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SEC Lifts Ban on General Solicitation by Private Funds

Elimination of the Ban on General Solicitation and General Advertising On July 10, 2013, the Securities and Exchange Commission (the "SEC") adopted an amendment to Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act") to implement section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act").[1] The amendment permits issuers such as hedge funds, UCITS funds, private equity funds, and venture capital funds (collectively, "private funds") to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors, and issuers take reasonable steps to verify that such purchasers are accredited investors. General solicitation or advertising may include, but not be limited to, use of advertisements in newspapers or industry magazines, radio or television, and the issuer's (or private fund sponsor's) website. The amendment also includes a non-exclusive list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons.[2]

Although section 201(a)(1) of the JOBS Act makes no specific reference to private funds, the SEC noted in the Adopting Release that section 201(b) of the JOBS Act provides that offers and sales exempt under Rule 506, as revised pursuant to section 201(a), shall not be deemed public offerings under the federal securities laws as a result of general advertising or general solicitation. As such, the SEC reaffirmed its view that the effect of section 201(b) is to permit private funds to engage in general solicitation in compliance with new Rule 506(c) without losing either the section 3(c)(1) or section 3(c)(7) exclusion under the Investment Company Act of 1940 (the "Investment Company Act"),[3] notwithstanding the fact that private funds are precluded from relying on either of the foregoing two exclusions if they make a public offering of their securities.

Although Rule 506(c) permits private funds to engage in general advertising, investment advisers to such funds should note that they remain subject to Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act"), which prohibits any investment adviser to a pooled investment vehicle (e.g., a private fund) 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. Additionally, investment advisers to private funds must ensure that any advertisements for such funds comply with Rule 206(4)-1 under the Advisers Act, which governs advertisements by investment advisers, and must comply with various no-action and interpretive letters issued by the SEC regarding advertisements.[4]

"Bad Actor" Provisions In a separate release[5], to implement section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the SEC adopted amendments to Rule 506[6] to disqualify issuers and other market participants from relying on Rule 506 if "felons and other 'bad actors'"[7] are participating in the Rule 506 offering. Notwithstanding the foregoing, the SEC has determined not to trigger the foregoing Rule 506 disqualification on the basis of preexisting events. Accordingly, the Rule 506 disqualification will not arise as a result of triggering events that occurred before the effective date of the foregoing disqualification provisions. However, the issuer in question would be required to provide written disclosure of those matters that occurred before the effective date of the new disqualification provisions that would have otherwise triggered disqualification. The foregoing disclosure requirement, as described in new Rule 506(e), will apply to all offerings under Rule 506, regardless of whether purchasers are accredited investors. Issuers will be required to provide such disclosure at "a reasonable time prior to sale." However, Rule 506(e) does provide that the failure to furnish the required disclosure on a timely basis will not prevent an issuer from relying on Rule 506 if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, of the existence of the undisclosed matter or matters.

The above rule amendments are effective 60 days after publication in the Federal Register.

Intersection with the Commodities Exchange Act Many sponsors of private funds that also invest in commodities and futures rely on Rule 4.13(a)(3) under Commodities Exchange Act (the "CEA"), which provides for an exemption from registration for commodity pool operators that use commodity interests on a de *minimis* basis, and Rule 4.7 under the CEA, which provides for certain disclosure

and periodic reporting relief for registered commodity pool operators. The availability of both of the foregoing CEA rules requires that the interests of the private funds in question be offered and sold without marketing to the public. This, in effect, would preclude those private funds from engaging in general solicitation and/or general advertising pursuant to Rule 506(c). As of this time, the Commodities Futures Trading Commission (the "CTFC") has not commented on the applicability of Rule 506(c) with respect to Rule 4.13(a)(3) and Rule 4.7.

