News Briefs

Private Placement Reform, or How the SEC Learned to Stop Worrying and Love General Solicitation: Part 3 of a 4-Part Series on the Jobs Act

chrismanderson - 25 April 2012

This is part three of a four-part series examining how the Jumpstart Our Business Startups Act (JOBS Act) will affect the capital markets. Signed into law on April 5, the JOBS Act results from efforts to reduce regulatory burdens on small companies attempting to access the capital markets, and it contains some overdue reforms to the securities laws.

Part one of the series explained "emerging growth companies," while part two examined the "Facebook Problem," secondary market trading and the "500 Shareholder Rule." Part three examines changes designed to make private placements easier to publicly discuss, and even to advertise. These rule changes should enable growing early stage and middle market

companies to raise more private capital, without fear of inadvertently triggering registration requirements under the federal securities laws by violating the private placement "safe harbor" rules. The reforms also recognize that in current practice, private placements by sophisticated issuers are generally sold only to accredited investors.

The Private Placement Exemption from Registration — Rule 506

Companies have long conducted private placements utilizing the "safe harbor" exemption from registration provided by Rule 506 of Regulation D under the Exchange Act. Rule 506 allows an issuer to sell an unlimited dollar amount of securities to an unlimited number of accredited investors, and up to 35 non-accredited investors, without the expensive, burdensome and timeconsuming requirements of registering a public offering with the SEC. Issuers utilize Rule 506 to raise capital quickly and at lower cost than in a public offering. If an issuer does not conduct a public offering, it also avoids the ongoing expense of filing periodic reports (e.g. 10-Ks, 10-Q and the like) under the Exchange Act.

Private placements are typically conducted by investment bankers, brokers or issuers directly circulating numbered Private Placement Memoranda, or PPMs to potential investors. The PPM describes the offering, the issuer's business and management, risks relating to the investment, and similar information. Non-institutional investors are usually required to fill out an "Accredited Investor Questionnaire" certifying how they qualify as such. The purchase is consummated via a Subscription Agreement in which the accredited investor certifies that it agrees to purchase the securities, it has conducted satisfactory diligence, and understands and freely undertakes the investment risks.

The Problem: Rule 506 Prohibited General Solicitation or Advertising

One problem with Rule 506 was its prohibition on "general solicitation or advertising". To qualify for the safe harbor exemption from registration, issuers could not advertise their private placements. An issuer that violated this prohibition would disqualify the offering from Rule 506 and be required to register its offering, and possibly be liable for civil and criminal penalties for the unlawful sale of securities.

The real problem is that "general solicitation" was broadly construed, prohibiting virtually any communications when a company was contemplating issuing securities. Direct advertising was obviously general solicitation, but indirectly promoting an issuer, its management, technology or business could also constitute general solicitation. Therefore, when an issuer was conducting and offering, or even contemplating one, it had to tread very carefully over any public statements about its business. Well advised companies avoided giving management interviews, seminars, talking publicly about their technology and promoting their business generally.

Rule 506 then turned out to be effectively a "gag order" on issuers pursuing—or even contemplating—a private placement. This hampered business operations, capital raising, and efficient functioning of the market. But it provided little investor protection because most private placements were sold to accredited investors, who are deemed to have access to adequate information and be able to protect themselves when making an investment decision.

The Solution: General Solicitation and Advertising Will Be Permitted Under the JOBS Act, as Long as Securities Sold only to Accredited Investors

The JOBS Act has done away with the prohibition on general solicitation or advertising in private placements under Rule 506, provided that all purchasers are accredited investors. More specifically, Section 201(a)(1) of the JOBS Act requires the SEC to amend Rule 506 to exempt offers and sales of securities under Rule 506 from the prohibition on general solicitation or advertising in Rule 502(c), when all purchasers are accredited investors.

Similarly, Rule 144A, which is often used as a safe harbor for resales of privately placed securities, will be amended to provide that securities sold under Rule 144A may be offered to persons other than qualified institutional buyers (QIBs), including by general solicitation or advertising, provided that securities are only sold to persons reasonably believed to be QIBs.

This rule change effectively recognizes the system that had been in place for years, but for issuers removes the risk of destroying a private placement or resale by inadvertently communicating. In practice, very few private placements are sold to unaccredited investors, in part because the disclosure requirements were extremely burdensome if any unaccredited were included.

Note that the Rule 502(c) prohibition on general solicitation or advertising still applies to: (i) private placements under Rule 506, if any purchasers are not accredited investors, and (ii) other private placements under Regulation D, such as smaller private placements under Rules 504 or 505.

SEC Rulemaking; 90-day Interim Period

The SEC has 90 days from the April 5, 2012 signing of the JOBS Act to amend Rule 506 and Rule 144A to permit general solicitation or advertising. In the interim period, the old rules continue to apply, according to this **"14 Law Firm Consensus Report"** prepared by some of the nation's leading law firms. The 14 Law Firm consensus view is almost certain to be followed in the interim. While it is unusual for a large number of major law firms to issue an interpretive statement of new legislation, it is not unprecedented. In 2002, just after the passage of **the Sarbanes Oxley Act, 25 major law firms issued interpretive guidance on Section 402 of that Act,** which prohibited public companies from making loans to insiders. While this report was "unofficial" and did not have the weight of legal authority or even SEC guidance, it was widely persuasive.

What Are the Consequences for Issuers?

Obviously the ability to communicate and advertise will facilitate private placements and reduce the risk of inadvertently disqualifying a private placement through misguided communications. Issuers will be able to actively promote their companies and private placements, give interviews to the press and conduct roadshows and seminars without risk, so long as securities are sold only to accredited investors. These changes should improve access to the capital markets for issuers that were previously had to conduct private placements through brokers, investment banks, or family and friends. For startups and lower middle market companies, **"Angel" rounds should continue to be a viable alternative for growth capital**. For larger issuers, the rule changes will mean private placements can be offered to a much larger pool of investors through general promotion, and capital raising will no longer require a "gag order" on executive interviews and communications promoting the business.

The changes to Rule 506 are unlikely to change how private placements are executed, however. For sales to accredited investors, Rule 506 does not require PPMs, Questionnaires, or Subscription Agreements; accredited investors are deemed to have adequate access to information and be able to protect themselves. In fact, an issuer could theoretically conduct a private placement to accredited investors without any of these documents. Issuers use these documents to protect themselves, so there is a clear record of (i) what representations and disclosure were made to the investor, and (ii) the investor's certification of accredited status and willingness and ability to bear the risk of the investment. Because of the rule's expanded safe harbor for sales made solely to accredited investors, look for even greater emphasis on issuers certifying an accredited investor's status before selling securities.

Finally, the new rules will continue the trend of de-emphasizing sales to unaccredited investors in private placements. *The rule changes do not lift the prohibition on general solicitation if any securities are sold to even a single unaccredited investor.* In light of the increased risk of selling to unaccredited investors, sophisticated issuers will continue to avoid unaccredited investors in private placements.

*About the author: **Chris Manderson** is a founding partner of **Manderson, Schafer & McKinlay LLP**, an independent corporate practice specializing in business and transactional law. Manderson advises companies and private equity funds on all aspects of corporate and securities law, with an emphasis on public and private mergers, acquisitions and asset sales. His clients include publicly traded companies, privately-held companies, private equity funds and individual investors and executives.*

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