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Financial Services & Products ADVISORY ■

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SEC Adopts Final Rules Eliminating Prohibition on General Solicitation and General Advertising; Impact on Private Funds

On July 10, 2013, the Securities and Exchange Commission (SEC) approved final rules to implement changes mandated by the Jumpstart Our Business Startups Act (the "JOBS Act"). In particular, the SEC adopted the following:

- final rules that eliminate the prohibition on general solicitation and advertising (the "Final Rule") for certain offerings made pursuant to Rule 506 of Regulation D and Rule 144A of the Securities Act of 1933, as amended (the "Securities Act");
- final rules that prohibit certain "felons and other 'bad actors'" from participating in securities offerings conducted in reliance upon Rule 506; and
- proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act.

The Final Rule goes into effect on Monday, September 23, 2013.

Elimination of the Prohibition on General Solicitation and Advertising

Rule 506

Prior to the effectiveness of the Final Rule, 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")) continue to be prohibited from engaging in activity that would constitute general solicitation and general advertising ("general solicitation") of investors in connection with offering interests in a private fund. Rule 506 (upon which private funds frequently rely) provides issuers with a safe harbor from registration to offer an unlimited amount of securities, provided that they do not engage in any type of general solicitation and meet certain other conditions of Rule 506.

The Final Rule permits private funds that rely on Rule 506 to publicly advertise the sale of interests in their fund and engage in other forms of general solicitation without registering interests in the private fund.

Verification of Accredited Investor Status

Pursuant to new Rule 506(c), general solicitation will be permitted by a private fund provided that (1) the private fund 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 private fund reasonably believes that the purchaser falls within one of the accredited investor categories at the time of purchase.

The "Facts and Circumstances" Approach

In the Final Rule, the SEC maintains that it may utilize a "facts and circumstances" approach in determining what steps would be considered "reasonable" in verifying the accredited investor status of a purchaser. The SEC has stated that whether or not steps taken for such verification were reasonable would be an objective determination made on a case-by-case basis, dependent upon the facts and circumstances of each transaction. Under this principle-based approach, private funds would consider a number of factors when determining the reasonableness of the steps to verify that a purchaser is an accredited investor, such as:

- the nature of the purchaser, and the accredited investor category being claimed by the purchaser;
- the amount and type of information the private fund 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 information gained by looking at these factors would help a private fund assess the reasonable likelihood that a potential purchaser is an accredited investor. This, in turn, affects the steps that would be reasonable to take to verify a purchaser's accredited investor status. Importantly, the Final Rule notes that it would be acceptable for a private fund to use different methods of verification for different types of investors. For example, the steps that may be reasonable to verify that an entity is an accredited investor by virtue of being a registered broker-dealer, such as by going to the Financial Industry Regulatory Authority's (FINRA) BrokerCheck website, will necessarily differ from the steps that may be reasonable to verify whether a natural person is an accredited investor.

Specific Methods to Verify Accredited Investor Status of Natural Persons

In addition to adopting a principle-based method of verification, the Final Rule includes four specific, non-exclusive methods of verifying the accredited investor status of a *natural person* that, if used, are deemed to satisfy the verification requirement in Rule 506(c).[1] Such procedures include:

- for accredited investors qualifying on the basis of income,[2] the private fund reviews any Internal Revenue Service (IRS) form used to report income (i.e., W-2s, 1099s, Schedule K-1s, 1040s, etc.) for the two most recent years and obtains a written representation that the purchaser has a reasonable expectation of achieving the necessary income level in the current year;

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[1] Provided, however, that none of these methods will be deemed to satisfy the verification requirement if the private fund has knowledge that the purchaser is not an accredited investor.

[2] He or she meets the income test by having 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, and has a reasonable expectation of reaching the same income level in the current year.

