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Proposed House Legislation Would Lift General Solicitation Ban in Rule 506 Offerings to Accredited Investors

Congress is considering eliminating the prohibition against general solicitation of investors in Rule 506 securities offerings purchased only by accredited investors. Rep. Kevin McCarthy (R-CA) introduced HR 2940, The Access to Capital for Job Creators Act, on September 15, 2011. Rep. McCarthy cited the prohibition as a significant barrier to small business capital formation, which is a key driver of job creation, at a time when unemployment and job growth are leading issues in the current political environment.

Over the past decade, the Securities and Exchange Commission ("SEC") has reviewed ways to promote capital formation for small businesses. These include providing a new private offering exemption allowing for limited general advertising, which was never approved. If enacted in its current form, HR 2940 would go far beyond those prior proposals. It represents a "sea change" in how an offering can be conducted and remain exempt from registration as a public offering under the Securities Act of 1933 and applicable state securities laws.

Under current law an issuer wishing to conduct a private offering exempt from registration, is limited to approaching potential investors with whom the issuer or its agents have a pre-existing relationship. Except for very narrow circumstances, (e.g., some intrastate offerings) the issuer cannot solicit the general public. The origin of the prohibition on general solicitation is the statutory provision of the Securities Act pursuant to which Rule 506 was promulgated, namely Section 4(2), also known as the "private offering exemption." Interpretations of Section 4(2) and Rule 506 have generally required issuers or their broker/dealers to have a substantive, pre-existing relationship with persons to whom offers are made, whether or not that person actually invests in the offering, thus preserving the private nature of the offering. The facts and circumstances analysis involved in this determination creates significant uncertainty for compliance-minded issuers. Questions such as "what constitutes substantive," "how long is 'pre-existing'" and "who exactly needs to have the relationship," have led to an array of responses from the SEC in the form of no action letters through which issuers, financial intermediaries and their counsel must meander. These letters are not authoritative for issuers or their intermediaries generally. The additional question of whether the sheer number of offerees involved could cause an offering to become public, despite pre-existing relationships, remains

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unanswered. The lack of clear lines in this area, accompanied by the seemingly limitless number of scenarios in the communication age, have led to varying degrees of compliance with the prohibition. Enforcement has been inconsistent and, likely, has resulted in an uneven playing field among sponsors and their financial intermediaries.

Enactment of HR 2940 would lift a significant barrier to capital access for small real estate sponsors and other small businesses, who have tapped out their existing investors, friends and family for funds or do not have access to or traction with financial intermediaries or institutional investors. The tight lending environment exacerbates this barrier where traditional real estate and small business lenders are trying to move credit risk off their balance sheets, not take more on. Businesses should note that enactment of HR 2940 would not modify the various Federal and state laws and rules regulating whether or not a person involved in the offering needs to register as a broker, dealer or agent.

For financial intermediaries (and the businesses that use them), a lift of the ban on general solicitation means they would be able to widely advertise securities offerings, cold call and reach accredited investors to which they would not otherwise have access. It would also alleviate uncertainties for issuers that sell products through registered investment advisors, who the SEC has not expressly blessed as a widely permitted Rule 506 agent.

Whether political support exists to enact HR 2940 is certainly a question. Removing the ban is perceived by some to erode investor protection, with several high-profile frauds and scams involving Rule 506 in recent memory providing support for this position. Indeed, the North American State Securities Administrators has testified that HR 2940 would perpetuate fraudulent issuer activity under Rule 506. Certainly, issuers and financial intermediaries would need to consider “best practices” for contacting investors even if the ban on general solicitation is lifted. But the prospect of lifting the ban for accredited only offerings at least provides a glimmer of hope to a private securities and independent broker dealer industry beleaguered by a slow capital raising environment and heavier regulation over the past few years. HR 2940 is currently under House committee review. Stay tuned.