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Private Placements under New Rule 506(c) – Interplay with Other Exemptions and State Law Implications

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A fundamental precept of the federal securities laws is that any purchase or sale of a security must either be registered under the Securities Act of 1933 (the Securities Act) or qualify for an exemption from registration. One of the primary exemptions from such requirement is set forth in Section 4(a)(2) of the Securities Act, which provides that the securities registration requirements shall not apply to transactions by an issuer not involving any public offering. Regulation D under the Securities Act, adopted in 1982, provided a series of non-exclusive safe harbors from registration for limited offerings: a transaction satisfying the requirements of Rule 506 under Regulation D is a "private placement" deemed not to involve a "public offering" under Section 4(a)(2) and therefore exempt from registration.

The JOBS Act rule amendments add a further category of private placement to Regulation D that qualifies the transaction for exemption from the registration requirements: the "*general solicitation offering that does not involve a public offering*." This is the first significant liberalization of the private placement rules since the adoption of Regulation D in 1982. Prior to the JOBS Act rule amendments, issuers of securities in private placements under Rule 506 of Regulation D were required to have a bona fide pre-existing relationship with all offerees and were prohibited from engaging in a general solicitation of such persons. Indeed, numerous Securities and Exchange Commission releases in regards to Regulation D have specifically acknowledged that public advertising is incompatible with a claim of exemption under Section 4(a)(2). The basis for this condition was that public advertising and general solicitation would constitute a "public" offering, which would, by definition, not be exempt under Section 4(a)(2). New Rule 506(c) completely alters this analysis.

Under Rule 506(c), the previous requirements of having a pre-existing relationship with a prospective investor and the prohibition on general solicitation are no longer applicable. An offering of securities by an issuer will comply with Rule 506(c) of Regulation D (and therefore satisfy the exemption set forth in Section 4(a)(2) of the Securities Act), regardless of whether a general advertisement or general solicitation is involved, and regardless of whether the issuer has a pre-existing relationship with a prospective investor, so long as (i) the issuer takes reasonable steps to verify that the purchasers of securities in the offering satisfy the criteria for "accredited investors" and (ii) all of the ultimate purchasers of the offered securities are "accredited investors" at the time of sale. Effectively, Rule 506(c) permits general advertising or general solicitation and does not place any limits on who can receive offers of the securities, but requires that sales must only be made to accredited investors. Section 4(b) of the Securities Act now specifically provides that securities transactions exempt under Rule 506 shall not be deemed to be public offerings under the federal securities laws as a result of general advertising or general solicitation.

Since 1996, securities offerings under Rule 506 were deemed to be "covered securities" under federal law, which preempted the states from substantively regulating such offerings under state securities laws (also known as "blue sky laws"). (The most a state may require of an issuer is a notice filing and the payment of a filing fee. States continue to retain jurisdiction over anti-fraud enforcement and the regulation of intermediaries such as broker-dealers). Offerings under new Rule 506(c) will likewise be considered "covered securities" and the states will be preempted from regulating them. A number of states have

passed regulations prohibiting unregistered offers of securities to residents of those states by means of the Internet. Securities offered in compliance with Rule 506(c) will constitute "covered securities" and will be exempt from such state regulations. It is worth noting, however, that issuers that have previously relied on state limited offering exemptions (rather than federal preemption as "covered securities") that include a condition that there be no general solicitation or general advertising, will no longer be able to utilize such limited offering exemptions if they take advantage of new Rule 506(c). Of course, that means that the offering must comply with all of Rule 506(c), including that only accredited investors are allowed to buy after the effective date and that the various "bad actor" limitations are met. In that sense, Rule 506(c) is an "all or nothing" rule: the drafters have made it clear that issuers cannot bundle together various Securities Act exemptions taking advantage of the "general solicitation relaxation" without also complying with the other limitations.

Similar concerns will apply if an issuer initially utilizes Rule 506(c) and subsequently determines to alter the terms of the offering to comply with a different provision of Regulation D, such as Rule 506(b) (the "old" Rule 506) or Rule 505. An issuer that initially pursues a general solicitation under Rule 506(c) may have "tainted" its ability to rely on the other provisions of Regulation D that continue to require a bona fide pre-existing relationship with offerees and that the issuer avoid a general solicitation or general advertisement. In such a situation, consultation with legal counsel would be crucial. Prior to utilizing a different exemption under Regulation D for a private placement of securities, counsel may advise the issuer to wait at least six months and one day to avoid integration of the two separate offerings. Alternatively, it may be possible to proceed immediately with the private placement to investors with which that the issuer had a pre-existing relationship prior to its general solicitation under Rule 506(c).

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- In practice, issuers that choose to use general advertising or general solicitation in Rule 506(c) offerings will do so at the cost of eliminating non-accredited but financially sophisticated investors from the possible pool of investors (who might otherwise be able to invest in private placements under other provisions of Regulation D) and require that issuers take greater precautions in order to ensure that the purchasers are indeed "accredited investors."
- State securities commissioners and regulators will now be precluded from applying their "blue sky" laws and regulating offerings of securities that involve general solicitation or general advertisement, provided that the issuer complies with Rule 506(c) and notice filing and fee payment requirements in the relevant states. States will continue to be authorized to enforce anti-fraud rules and regulate financial intermediaries, however.
- Issuers of securities in private placements should use an abundance of caution before proceeding with a general solicitation under Rule 506(c) to ensure that, if the offering does not meet their business objectives, they will be able to utilize another exemption under Regulation D in order to secure the required funding, which may require advance planning and/or waiting a substantial period of time after the initial offering.
- Offshore funds that target the U.S. market (in particular foreign blocker corporations that act as feeder funds) will also need to file a U.S. Form D under Rule 506(c) if they plan to engage in a private placement using general solicitation or general advertising in the United States and want to take advantage of the preemption of state filing requirements (other than the notice filings) offered by the federal rule.

More Resources on the JOBS Act

Pepper Hamilton is hosting two in-person seminars (in Philadelphia on August 13 and in Princeton on August 20) to complement the ones held in New York and Boston recently.

For additional information, please visit Pepper's JOBS Act Resource Center available online at www.pepperlaw.com/news.aspx?AnnouncementKey=1957.