Integration with Offshore Offerings Regulation S under the Securities Act exempts offers and sales of securities in certain offshore transactions, but prohibits the issuer from making "directed selling efforts" in the United States. Many private funds concurrently offer securities in the United States in reliance of Regulation D and outside the United States in reliance on Regulation S. Addressing questions regarding the impact of the use of general solicitation pursuant to Rule 506(c) on the availability of Regulation S for concurrent unregistered offerings inside and outside the United States, the SEC stated that concurrent offshore offerings that are conducted in compliance with Regulation S will not be integrated with U.S. unregistered offerings that are conducted in compliance with Rule 506.

New Rule 506(c) Under new Rule 506(c), issuers can offer securities through means of general solicitation, provided that they satisfy all of the following conditions of the exemption:

- All terms and conditions of Rule 501 and Rules 502(a) and 502(d) must be satisfied
- All purchasers of securities must be accredited investors
- The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors

It is important to note that while the SEC adopted new Rule 506(c) to enable issuers to use general solicitation in Rule 506 offerings, it also preserved the existing ability of issuers to conduct Rule 506 offerings subject to the prohibition against general solicitation (which is now reflected under Rule 506(b)).

For an ongoing offering under Rule 506 that commenced before the effective date of Rule 506(c), the issuer 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 an issuer chooses to continue the offering in accordance with the requirements of Rule 506(c), 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).

Principles-Based Method of Verification of Accredited Investor Status

Issuers relying on Rule 506(c) are required to take reasonable steps to verify the accredited investor status of purchasers. Whether the steps taken are "reasonable" will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. Among the factors that issuers should consider under this facts and circumstances analysis are:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be
- The amount and type of information that the issuer has about the purchaser
- The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount

The SEC noted that the above factors are interconnected and are intended to help guide an issuer in assessing the reasonable likelihood that a purchaser is an accredited investor – which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status. For example, if the terms of the offering require a high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor may be sufficiently high such that, absent any facts that indicate the purchaser is not an accredited investor, it may be reasonable for the issuer to take fewer steps to verify or, in certain cases, no additional steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by a third party. Each of the above factors is discussed below.

Nature of the Purchaser In determining the reasonableness of the steps to verify accredited investor status, an issuer should consider the nature of the purchaser of the offered securities. As Rule 501(a) sets forth different categories of accredited investors,[8] an issuer should recognize that the steps that will be considered reasonable to verify whether a purchaser is an accredited investor will vary depending on the type of accredited investor that the purchaser claims to be. 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 FINRA's BrokerCheck website – will necessarily differ from the steps that may be reasonable to verify whether a natural person is an accredited investor. The question of what type of information would be sufficient to constitute reasonable steps to verify accredited investor status under the particular facts and circumstances will also depend on other factors, as described below.

Information about the Purchaser The amount and type of information that an issuer has about a purchaser can also be a significant factor in determining what additional steps would be reasonable to take to verify the purchaser's accredited investor status. The more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it may have to take, and vice versa. Examples of the types of information that issuers could review or rely upon – any of which might, depending on the circumstances, in and of themselves constitute reasonable steps to verify a purchaser's accredited investor status – include, without limitation: Publicly available information in filings with a federal, state or local regulatory body – for example, without limitation: (i) the purchaser is a named executive officer of an Exchange Act registrant, and the registrant's proxy statement discloses the purchaser's compensation; or (ii) the purchaser claims to be an IRC section 501(c)(3) organization with $5 million in assets, and the organization's Form 990 series return filed with the Internal Revenue Service discloses the organization's total assets

- Third-party information that provides reasonably reliable evidence that a person falls within one of the enumerated categories in the accredited investor definition – for example, without limitation: (i) the purchaser is a natural person and provides copies of pay stubs for the two most recent years and the current year; or (ii) specific information about the average compensation earned at the purchaser's workplace by persons at the level of the purchaser's seniority is publicly available, or

- Verification of a person's status as an accredited investor by a third party, such as a placement agent, provided that the issuer has a reasonable basis to rely on such third-party verification[9]

Nature and Terms of the Offering The nature of the offering – such as the means through which the issuer publicly solicits purchasers – may be relevant in determining the reasonableness of the steps taken to verify accredited investor status. For example, an issuer that solicits new investors through a website accessible to the general public, through a widely disseminated email or social media solicitation, or through print media, such as a newspaper, will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by the issuer or a reasonably reliable third party.

