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New General Solicitation Rules Impact On Private Funds

Beginning September 23, many issuers, including hedge funds, private equity funds and venture capital funds, were permitted to use general advertising and general solicitation in connection with offerings made pursuant to Rule 506 of Regulation D and Rule 144A of the Securities Act of 1933 (the Securities Act). In conjunction with adopting these amendments to Rules 506 and 144A, the Securities and Exchange Commission (SEC) proposed amendments to Regulation D, Form D and Rule 156 of the Securities Act (the Regulation D Proposals). The Regulation D Proposals were designed to address concerns raised in relation to the use of general solicitation. The SEC also adopted rules prohibiting issuers and certain other market participants from relying on the Rule 506 exemption for offerings in which certain felons and other "bad actors" are involved. This white paper focuses on the impact of these developments for private funds. For a general discussion of the final and proposed rules, please see the following Day Pitney client alert: http://www.daypitney.com/news/newsDetail.aspx?pkID=4764.

New Rules Permitting General Solicitation and General Advertising in Private Offerings

I. General Solicitation and Reliance on Rule 506(c)

Most offerings in the United States by private funds are made pursuant to the Rule 506(b) exemption from registration. Issuers relying on this exemption are prohibited from using any form of general solicitation or general advertising to market the fund interests. The recently enacted Rule 506(c) establishes an additional exemption, which differs from Rule 506(b) in that general solicitation and general advertising are permitted, so long as (i) all purchasers are "accredited investors" (up to 35 nonaccredited investors can purchase securities in an offering under Rule 506(b)); and (ii) reasonable steps are taken by issuers to verify that the purchasers are accredited investors. Additionally, issuers are required to check a box on their Form D filing, indicating that they are relying on Rule 506(c) to make general solicitations.

Practical Points:

- Despite the availability of Rule 506(c), some private funds may choose not to engage in general solicitation because of the proprietary nature of their information or because they do not want the distraction that may come from retail investors.
- Although only a small percentage of investment funds include nonaccredited investors, some issuers may wish to sell securities to certain nonaccredited investors.
- Without further revision to the accredited investor definition, "knowledgeable employees" of an adviser who invest in a fund pursuant to 3c-5 of the Investment Company Act of 1940 (the Investment Company Act) may be precluded from participating in an advertised offering if they are not accredited investors. Fund managers must consider the impact of losing their ability to incentivize such employees with fund securities.
- Section 4(a)(2) of the Securities Act may not be used as a safe harbor if the issuer inadvertently fails to comply with Rule 506(c), because Section 4(a)(2) is not available to issuers that engage in general solicitation.
- Issuers must decide in advance whether they are relying on Rule 506(b) or Rule 506(c), as they will not be able to check both boxes on Form D at the same time for the same offering. As a result, private placements cannot be bifurcated.

- It is important to note that investors in a private fund managed by an investment adviser that is registered or required to be registered with the SEC and that charges performance fees must still be "qualified clients" as defined under Rule 205-3 of the Investment Advisers Act of 1940 (the Advisers Act). [1][1]

II. Verification of Accredited Investor Status

In order to rely on Section 506(c), issuers must take reasonable steps to verify that each investor is accredited. The reasonableness of such steps must be determined objectively by the issuer in the context of the particular facts and circumstances. The nature of the purchaser, the type of general solicitation used and the size of the investment are some of the factors the SEC has noted may be relevant in determining the reasonableness of the issuer's verification methods.

The final rules include a nonexclusive list of methods that issuers may use to verify a purchaser's accredited investor status, including the following:

- Verifying accredited investor status on the basis of income through the review of IRS forms along with a written representation from the individual.
- Verifying accredited investor status on the basis of net worth through the review of certain bank, brokerage and other documents along with a written representation from the individual.
- 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.
- Obtaining a certification from the purchaser at the time of sale, for any natural person who invested in an issuer's 506(b) offering as an accredited investor before the effective date of Rule 506(c) and who remains an investor.

The Adopting Release states that self-certification (such as filling out a questionnaire or checking a box on a subscription agreement) without collecting other information regarding the investor is not sufficient to meet the verification requirements. The existence of the verification requirement makes it important for issuers to retain adequate records regarding verification steps.

Practical Points:

- Issuers must determine whether the increased compliance costs due to the verification requirements will be offset by the additional capital obtained from general solicitation.
- Issuers may wish to evaluate the desirability of using independent verification service providers, as they inevitably emerge as a result of these developments.
- Issuers will have to consider whether the verification process could deter potential investors who are concerned about providing sensitive financial documents.
- Funds wishing to rely on Rule 506(c) should have their advisers review their subscription documents (including investor questionnaires) and current procedures regarding investor assessment.
- It is important for issuers to maintain adequate records regarding verification steps. Should it subsequently be determined that a participating investor is not accredited, 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 the purchaser was an accredited investor at the time of sale. The issuer may be able to establish that it had a "reasonable belief" through the production of records.