- for accredited investors qualifying on the basis of net worth,[3] the private fund obtains a written representation that all liabilities have been disclosed and reviews the following forms (each dated within three months):
  - for assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by third parties; and
  - for liabilities: a consumer report from at least one of the nationwide consumer reporting agencies;
- the private fund obtains a written confirmation from one of the following people that such person has verified, within the past three months, the purchaser's accredited investor status:
  - a registered broker-dealer;
  - an investment adviser registered with the SEC;
  - a licensed attorney (in good standing); or
  - a certified public accountant (duly registered and in good standing); and
- for any natural person who has previously invested with the private fund as an accredited investor, such private fund may rely upon a written certification by the investor that it continues to qualify as an accredited investor with respect to the 506(c) offering.

Private funds are not required to use any of the methods discussed above and may develop their own methods. Whatever method a private fund chooses to use to verify accredited investor status, it is important for the private fund to retain complete records documenting the steps it has taken during the verification process to ensure that it can prove it is entitled to rely on the exemptions provided by Rule 506(c).

Form D

The Final Rule also includes a change to Form D—a filing required for all private funds selling interests in the fund in reliance on Regulation D. The Final Rule revises the form to add a check box, requiring private funds to indicate their reliance on Rule 506(c).

Investment Company Act Exemptions

The Final Rule clarifies that private funds 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), even though such Investment Company Act exclusions state that they are not available to a private fund making a "public offering."

CFTC Rule 4.7 and 4.13(a)(3)

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 Final Rule will affect managers of 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

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[3] He or she meets the net worth test by having a personal net worth of at least $1 million, excluding the value of his or her primary residence.

conducted without "marketing to the public" in the United States. Although the CFTC has not yet provided guidance regarding this matter, industry participants expect the agency to do so in the form of proposed rules later this year. Until the CFTC acts, private funds that trade futures and swaps will not be able to engage in a general solicitation.

Questions and Answers

What are permissible forms of general solicitation?

While the Final Rule does 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. It is expected that these should be permissible forms of general solicitation.

Will private placements under existing Rule 506 be eliminated or altered?

No, the Final Rule does not eliminate or otherwise alter the existing Rule 506, which will be renamed Rule 506(b). Private funds wishing to rely on this relief from registration 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 private funds 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 private funds relying on new Rule 506(c) would only be permitted to sell to accredited investors*.

What if a private fund currently conducts a Rule 506 private placement offering (i.e., no general solicitation) but would like to use general solicitation for that same offering once the Final Rule becomes effective?

The Final Rule provides that for an ongoing offering under Rule 506 (one without general solicitation) that commenced before the effective date of Rule 506(c) (which will permit general solicitation), the private fund may choose to continue the offering after the effective date in accordance with the requirements of either Rule 506(b) or Rule 506(c). If a private fund chooses to engage in general solicitation after the effective date of the Final Rule, any general solicitation that occurs after the effective date will not affect the exempt status of offers and sales of securities that occurred prior to the effective date in reliance on Rule 506(b).

The Final Rule does provide, however, that once a general solicitation has been made to the purchasers in the offering, a private fund is precluded from making a claim of reliance on Rule 506(b), which remains subject to the prohibition against general solicitation, for that same offering.

In verifying accredited investor status, can a manager simply rely upon a "check-the-box" election in an investor's subscription documents?

Under the Final Rule, a private fund is required to take "reasonable" steps to verify the accredited investor status of each purchaser of its securities. While certain practices commonly engaged in by private funds 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. The use of a "check-the-box" election should be viewed in light of the facts and circumstances of the methods being used to verify accredited investor status.

Is there any guidance on the actual content for materials used in general solicitation?

While the Final Rule does not provide any specific guidance relating to the content of advertisements used in general solicitation,[4] the SEC reminds private fund managers that there are considerations to keep in mind in deciding the content. Private fund managers are subject to Rule 206(4)-8 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which provides that it shall constitute a fraudulent, deceptive or manipulative act, practice or course of business under the Advisers Act for any manager to a pooled investment vehicle to "(1) make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

Will private fund managers be required to submit marketing materials to the SEC or any self-regulatory body in connection with a 506(c) offering?

