Financial Services & Products ADVISORY

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SEC Proposes Rule Amendments to Lift Prohibition on General Solicitation and General Advertising in Connection with Private Offerings Made Pursuant to Regulation D

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the "JOBS Act"), which was designed to facilitate the raising of capital by small businesses. Section 201(a) of the JOBS Act called for a significant relaxation of the current restrictions on general solicitation and general advertising (hereinafter referred to together as "general solicitation") in connection with private offerings made pursuant to Rule 506 of Regulation D of the Securities Act of 1933, as amended (the "Securities Act"). Recently, the Securities and Exchange Commission (SEC) proposed amendments to Rule 506 (the "Proposed Amendments") to implement these changes mandated by the JOBS Act.

Currently, issuers of securities (including hedge funds, venture capital funds, private equity funds and privately offered managed futures funds (hereinafter referred to together as "private funds")) are prohibited from making any general solicitation of investors in connection with an offering of their securities unless the securities being offered are registered with the SEC pursuant to the Securities Act. Rule 506 (upon which private funds frequently rely) offers issuers a safe harbor from registration, provided that they do not engage in any type of general solicitation and instead market such offerings only to individuals with whom the issuer has a prior existing relationship.

The JOBS Act and the Proposed Amendments loosen these current restrictions by allowing issuers that rely on Rule 506, including private funds, to publicly advertise the sale of their securities and engage in other forms of general solicitation without needing to register the securities being offered with the SEC.

Rule 506

Under the Proposed Amendments, issuers of securities will be permitted to communicate freely with potential investors to raise capital, including through the use of general solicitation, as set forth in new Rule 506(c). Pursuant to this new rule, general solicitation will be permitted by an issuer provided that (1) the issuer takes ***reasonable steps*** to verify that each purchaser qualifies as an "accredited investor" as defined in Regulation D of the Securities Act and (2) either (A) the purchaser actually qualifies as an accredited investor or (B) the issuer reasonably believes that the investor falls within one of the accredited investor categories at the time of purchase.

In drafting the Proposed Amendments, the SEC declined to specify what steps would be considered reasonable in verifying the accredited investor status of a purchaser. Instead, the SEC said that whether or

not steps taken in verifying accredited investor status were reasonable would be an objective determination made on a case-by-case basis, dependent upon the facts and circumstances of each transaction. The SEC did set forth a brief, non-exclusive set of factors that should be taken into consideration (considering the circumstances), which include:

- the nature of the purchaser and the type of accredited investor the purchaser claims to be;
- the amount and type of information the issuer has regarding the purchaser; and
- the nature of the offering, meaning: (i) the manner in which the purchaser was solicited to participate in the offering and (ii) the terms of the offering, such as minimum investment amount.

The Proposed Amendments note that it would be acceptable for an issuer to use different methods of verification for different types of investors. The SEC has requested comments on this aspect of the Proposed Amendments, specifically inquiring as to whether industry participants felt that further, more specific guidance with respect to what steps would be considered reasonable in verifying accredited investor status was warranted and asking for suggestions as to what verification procedures would be reasonable and practical.

It should be noted that the Proposed Amendments do not change the existing Rule 506, which would be renamed Rule 506(b) under the Proposed Amendments. Issuers wishing to rely on the relief from registration currently provided under Rule 506 may continue to do so without having to comply with the enhanced accredited investor status verification requirements, provided that they do not engage in general solicitation. Such issuers would also still be permitted to raise capital from up to 35 non-accredited investors (provided that any such non-accredited investor meet certain sophistication requirements), whereas issuers relying on new Rule 506(c) would only be permitted to sell to accredited investors.

Form D

The Proposed Amendments also include a change to Form D, the filing required of all issuers selling securities in reliance on Regulation D. The Proposed Amendments would revise the form to add a check box to allow issuers to indicate their reliance on Rule 506(c).

Investment Company Act Exemptions

The Proposed Amendments clarify that private funds currently relying on the exclusions from the definition of "investment company" provided in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), will not lose their ability to rely on these exclusions if they choose to engage in general solicitation under new Rule 506(c), as issuers that do so will not be deemed to be engaging in a public offering for purposes of the Investment Company Act and other federal securities laws.

