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SEC Relaxes Ban on "General Solicitation" and "General Advertising" in Private Securities Offerings

July 11, 2013. Yesterday, the U.S. Securities and Exchange Commission adopted certain long-anticipated amendments to two of its safe harbor exemptions for private securities offerings. The amendments had been mandated by Congress under the JOBS Act, which became law over a year ago in April 2012. The amendments, when effective, will make it possible for companies and funds to use advertising, the Internet and other forms of mass communication when marketing their securities offerings, so long as securities sales are made only to "accredited investors" ("AIs") in conformance with Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act"), or "qualified institutional buyers" ("QIBs") in conformance with Rule 144A under the Securities Act. AIs include, among others, individuals with more than $1 million in net worth (excluding primary residence) or more than $200,000 ($300,000 with a spouse) in annual income in each of the last two years, and companies with more than $5 million in assets. QIBs include, among others, institutions with investments in securities of at least $100 million.

Currently, communications about a securities offering that are circulated in any broad, blanket or public manner constitute "general solicitation" or "general advertising", and cannot be employed to market private offerings that are exempt from registration with the SEC. The SEC's amendments will permit such communications to be made in private, unregistered offerings that are conducted under Rule 506 of Regulation D or under Rule 144A. The amendments are expected to go into effect in September, 60 days after the official publication of yesterday's rulemaking in the U.S. Federal Register.

Easing the ban on general solicitation and general advertising has been a source of controversy since the passage of the JOBS Act, with consumer advocates, among others, expressing fear that changes could lead to the fraudulent mass-marketing of securities offerings, and Congress, among others, taking the view that the ban represents an unnecessary brake on capital-raising. The SEC's rules reflect certain concessions to the proponents of the ban, but at the same time provide significant opportunities for companies, funds and other parties active in the private securities offering process to make use of broad communications to market unregistered transactions.

Implications for Private Placements to Accredited Investors

Currently, Rule 506 of Regulation D permits a company or fund to offer and sell an unlimited amount of securities to AIs and up to 35 other persons, provided various conditions are met, including the

filing, after the offering is complete, of a short "Form D" notifying the SEC of the existence of the offering. The amendment to Rule 506 removes the condition that the offering be conducted without general solicitation or general advertising, so long as all the purchasers of the securities are AIs and the company or fund takes reasonable steps to verify that all such purchasers are AIs. In other words, ***offers*** can be made using mass communication, so long as, in the end, ***sales*** are made only to verified AIs. The amendment includes a non-exclusive list of methods that companies and funds may use to satisfy the verification requirement for purchasers who are natural persons, including reviewing a copy of any IRS form which reports the income of the purchaser and obtaining a written representation that the purchaser will likely continue to earn the necessary income in the current year, and receiving written confirmation from a registered broker-dealer, registered investment adviser, licensed attorney or certified public accountant that such person has taken reasonable steps to verify the purchaser's status as an AI.

The SEC also intends to make the Form D filing process more elaborate, so that it can better monitor the market consequences of the removal of the general solicitation ban. Yesterday, at the same time that it announced the lifting of the ban, the SEC issued proposed rules which would require issuers to include certain legends and cautionary statements in any written general solicitation materials used in a Rule 506 offering. It also issued proposed rules for modifying the Form D process, which it expects to make final at the same time that the general solicitation ban takes effect in September. Under the SEC's proposals, if a company or fund intends to use general solicitation or general advertising to offer securities under Rule 506, it would be required to file a Form D at least 15 days ***before*** the first use of general solicitation or general advertising, file an updated Form D within 30 days of the end of the offering, provide additional information in the Form D regarding the conduct of the offering and provide the SEC with non-public, electronic copies of its written general solicitation materials. A company or fund would be banned from using Rule 506 for a year if it or any of its "affiliates" failed to file a proper Form D. The SEC defines "affiliate" broadly, and consequently a company or fund could be banned from using Rule 506 if a range of persons with a material interest in the success of the offering were to fail to comply with the new Form D requirements. In a separate release yesterday, the SEC also adopted amendments intended to disqualify companies and funds from relying on Rule 506 if certain felons and other "bad actors" participate in the offering.