III. Proposed Amendments to Regulation D, Form D and Rule 156

Proposed Amendments

In conjunction with lifting the general solicitation ban, the SEC proposed rules regarding Regulation D offerings. The Regulation D Proposal would require, among other things (i) an advance Form D filing to be delivered 15 calendar days

before the first use of general advertising, in addition to the required Form D filing after the offering is completed; (ii) additional disclosure on Form D, including types of solicitation and verification methods; (iii) inclusion of certain legends and disclosures in all written general solicitation materials (including that the securities are not subject to the protections of the Investment Company Act); and (iv) the filing of general solicitation material with the SEC for a period of two years after a final rule incorporating these proposed rules becomes effective. Importantly, the proposals also provide for a one-year time-out period from making an offering pursuant to Regulation D, for issuers who fail to comply with the Form D filing requirements, subject to a cure period. This disqualification would be subject to a five-year look-back period that would not extend back beyond the effective date of any final adopting rule. Further, proposed rules would expand Rule 156 to private funds. Rule 156 provides guidance as to the types of information in sales literature that can be deemed fraudulent or misleading.

The SEC also solicited public comments on possible amendments to the definition of "accredited investor." The SEC is required to review the definition in July 2014 pursuant to Section 413(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Further, Section 415 of the Dodd-Frank Act required the Government Accountability Office to perform a study of the definition, which was completed in July 2013. *See* http://gao.gov/assets/660/655963.pdf.

The SEC set a deadline of September 23, 2013, for the receipt of comments regarding these proposed amendments, but in light of the public interest in the proposed amendments, the SEC reopened the comment period until November 4, 2013, to permit interested persons additional time to analyze and comment on the proposed amendments. Although the SEC has noted its interest in imposing rules to enable it to monitor the evolving practice of general solicitation, certain SEC commissioners have expressed concern that the proposed rules are unduly burdensome and undermine the goals of the JOBS Act.

Practical Points:

- The date on which an issuer first uses general solicitation may not be easy to determine. If the Regulation D Proposal is adopted, issuers should start discussing possible use of general solicitation at a very early stage in order to make sure they satisfy the pre-solicitation filing requirements.
- If adopted, the new rules would make it imperative for an issuer to closely monitor the general solicitation activities of its officers and promoters in order to prevent inadvertent general solicitation by careless use of general solicitation, particularly via social media.
- If these rules are adopted as proposed, an issuer that does not file a Form D before engaging in general solicitation in violation of Rule 506(c) may not rely on either Rule 506(b) as a safe harbor or the Section 4(a)(2) statutory exemption, and could potentially be banned from engaging in a Regulation D offering for one year.
- Many issuers may wait until final rules are published before they engage in any general solicitation, in order to fully understand the risks and burdens of these new regulations.

Comments on Proposed Amendments

The SEC has received several hundred comment letters regarding the proposed rules. A small minority have supported the proposed rules, including an accredited investor verification service company and a social media compliance advisory company.

The vast majority of commenters have expressed concern. AngelList, which, among other things, provides a platform to connect accredited investors and startups, stated that the burdens placed on issuers at a stage before they may have legal advice, combined with the severe penalty for noncompliance, "is a death penalty for a not-yet-profitable business." In its comment letter, the Managed Funds Association asserted that the proposals are both unnecessary and duplicative, because private funds are already subject to oversight and because certain information required by the proposals is already available to the SEC. The organization suggested a number of changes to the proposed rules, including the elimination of the advance Form D filing requirement on the grounds that it is overly burdensome; a reconsideration of the requirement to file a closing Form D amendment because it is not workable for hedge funds and other issuers that engage in continuous offerings; the reconsideration of disclosure regarding persons who control the issuer and information regarding investors on the grounds that it is not appropriate for public disclosure; the reconsideration of the one-year disqualification, in light of both the

ambiguity that surrounds what exactly constitutes general solicitation and the adverse impact this penalty could have with respect to existing fund investors; the reconsideration of the expansion of Rule 156 of the Securities Act to private funds; and the reconsideration of the appropriateness for funds managed by SEC-registered investment advisers (those already required to retain written solicitation materials in their books and records that are subject to inspection by the SEC) to submit these materials to the SEC.

IV. Implicit Limitations on Communications Because of Anti-Fraud Rules

Although the SEC declined to provide any explicit form and content restrictions on the types of general solicitation materials used by private funds relying on Rule 506(c), private investment funds and their fund managers will remain subject to the anti-fraud provisions of the various securities laws and, in the case of investment advisers, to the particularly broad provisions set forth in Section 206 of the Advisers Act. Fund advisers should also be aware of FINRA's rules regarding communications, especially if such advisers are registered broker-dealers.

Practical Points:

- Compliance with the anti-fraud provisions of the securities laws may be more or less difficult depending on the form of advertising used.
- Careful consideration must be given to the content of advertisements and other communications to ensure that they will not be deemed fraudulent or misleading, with particular attention paid to any performance claims, including the track records of principals.
- Marketing policies and procedures should be reviewed to appropriately address the risks involved as a firm expands its marketing practices.