CFTC Rule 4.7

While provisions of the JOBS Act ensured that private offerings conducted in reliance on Regulation D would be treated consistently under all federal securities laws, the JOBS Act was silent as to consistent treatment of such offerings under the Commodity Futures Trading Commission's (CFTC) regulations. It remains to be seen how the Proposed Amendments will affect advisers to private funds that rely on the exemptions from

registration as commodity pool operators (CPOs) provided by CFTC Regulations 4.7 and 4.13(a)(3), as both exemptions require that such offerings be conducted without marketing to the public in the United States. Although the CFTC has been asked by industry participants to clarify this inconsistency, the CFTC has not yet provided further guidance regarding this matter.

Questions and Answers

What kind of verification process will a private fund have to establish in order to meet the standard under Rule 506(c)?

Under the Proposed Amendments, a private fund would be required to take "reasonable" steps to verify the accredited investor status of each purchaser of its securities. While certain practices commonly engaged in by issuers may suffice under these new requirements, others will not, including in certain circumstances the widely used practice of simply asking investors to check a box confirming their accredited investor status in a subscription agreement or other form. Although the SEC declined to provide specific guidance as to what methods it would deem reasonable in verifying accredited investor status, it did set forth in the Proposed Amendments some examples of what might be considered reasonable. Such examples include the following:

- In the case of a purchaser claiming to be accredited because he or she meets the net worth test (i.e., he or she has a personal net worth of at least $1 million, excluding the value of his or her primary residence), it would most likely be reasonable for an issuer to rely on the fact that the purchaser can meet the minimum investment requirement of an offering (if such minimum is sufficiently high), provided that the issuer confirms that the purchaser will be funding his or her investment directly with cash out of his or her own assets and there are no other factors indicating the investor is not an accredited investor.

- In the case of a purchaser claiming to be accredited because he or she meets the income test (i.e., he or she has earned $200,000 a year for the last two years individually, or $300,000 a year for the last two years combined with his or her spouse, with a reasonable expectation of reaching the same income level in the current year), it would most likely be reasonable for an issuer to rely on W-2s provided by the purchaser or on publicly available information pertaining to the purchaser personally (such as information relating to compensation contained in filings with a federal, state or local regulatory body, including compensation disclosure in a proxy statement) or pertaining to the purchaser's position generally (such as industry or trade publications that disclose average annual compensation for specific levels of employees in a field and specific information about the average compensation earned at the purchaser's workplace by persons at the same level of seniority as the purchaser).

- In the case of a purchaser claiming to be accredited because it is a registered broker-dealer, it would most likely be reasonable for an issuer to verify the status of the purchaser by confirming its registration through FINRA's BrokerCheck site.

- In the case of a purchaser claiming to be accredited because it is a 501(c)(3) organization with assets in excess of $5 million, it would most likely be reasonable for an issuer to verify the assets of the purchaser by relying on information contained in the organization's tax returns.

- In the case of a purchaser that was solicited from a database of pre-screened, accredited investors maintained by a reliable third party, it would most likely be reasonable for an issuer to rely on the steps taken by such third party to verify the purchaser's accredited investor status, provided that the issuer had a reasonable basis for believing that the third-party source was reliable. Conversely, if a purchaser was solicited by means of a publicly accessible website, an issuer would be required to take more stringent steps in verifying the purchaser's status to be considered to have taken reasonable steps. In the case of the latter, relying on the fact that a purchaser may have checked a box stating that it is accredited would not be reasonable absent further proof.

The Proposed Amendments also note that it may be reasonable for an issuer to rely on verification of a purchaser's accredited investor status received from a third party, such as an attorney, accountant or broker-dealer, provided that the issuer has a reasonable basis for believing that the third-party source is reliable.

Whatever method an issuer chooses to use to verify accredited investor status, it is important for the issuer to retain complete records documenting the steps it has taken during the verification process to ensure that it can prove that it is entitled to rely on the exemptions provided by Rule 506(c).

What are permissible forms of general solicitation?

While the SEC did not provide a list of permissible forms of general solicitation, Rule 502(c) of the Securities Act provides the following examples of general solicitation: advertisements published in newspapers and magazines, communications broadcast over television and radio and seminars whose attendees were invited by means of general solicitation. The SEC has also, in the past, confirmed that other uses of publicly available media, such as unrestricted websites, also constitute general solicitation.

For the full text of the Proposed Amendments, please visit http://www.sec.gov/rules/proposed/2012/33-9354.pdf. The comment period for the Proposed Amendments will remain open for 30 days following the publication of the Proposed Amendments in the Federal Register. We intend to update this advisory following the release of the final amendments.

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