In regard to the above, the SEC stated in the Adopting Release that an issuer will be entitled to rely on a third party that has verified a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on such third-party verification. However, the SEC also noted that it does not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box

in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.

The terms of the offering will also affect whether the verification methods used by the issuer are reasonable. The SEC reaffirms its beliefs that there is merit to the view that a purchaser's ability to meet a high minimum investment amount could be a relevant factor to the issuer's evaluation of the types of steps that would be reasonable to take in order to verify that purchaser's status as an accredited investor. By way of example, the ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors could reasonably be expected to meet it, with a direct cash investment that is not financed by the issuer or by any third party, could be taken into consideration in verifying accredited investor status.

Non-Exclusive Methods of Verifying Accredited Investor Status In addition to adopting a principles-based method of verification as discussed above, the SEC included in Rule 506(c) four specific non-exclusive methods of verifying accredited investor status for natural persons that, if used, are deemed to satisfy the verification requirement in Rule 506(c); provided, however, that none of these methods will be deemed to satisfy the verification requirement if the issuer or its agent has knowledge that the purchaser is not an accredited investor.

The SEC also noted that issuers are not required to use any of these four methods and can apply the reasonableness standard directly to the specific facts and circumstances presented by the offering and the investors.

Method to Verify Accredited Investor Status Based on Income In verifying whether a natural person is an accredited investor on the basis of income, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of any Internal Revenue Service ("IRS") form that reports income, including, but not limited to, a Form W-2 ("Wage and Tax Statement"), Form 1099 (report of various types of income), Schedule K-1 of Form 1065 ("Partner's Share of Income, Deductions, Credits, etc."), and a copy of a filed Form 1040 ("U.S. Individual Income Tax Return"), for the two most recent years, along with obtaining a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.

In the case of a person who qualifies as an accredited investor based on joint income with that person's spouse, an issuer would be deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of these forms for the two most recent years in regard to, and obtaining written representations from, both the person and the spouse.

Method to Verify Accredited Investor Status Based on Net Worth In verifying whether a natural person is an accredited investor on the basis of net worth, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing one or more of the following types of documentation discussed below, dated within the prior three months, and by obtaining a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed.

- For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties are deemed to be satisfactory
- For liabilities: a consumer report (also known as a credit report) from at least one of the nationwide consumer reporting agencies is required

In the case of a person who qualifies as an accredited investor based on joint net worth with that person's spouse, an issuer would be deemed to satisfy the verification requirement in Rule 506(c) by reviewing such documentation in regard to, and obtaining representations from, both the person and the spouse.

Method to Verify Accredited Investor Status Based on Third-Party Confirmation An issuer is deemed to satisfy the verification requirement in Rule 506(c) by obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months, and has determined that such purchaser is an accredited investor.[10] While third-party confirmation by one of these parties will be deemed to satisfy the verification requirement in Rule 506(c), depending on the circumstances, an issuer may be entitled to rely on the verification of accredited investor status by a person or entity other than one of these parties, provided that any such third party takes reasonable steps to verify that purchasers are accredited investors and has determined that such purchasers are accredited investors, and the issuer has a reasonable basis to rely on such verification.

Method to Verify Accredited Investor Status Based on Prior Investments With respect to any natural person who invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the issuer, for any Rule 506(c) offering conducted by the same issuer, the issuer is deemed to satisfy the verification requirement in Rule 506(c) with respect to any such person by obtaining a certification from such person at the time of sale that he or she qualifies as an accredited investor.

The SEC noted that it included this fourth method on the basis that existing accredited investors who purchased securities in an issuer's Rule 506(b) offering

prior to the effective date of Rule 506(c) would presumably participate in any subsequent offering by the same issuer conducted pursuant to Rule 506(c) based on their pre-existing relationships with the issuer. However, this fourth method of verification does not extend to existing investors in an issuer who were not accredited investors in a Rule 506(b) offering that was conducted prior to the effective date of Rule 506(c).