No, the Final Rule does not require that any marketing materials, including written marketing materials, be submitted to the SEC or any self-regulatory body. However, if the proposed amendments to Regulation D, Form D and Securities Act Rule 156 (discussed below) are adopted, private funds would be required to submit to the SEC any written general solicitation materials for Rule 506(c) offerings for two years following the enactment of the rule. Such records would not, however, be made available to the public. In any event, managers should maintain such materials as part of their regular recordkeeping process.

Adoption of "Bad Actor" Rules

Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") required the SEC to adopt rules that would prohibit certain "felons and other 'bad actors,'" including private investment funds and their principals, from participating in securities offerings conducted in reliance upon Rule 506. In response to this directive, in May 2011, the SEC proposed amendments to Rule 501, Rule 506 and Form D, which provided a list of persons potentially disqualified from relying on Rule 506, together with a list of disqualifying events.

On July 10, 2013, the SEC adopted amendments implementing Section 926 ("Bad Actor Rules"), which will become effective on September 23, 2013. The Bad Actor Rules provide for the following:

- The Bad Actor Rules cover the investment manager and investment manager principals for any pooled investment fund issuers.
- Disqualification is triggered by events that occur after the effective date of the Bad Actor Rules. Events occurring prior to the effective date must be disclosed to investors.

A complete list of covered persons and disqualifying events can be found in the SEC's Fact Sheet regarding the Disqualification of Felons and Other "Bad Actors" from Rule 506 offerings.

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[4] See our note on proposed amendments to Regulation D, which, if adopted, would require certain legends and other disclosure in any written general solicitation materials for Rule 506(c) offerings.

What This Means for You

A private fund will no longer be able to rely on Rule 506's safe harbor from registration of securities under the Securities Act if the fund, its predecessors or affiliates, or any of the fund's directors, executive officers, managing members, investment managers, principals, promoters, 20-percent owners or compensated solicitors are subject to any "disqualifying event." If any person covered by the Bad Actor Rules has been subject to a "disqualifying event" at any time prior to the effective date of the Rules, such event must be disclosed in writing to investors. This "bad actor" disclosure must be provided "a reasonable amount of time prior to sale," and given "reasonable prominence" in the information provided to investors.

Proposal of Amendments to Regulation D, Form D and Securities Act Rule 156

Additionally at the open meeting, the SEC released proposed amendments to Regulation D, Form D and Securities Act Rule 156 ("Proposed Rules") that are intended to enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings, now that issuers will be permitted to engage in general solicitation and advertising under Rule 506(c). Specifically, the Proposed Rules would:

- require the filing of a Form D for Rule 506(c) offerings 15 days *prior* to the first use of general solicitation;
- revise Form D to require additional information, including information specific to Rule 506(c) offerings, such as the methods used to verify accredited investor status;
- require the filing of a closing amendment to Form D following the termination of a Rule 506 offering;
- require certain legends and other disclosure in the written general solicitation materials for Rule 506(c) offerings;
- require written general solicitation materials for Rule 506(c) offerings to be submitted to the SEC for two years following the enactment of the Proposed Rules;
- disqualify any issuer from relying on Rule 506 for one year if the issuer, or any predecessor or affiliate of the issuer, did not comply with Form D filing requirements during the past five years; and
- extend the antifraud guidance contained in Securities Act Rule 156 to sales literature for private funds.

Although the SEC voted to publish the Proposed Rules for comment, certain of the Commissioners expressed concern that the expanded Form D requirements would undermine the goal of the JOBS Act and threaten the private securities market. The Commissioners emphasized that there "was a distance to go" from the Proposed Rules to any final rule, and encouraged industry participants to comment on the proposal, especially with respect to burdens the Proposed Rules would impose on smaller issuers. All comments regarding the Proposed Rules must be received on or before Monday, September 23, 2013.

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