In addition to the "new" Rule 506/Form D offering method, companies and funds can continue to make use of the "old" Rule 506/Form D method (i.e. refrain from "general solicitation" and "general advertising" activities and continue to comply with current requirements regarding investors and Form D.)

It is difficult to predict at this time whether, and to what extent, changes to the Form D process may discourage the use of mass communication in Rule 506 offerings. The more stringent the final changes turn out to be, the more risk there will be that a company or fund that seeks to market its Rule 506 offering broadly violates the rules, even inadvertently. Currently, we expect market practices concerning the use of general solicitation and general advertising in Rule 506 offerings to develop slowly, and with a fair degree of uniformity across the market, once the new rules have taken effect.

Implications for Rule 144A Offerings to Qualified Institutional Buyers

Rule 144A is typically used by companies and funds, and their underwriting and placing banks, to offer and sell securities not listed on any U.S. exchange to pension funds, mutual funds and other very large institutional investors. The amendment to Rule 144A removes the condition that the offering be conducted without general solicitation or general advertising, so long as the securities are, in the end, sold only to persons that the seller reasonably believes are QIBs.

Because there are no existing or proposed provisions regarding a Form D-like filing under Rule 144A, market participants may find it easier to develop mass-marketing techniques in connection with Rule 144A offerings. However, the audience for Rule 144A offerings is still small and highly

concentrated. Therefore, there may not be much commercial incentive for companies, funds or banks to use mass communication in a Rule 144A context.

Implications for Offerings by Private Equity, Hedge and Other Funds

Although a number of commentators expressed concern regarding the extension of the new Rule 506 relief to private funds, the SEC notably did not exclude private funds in the scope of its amendments.

Historically, private investment funds were most often prevented from advertising based on two securities law provisions: (i) the ban against general solicitation and general advertising applicable to Rule 506 offerings, and (ii) the ban on making a public offering contained in the widely relied-upon 3(c)(1) and 3(c)(7) exemptions to registration under the Investment Company Act of 1940 (the "Company Act"). However, the JOBS Act states expressly that offerings that comply with Rule 506 "shall not be deemed public offerings under Federal securities laws" (including the Company Act) due solely to employing general solicitation and advertising. As a result, private funds may advertise publicly when complying with Rule 506 without jeopardizing the "private" status of their offerings as required under the Company Act.

On a pragmatic note, the SEC's amendments may not impact large- and mid-size private funds as significantly as they may impact smaller issuers. While all funds may now engage in "general solicitation" and "general advertising", which may include website and tombstone announcements, email blasts and other forms of mass communication, doing so would necessitate complying with the heightened disclosure and diligence requirements described above. Large- and mid-sized funds, whose investors typically consist of high net worth individuals and institutions, may not find that the added benefit of widening their marketing scope justifies the additional expense and inconvenience of having to comply with these heightened requirements, and instead may continue to seek investors under the existing regulatory framework. Smaller funds and funds without established track records may find that the broader reach achieved by general solicitation and general advertising is worth the expense and inconvenience of complying with the heightened disclosure and diligence requirements.

The Rule 506 amendments also impose additional requirements – primarily disclosure-related – on general solicitation materials used by private investment funds, although many of these requirements overlap with requirements in the Investment Advisers Act of 1940 for private fund managers who are also registered investment advisers. Smaller fund managers who are not registered as investment advisers should carefully review their general solicitation materials to ensure compliance with the Rule.

In its announcements yesterday, the SEC also proposed amendments to Rule 156 under the Securities Act of 1933 that would extend the antifraud provisions contained in that rule to the advertising literature of private investment funds.

Any fund that considers taking advantage of the new general solicitation option under Rule 506 should also consider whether general solicitation would be consistent with any commodities laws and rules that may apply to it, including any exemptions from commodities regulation on which it may rely.

If you have any questions concerning the SEC's amendments, or any other corporate-, securities-, or fund-related inquiries, please feel free to contact the Morrison Cohen attorneys named below (or your usual Morrison Cohen contacts):

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