Reasonable Belief that All Purchasers Are Accredited Investors In the Adopting Release, the SEC also addressed concerns raised by a number of commenters that the language of section 201(a) of the JOBS Act could be interpreted as precluding the use of the "reasonable belief" standard in the definition of "accredited investor" in Rule 501(a) in determining whether a purchaser is an accredited investor, such that an issuer's determination as to whether a purchaser is an accredited investor is subject to an absolute, rather than a "reasonable belief," standard.

In addressing these concerns, the SEC noted that the definition of "accredited investor" remains unchanged with the enactment of the JOBS Act and includes persons that come within any of the listed categories of accredited investors, as well as persons that the issuer reasonably believes come within any such category. Accordingly, if a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, the SEC believes that the issuer will not lose the ability to rely on Rule 506(c) for that offering, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale.

Form D Check Box for Rule 506(c) Offerings Issuers conducting Rule 506(c) offerings must indicate that they are relying on the Rule 506(c) exemption by marking the new check box in Item 6 of Form D.[11] Further, the current check box for "Rule 506" will be renamed "Rule 506(b)." An issuer will not be permitted to check both boxes at the same time for the same offering. Additionally, once a general solicitation has been made to the purchasers in the offering, an issuer 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.

Proposed Amendments and Timing with Respect to New Form D In addition to adopting rules amending Rule 506 to permit general solicitation and adding rules regarding disqualification of "bad actors" as discussed above, the SEC proposed rules that would amend Regulation D as it relates to Form D.[12] Specifically, the SEC proposed rules:

- Amend Rule 503 of Regulation D to require: (1) the filing of a Form D no later than 15 calendar days in advance of the first use of general solicitation in a Rule 506(c) offering; and (2) the filing of a closing Form D amendment within 30 calendar days after the termination of a Rule 506 offering
- Amend Form D to require additional information primarily in regard to offerings conducted in reliance on Rule 506
- Amend Rule 507 of Regulation D to disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the past five years, with all of the Form D filing requirements in a Rule 506 offering
- The proposed rule amendments also include a cure period for late filings, as well as recourse to the waiver provision of Rule 507, under which disqualification may be waived by the SEC for good cause shown.

Comments on the above proposed rules should be received on or before 60 days after publication in the Federal Register.

What Does All this Mean for Private Funds Private funds that are considering engaging in general solicitation and general advertising pursuant to new Rule 506(c) should proceed with an abundance of caution in light of the fact-specific determination of certain provisions of the Rule. For example, whether a private fund took "reasonable" steps in determining whether a particular investor is an "accredited investor" would be an objective determination by the private fund, based on the particular facts and circumstances of the transaction. Additionally, the provisions of Rule 506(c) may conflict with applicable state "blue sky" laws to which such private funds are subject, as well as certain CEA rules, as discussed above.

Sponsors to private funds seeking to engage in general solicitation and general advertising should reconsider and, if necessary, revise their procedures governing marketing activities and relevant offering documents.

Private funds that have entered into agreements with third-party placement agents and who wish to rely on Rule 506(c) should review their current forms of placement agreements to ensure that the terms of such agreements meet the new verification requirements, and consider whether amendments to existing agreements should be made.

Please contact us before engaging in any general solicitation and general advertising activities.

1. Section 201(a) of the JOBS Act requires the SEC to, among other things, amend Rule 506 to provide that the prohibition against general solicitation or advertising contained in Rule 502(c) of Regulation D shall not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors.

2. *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9415, No. 34-69959; No. IA-3624, File No. S7-07-12 (July 10, 2013) (the "Adopting Release").

3. Private funds generally rely on either the section 3(c)(1) or section 3(c)(7) exclusion from the definition of "investment company" under the Investment Company Act, which enables them to be excluded from substantially all of the regulatory provisions of that Act.