V. Restrictions Imposed by Rules Under the Commodity Exchange Act

Certain private funds that invest in commodity interests and rely on the de minimis exemption from registration as commodity pool operators (CPOs) may find that engaging in general solicitation jeopardizes their ability to rely on the relevant exemption, CFTC Rule 4.13(a)(3), because the exemption includes a restriction against "marketing to the public in the United States." Also, private funds that are registered as CPOs but relieved from certain disclosure, reporting and record-keeping requirements otherwise applicable to CPOs, may not qualify for the "registration lite" regime, CFTC Rule 4.7, if they engage in general solicitations. Further, commodity trading advisers (CTAs) who are exempt from registration pursuant to 4(m) of the Commodity Exchange Act may be unable to conduct general solicitation offerings, as the exemption is available only to a person "who does not hold himself out generally to the public as a CTA." Although guidance is expected from the U.S. Commodity Futures Trading Commission, until such guidance is provided, private funds trading in commodity interests and relying on the exemptions discussed above should proceed cautiously.

VI. State Securities Laws

Securities issued in a Rule 506 offering are designated as "covered" securities under the Securities Act, and therefore state registration requirements are preempted by federal law. However, issuers may be subject to notice-filing requirements on such securities exempt from registration. Issuers engaging in general solicitation may have to perform additional review of the state "blue sky" laws in light of these developments and should keep apprised of any actions states might take to control or monitor "general solicitation" within the parameters of the federal law preemption.

VII. Non-U.S. Investment Funds; Securities Laws of Other Countries

In order for a non-U.S. investment adviser making offerings in the United States to rely on the foreign private adviser exemption from registration under the Advisers Act, such adviser must not hold itself out generally to the public in the United States as an investment adviser. Certain types of general solicitation could run contrary to this requirement.

Foreign jurisdictions may have securities laws that impact issuers engaging in general solicitation outside of the United States. Investment funds must be cognizant of the securities laws in other countries, especially where some of their investors and prospective investors are based. Issuers should determine if and to what extent their general solicitation methods may cross or be deemed to cross borders, notably in Europe, where increased marketing restrictions and regulations have recently been imposed by the Alternative Investment Fund Managers Directive.

Practical Points:

- Absent further guidance, non-U.S. fund managers engaging in offerings in the United States should review their marketing strategies if they do not want to risk losing the availability of the foreign private adviser exemption.
- Funds intending to use general solicitation should investigate the securities laws of other jurisdictions in which they intend to conduct their offering.
- Both U.S. and non-U.S. fund advisers should determine whether it may be useful to protect information (for example, on websites) by passwords based on a particular investor's country of residence.

VIII. Investment Company Act

The SEC confirmed in its final general solicitation rules that private funds relying on exclusions from the definition of "investment company" provided in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act may still rely on such exclusions when engaging in general solicitation under Rule 506(c), even though such exclusions prohibit private funds from making "public offerings."

IX. Regulation S

A large number of issuers conduct parallel U.S. and non-U.S. offerings, the latter of which are typically made pursuant to Regulation S, which prohibits "direct selling efforts" in the United States. The SEC has confirmed that concurrent offshore offerings conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings conducted in compliance with Rule 506(c), and therefore an issuer's reliance on Regulation S in such offerings will not be jeopardized.

X. Rule 144A Amendments

The SEC has also amended Rule 144(A)(d)(1) to permit general solicitation in Rule 144A transactions, so long as securities are sold to qualified institutional buyers (QIBs) or persons whom the seller reasonably believes are QIBs. As a result, the current ban on general solicitation no longer exists for Rule 144A transactions.

Bad Actor Rules

As mandated by the Dodd-Frank Act, the SEC has approved "bad actor" rules, which disqualify issuers from making private offerings in reliance on Rule 506 of Regulation D if the fund or any other person covered by the "bad actor" rule (including any of the fund's directors, executive officers, managing members, investment managers, principals, promoters, 20 percent owners or persons compensated for solicitation of investors) had a "disqualifying event." Disqualifying events include, among others, certain criminal convictions, certain court injunctions and restraining orders, and a variety of disciplinary actions and orders. The disqualification is limited to events that occurred after the "bad actor" rule became effective, although pre-existing events are subject to mandatory disclosure to investors in writing. Such disclosure must be provided a reasonable amount of time before the sale of the securities and must be given reasonable prominence in the information provided to investors. An exception allows an issuer to rely on Rule 506 to the extent the issuer had no knowledge of the disqualifying event and through the exercise of reasonable care could not have known of such event. Private fund advisers should adopt appropriate procedures to detect and monitor whether their private funds and/or "covered persons" have engaged in any disqualifying event(s).

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[1] Under Rule 205-3, a "qualified client" is defined as a natural person (1) with at least $1 million in assets under management with the adviser immediately after entering into the advisory contract, or (2) whom the adviser reasonably believes has, before entering into the advisory relationship, a net worth (together with assets held jointly with a spouse) of more than $2 million, excluding the value of the client's primary residence and certain property-related debt.