined in Regulation D) and a maximum of 35 non-accredited investors who meet certain sophistication requirements, provided that the issuer does not offer or sell the securities through any form of general solicitation or advertising. Prohibited forms of general solicitation or advertising have generally included magazine, newspaper, television, and Internet communications.

Proposed Rule 506(c)

In its proposing release the SEC clarified the proposed amendments would affect only the Rule 506 safe harbor. Specifically, the SEC proposed a new Rule 506(c), which would permit the use of general solicitation to offer and sell securities under Rule 506, provided that certain conditions are satisfied.

These conditions are:

- the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
- all purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they do, at the time of the sale of the securities; and
- all terms and conditions of Rule 501 and Rules 502(a) and 502(d), which address the definition of an accredited investor, the integration of offerings made within a certain time frame, and restriction on the resale of the securities, must be satisfied.

Importantly, as proposed, the amendments the SEC would preserve, under existing Rule 506(b), the current ability of issuers to conduct Rule 506 offerings without the use of general solicitation or advertising. Issuers would still be able to conduct Rule 506 offerings under the current Rule 506- i.e., privately offering securities to accredited investors and certain non-accredited investors who meet the sophistication requirements of Rule 506, without the use of general solicitation or general advertising.

Reasonable Steps to Verify Accredited Investor Status

Under the proposed amendments, if adopted, the determination of whether the steps taken by the issuer are reasonable will be objective, but variable so the analysis will be adjusted to the particular facts and circumstances of each offering and each purchaser. By tailoring the steps used to verify that purchasers are accredited investors, issuers would be provided with the flexibility to adopt verification procedures that are more suited to their particular offering instead of being obligated to verification methods that may be inapplicable. While the SEC declined to specify the objective steps used in determining "reasonableness", the SEC did set forth factors that an issuer would consider relevant in determining the accredited investor status of a purchaser, such as:

- the nature of the purchaser and the type of accredited investor that the 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.

An issuer's determination of the nature of the purchaser may differ depending on the type of purchaser such as whether the purchaser is a broker dealer, a registered investment company, or a natural person. The SEC has also stated that the more information an issuer has about a purchaser, the fewer steps the issuer would have to take to verify the accredited investor status of the purchaser. Such information could be obtained through publicly available information, third-party information obtained from sources that include tax filings, industry publications, or the accountants or attorneys of such purchaser. Finally, the review of the nature of the offering to verify the accredited investor status of a purchaser would include the manner used by the issuer to solicit the purchaser. For instance, where an issuer solicits a purchaser through a general website, the issuer would have to take more steps to verify the accredited investor status of the purchaser than the standard investor questionnaire now typically in use. The terms of the offering would also affect the issuer's determination of the accredited investor status of a purchaser. For instance, the ability of an investor to meet the terms of an offering with a high minimum investment amount would be considered in determining the accredited investor status of such purchaser.

Reasonable Belief that All Purchasers Are Accredited Investors

The reasonable belief standard for accredited investor status in Rule 501(a) would continue to apply under proposed Rule 506(c). The SEC specifically stated in its proposing release that a if a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, the issuer would not lose the ability to rely on the proposed Rule 506(c) exemption for that offering, if the issuer had taken reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor.

Form D Check Box for Rule 506(c) Offerings

Under Rule 503 of Regulation D, an issuer offering or selling securities in reliance on Rules 504, 505 or 506 must file a notice of sales on Form D with the SEC for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering. Although the filing of a Form D is a requirement of Rule 503(a) of Regulation D, it is not a condition to the availability of the exemptions under Regulation D. To assist the SEC's efforts to monitor the use of general solicitation under Rule 506(c), the proposed amendments to Rule 506 also include an revision to Form D, which would include a separate check box for issuers to indicate whether they are using general solicitation or general advertising in a Rule 506 offering and claiming a exemption under Rule 506(c). The SEC also expects this revision to Form D to help the SEC to look into the practices that would develop to satisfy the verification requirement, which would help us assess the effectiveness of various verification practices in identifying and excluding non-accredited investors from participation in proposed Rule 506(c) offerings. The release also seeks comments on whether to require the pre-use filing of a Form D for a paragraph (c) offering.

Specific Issues for Privately Offered Funds

A significant number of private fund issuers, in order to take advantage of exclusions from the regulatory provisions of the Investment Company Act, generally rely on either Investment Company Act Section 3(c)(1) (for issuers who do not have more than 100 beneficial owners of its securities), or Investment Company Act Section 3(c)(7) (for issuers whose owners are "qualified purchasers"), which each require that there is no public offering of the issuer's securities. However, under the proposed amendments, these issuers would be able to make a general solicitation or general advertising in connection with securities offerings conducted under Rule 506(c) while still taking advantage of the exclusions of the Investment Company Act.

Integration with Offshore Offerings

In its proposing release the SEC confirmed that the use of general solicitation in offerings conducted pursuant to Rule 506, as amended, would not be deemed to constitute directed selling efforts by that issuer in connection with a contemporaneous offering under Regulation S.

Please note that, until the proposed rules implementing the elimination of the prohibition on general solicitation or general advertising are adopted and effective, no issuer may engage in any general advertising or any general solicitation and Rule 506 in its current form remains in effect.

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