4. *See, e.g., Clover Capital Mgmt., Inc.*, SEC No-Action Letter, 1986 WL 67379 (Oct. 28, 1986).

5. *See Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings*, Release No. 33-9414; File No. S7-21-11 (July 10, 2013).

6. See new Rule 506(d).

7. "Bad actor" disqualification requirements, sometimes called "bad boy" provisions, disqualify securities offerings from reliance on exemptions if the issuer or other "covered persons" (such as underwriters, placement agents and the directors, officers and significant shareholders of the issuer) have been convicted of, or are subject to court or administrative sanctions for, one or more "disqualifying events," which has been interpreted to include the following:

- Criminal convictions (felony or misdemeanor), entered within the past five years in the case of issuers, and 10 years in the case of other covered persons, in connection with the purchase or sale of any security; involving the making of a false filing with the SEC; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities

- Court injunctions and restraining orders, including any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security; involving the making of a false filing with the SEC; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities

- Final orders issued by state banking, credit union, and insurance regulators, federal banking regulators, the Commodity Futures Trading Commission, and the National Credit Union Administration that either create a bar from association with any entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking, or from savings association or credit union activities; or are based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the past 10 years

- SEC disciplinary orders entered pursuant to section 15(b) or 15(B)(c) of the Securities Exchange Act of 1934 or section 203(e) or (f) of the Advisers Act that, at time of the sale, suspend or revoke a person's registration as a broker, dealer, municipal securities dealer or investment adviser; place limitations on the activities, functions or operations of such person; or bar such person from being associated with any entity or from participating in the offering of any penny stock

- Suspension or expulsion from membership in, or suspension or a bar from association with a member of, an SRO, i.e., a registered national securities exchange or a registered national or affiliated securities association;

- Stop orders applicable to a registration statement and orders suspending the Regulation A exemption for an offering statement that an issuer filed or in which the person was named as an underwriter within the past five years, and being the subject at the time of sale of a proceeding to determine whether such a stop or suspension order should be issued

- U.S. Postal Service false representation orders, including temporary or preliminary orders entered within the past five years

Private funds should note that the term "covered person," as defined in Rule 506(d), also includes any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other

officer participating in the offering, general partner or managing member of any such investment manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member. With respect to the foregoing, the SEC specifically used the term "investment manager" rather than "investment adviser." The SEC's reasoning is that under section 202(a)(11) of the Advisers Act, an "investment adviser" is generally a person or firm that, for compensation, is engaged in the business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities. However, some private funds invest in assets other than securities, such as commodities, real estate and certain derivatives. As such, in order to ensure that Rule 506(d) covers the control persons of these funds, the SEC used a more general term in the form of "investment manager," which encompasses both investment advisers and other investment managers.

Rule 506, prior to being amended as described in the Adopting Release, does not impose any bad actor disqualification requirements.

8. The definition of "accredited investor" in Rule 501(a) includes natural persons and entities that come within any of eight enumerated categories in the rule, or that the issuer reasonably believes come within one of those categories, at the time of the sale of securities to that natural person or entity.

9. For example, the SEC noted in the Adopting Release that in the future, services may develop that verify a person's accredited investor status for purposes of new Rule 506(c) and permit issuers to check the accredited investor status of possible investors, particularly for web-based Rule 506 offering portals that include offerings for multiple issuers. This third-party service, as opposed to the issuer itself, could obtain appropriate documentation or could otherwise take reasonable steps to verify accredited investor status.

10. For purposes of this method, a licensed attorney must be in good standing under the laws of the jurisdictions in which the attorney is admitted to practice law, and a certified public accountant must be in good standing under the laws of the place of the accountant's residence or principal office.

11. Form D is the notice of an offering of securities conducted without registration under the Securities Act in reliance on Regulation D. An issuer relying on Regulation D must file a notice of sales on Form D with the SEC for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering.

12. *See Amendments to Regulation D, Form D and Rule 156 under the Securities Act*, Release No. 33-9416; Release No. 34-69960; Release No. IC-30595; File No. S7-06-13 (July 10, 2013).