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Management Alert

JOBS Act Update - SEC Rule Proposals on Regulation D and Rule 144A and FAQs on Analyst Activities

Proposed Amendments to Rules 506 and 144A

Section 201(a) of the Jumpstart Our Business Startups Act enacted on April 5, 2012 (the "JOBS Act") directed the Securities and Exchange Commission (the "SEC") to adopt rules eliminating the prohibition against general solicitation and general advertising in securities offerings conducted pursuant to Rule 506 of Regulation D under the Securities Act of 1933, as amended (the "Securities Act"), and Rule 144A under the Securities Act. On August 29, 2012, the SEC proposed new rules to implement the rule changes mandated by the JOBS Act.

The proposed rules add a new paragraph (c) to Rule 506 that permits general advertisement and solicitation of a Rule 506 offering where the issuer reasonably believes, and takes reasonable steps to verify, that each purchaser in the offering is an accredited investor within the meaning of Rule 501(a) of Regulation D. The proposed rules do not articulate the steps a company must take to satisfy its obligation to take reasonable steps to verify that a purchaser is an accredited investor other than to note that the company's actions must be reasonable under the facts and circumstances. In this regard, the proposing release states that a company should consider the following factors:

- the nature of the purchaser and the category of accredited investor that the purchaser claims to satisfy;
- the amount and type of information that is available to the company about the purchaser; and
- the nature of the offering, including the manner in which investors were solicited, and the terms of the investment, such as the minimum investment amount.

The proposed rules will require a company to make a reasonable inquiry of a prospective investor's accredited investor status, which may include identifying and assessing (i) publicly available information about the investor that is contained in filings with a federal, state or local regulatory body, (ii) third-party information about the investor that provides reasonably reliable evidence that the investor is an accredited investor, and (iii) verification of an investor's status as an accredited investor by a reliable third party, such as a broker-dealer, attorney or accountant. If an offering requires a minimum investment amount that only accredited investors could reasonably be expected to meet it and investors are investing their own funds without third party financing, then such minimum investment amount would be a material fact in verifying the investor's accredited investor status.

Current best practices for Rule 506 offerings generally require a prospective investor to complete a questionnaire or certification confirming the investor's status as an accredited investor at the time of its investment. If general solicitations or advertisements under new Rule 506(c) are targeted at investors identified from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party, such as a registered broker-dealer, then obtaining a certification from the investor as to its accredited investor status, coupled with the reasonable belief in the reliability of the third party screener, would likely satisfy the reasonable steps standard under the new proposed rules. Conversely, solicitations of new investors through a website accessible to the general public or through a widely disseminated email or social media solicitation would likely require a company to take greater measures to verify accredited investor status of its

investors. In this regard, we note that a majority of SEC commissioners had voiced opposition to the general solicitation provisions of Section 201(a) of the JOBS Act prior to enactment over concerns that the new rules would become conduits for unregistered public offerings. Although it is presumed that a company may claim the exemption it is relying upon to conduct an offering, the burden of proof remains on the company to prove that it meets the criteria to claim the exemption. In the proposing release, the SEC Staff is making it clear that the steps an issuer must take to meet this burden, particularly with respect to widely disseminated public offering materials, will be markedly more rigorous than would have been required to establish a purchaser's accredited investor status under existing rules and interpretative guidance and with respect to offerings conducted as conventional private placements.

The Rule 506 proposals also address a number of administrative items. Form D would be amended with a check the box election to indicate that an offering was conducted pursuant to new Rule 506(c). In addition, the proposing release clarifies that Rule 506(c) offerings by privately offered funds such as hedge funds, venture capital funds and private equity funds would not result in any such company being deemed an "investment company" under the Investment Company Act of 1940, as amended.

The proposed rules also would implement similar amendments to Rule 144A to permit general advertisements and solicitations in Rule 144A offerings so long as the purchasers are Qualified Institutional Buyers (each, a "QIB"). Specifically, Rule 144A would be amended to eliminate the restriction on "offers" to persons who are not QIBs contained in Subparagraph (d)(1) of Rule 144A. As proposed to be amended, the text of subparagraph (d)(1) would continue to condition the exemption on the securities being sold only to QIBs or to purchasers that the seller and any person acting on its behalf reasonably believe is a QIB as is the case under current Rule 144A. Unlike the Rule 506(c) proposals, the proposed amendments to Rule 144A do not create any additional standards for whether a company reasonably believes a purchaser to be a QIB.

The SEC is soliciting comments on the proposed amendments to Rules 506 and 144A. Comments must be submitted on or before October 5, 2012.

FAQs on Analyst Activities

On August 22, 2012, the SEC staff published a series of responses to Frequently Asked Questions ("FAQs") regarding certain provisions of the JOBS Act relating to research analyst communications and reports with respect to emerging growth companies ("EGCs"). Set forth below is a summary of the key items covered in the FAQs:

Global Research Settlement Restrictions Unaffected. In 2003 and 2004, the SEC, several Self-Regulatory Organizations ("SROs"), and other federal and state regulatory agencies instituted settled enforcement actions against 12 broker-dealers to address conflicts of interest between the firms' research and investment banking functions (the "2003 Global Settlement")[1]. The JOBS Act does not amend or modify the 2003 Global Settlement. Therefore, firms subject to the 2003 Global Settlement cannot take advantage of the provisions of the JOBS Act relating to research analysts and IPOs of EGCs unless and until the overseeing court approves an amendment or modification.

Analyst Communications. Section 105(b) of the JOBS Act prohibits the SEC and SROs from restricting investment banking personnel from "arranging for communications between a securities analyst and a potential investor" in connection with an IPO of an EGC. Although current SEC and SROs rules do not expressly prohibit "arranging" such communications, certain activities of this nature, while permitted by the JOBS Act, could be seen as directing analysts to engage in marketing which is directly prohibited under SRO rules. The FAQs provide for the following forms of permissible "arranging" activities:

- an investment banker may forward an analyst a list of clients for the analyst to contact at his or her own discretion and with appropriate controls;
- an investment banker may arrange calls between analysts and clients provided that the investment banker does not participate in such calls; and

1 The parties subject to the 2003 Global Settlement Bear, Stearns & Co. Inc., Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc., J.P. Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith, Incorporated, Morgan Stanley & Co. Incorporated, Citigroup Global Markets Inc., f/k/a Salomon Smith Barney Inc., UBS Warburg LLC, U.S. Bancorp Piper Jaffray Inc., Jack B. Grubman and Henry M. Blodget.

- an analyst may forward to investment banking, a list of potential clients it intends to communicate with, as a means to facilitate scheduling.

Analyst Participation in Pitches. With respect to IPOs of EGCs, Section 105(b) of the JOBS Act prohibits SROs from restricting analyst participation in communications with management when investment banking personnel are also present. However, the FAQs make clear that this provision in the JOBS Act does not impact the provisions in SRO rules and the 2003 Global Settlement, such that only firms that are not subject to the 2003 Global Settlement may avail themselves of the benefits of Section 105(b) of the JOBS Act. The FAQs also clarify the types of permitted activities in which analysts could participate within the protections of Section 105(b). Before a firm is formally retained to underwrite an offering, analysts not subject to the 2003 Global Settlement in attendance at pitch meetings could, for example, introduce themselves, outline their research program and the types of factors that the analyst would consider in his or her analysis of a company, and ask follow-up questions to better understand a factual statement made by the emerging growth company's management. In addition, after the firm is formally retained to underwrite the offering, analysts at a firm not subject to the 2003 Global Settlement could, for example, participate in presentations by the management of an emerging growth company to educate a firm's sales force about the company and discuss industry trends, provide information obtained from investing customers, and communicate their views. However, Section 105(b) does not exempt analysts from otherwise applicable SRO rules which prohibit certain activities deemed to be a conflict of interest. These prohibited activities include:

- soliciting investment banking business;
- changing research as a result of a communication in an effort to obtain investment banking business;
- giving tacit acquiescence to overtures from the management of an EGC that attempt to create an expectation of favorable research coverage if the analyst's firm is chosen to underwrite the EGC's IPO;
- providing views that are inconsistent with the analyst's personal views about the EGC or its securities;
- making statements that are misleading taking into consideration the overall context in which the statements are made; and
- directly or indirectly directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction.

Testing the Waters. Section 105(c) of the JOBS Act permits an EGC and its underwriters to engage in "testing-the-waters" communications, in order to gauge investor interest in an EGC's offering, either prior to or following the filing of a registration statement. However, according to the FAQs, Rule 15c2-8(e) of the Securities Exchange Act of 1934, as amended, continues to apply. Rule 15c2-8(e) prohibits a dealer from participating in the distribution of securities unless the statutory preliminary prospectus has been made available to prospective investors. After a registration statement for a contemplated offering by an EGC has been filed with the SEC, an EGC's underwriters must be cautious to avoid engaging in soliciting activities that may be deemed to be participating in a distribution under Rule 15c2-8. The FAQs clarify that solicitations of indications of interest at various share and price levels would be permissible under Section 105(c) of the JOBS Act and would not violate Rule 15c2-8 so long as purchase commitments were not solicited from the investors.

Quiet Periods. Section 105(c) of the JOBS Act prohibits SROs from restricting the publication or distribution of a research report or restricting a research analyst from making a public appearance related to the securities of an EGC following the EGCs IPO and prior to the expiration date of any lock-up agreement. However, the JOBS Act does not expressly address current SRO rules that impose similar quiet periods (i) following secondary offerings or (ii) after the expiration, waiver or termination of a lock-up. The SEC indicates in the FAQs that it believes the policy underlying the JOBS Act's elimination of the quiet periods mentioned above should apply equally to the quiet periods following secondary offerings and after the expiration, waiver or termination of a lock-up agreement. The FAQs indicate that FINRA is considering filing a proposal to its rules which would eliminate these remaining quiet periods.

Regulation AC and Other Unaffected Rules. The SEC Staff noted in the FAQs that the following provisions governing research analyst and research reports were not modified by the JOBS Act:

- the certification that brokers, dealers and certain associated persons of brokers or dealers are required to make under Regulation Analyst Certification ("Regulation AC") stating that the views expressed in the report accurately reflect his or her personal views remains unchanged;

- an analyst must still disclosure whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views;
- the types of materials that constitute a "research report" for purposes of Regulation AC; and
- current SRO rules, principally NASD Rule 2711 and NYSE Rule 472, regarding:
    - supervision, compensation or evaluation of research analysts;
    - pre-publication review of research reports by non-research personnel or the subject company (including an EGC); or
    - the content, filing and approval of communications, such as "sales literature."

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