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SEC Eliminates Advertising and Solicitation Restrictions for Private Funds

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On July 10, 2013, the SEC approved final amendments[1] to Rule 506 of Regulation D under the Securities Act of 1933 (Securities Act) to eliminate the current prohibition against general solicitation and general advertising for certain securities offerings, in accordance with, and as mandated by, the Jumpstart Our Businesses Startups Act (JOBS Act).[2] The amendments were adopted as proposed in August 2012, with only one modification.

As a result of the amendments to Rule 506, private investment funds will, for the first time, be able to engage in general solicitation and advertising, subject to certain specified conditions. Examples of general solicitation and advertising include: advertisements published in newspapers and magazines, communications broadcast over television and radio and provided at seminars whose attendees were invited by means of general solicitation, and information regarding private funds provided on unrestricted websites—all of which are otherwise prohibited for private placements.

The amendments are codified under new Rule 506(c), which becomes effective on September 23, 2013.

Marketing of Private Funds

Most private funds (*i.e.*, hedge funds, private equity funds, venture capital funds, and other private investment funds) offer interests in their funds pursuant to a safe harbor from registration provided by Rule 506 of Regulation D under the Securities Act. Under Rule 506, a private fund may offer and sell its securities, without any limit on the offering amount, to an unlimited number of "accredited investors," as defined in Rule 501(a) of Regulation D.[3]

The availability of the Rule 506 safe harbor has been subject to a number of requirements, including a condition that the private fund, or any person acting on its behalf, not offer or sell the private fund's securities through any form of "general solicitation or general advertising."[4] However, the addition of Rule 506(c) will now allow private funds to benefit from Rule 506's safe harbor while also engaging in general solicitation or general advertising, provided that the following conditions

are satisfied:

- The fund must take "reasonable steps to verify" that the purchasers of its securities are accredited investors;
- Each purchaser of the fund's securities must be an accredited investor (either because the purchaser comes within one of the enumerated categories of persons that are accredited investors or because the issuer had a "reasonable belief" that the purchaser was accredited at the time of the sale of the securities); ***and***
- All terms and conditions of Rule 501 and Rules 502(a) and 502(d) must be satisfied.[5]

As a result of the amendments, private funds can choose to engage in general solicitation or advertising in compliance with Rule 506(c) or refrain from doing so under Rule 506(b). If a private fund chooses to refrain from general solicitation or advertising, the private fund need not comply with the enhanced "accredited investor" verification requirements applicable to new Rule 506(c) offerings. Nonetheless, once a private fund makes a general solicitation in connection with an offering, the private fund will be precluded from relying on Rule 506(b) as to that offering and will be required to comply fully with the Rule 506(c) requirements until the offering is completed.

Private Funds Must Take "Reasonable Steps to Verify"

The most burdensome aspect of Rule 506(c) is the requirement that issuers, including private funds, that engage in general solicitation or general advertising must take "reasonable steps to verify" that the purchasers of their interests are in fact accredited investors. The SEC explicitly stated in its adopting release that issuers cannot satisfy the "reasonable steps" requirement by merely requiring potential investors to check a box in a questionnaire or sign a form. *In practice, this means that a private fund choosing to engage in general solicitation or advertising will generally not be able to rely solely on a person's completed subscription agreement as a basis for admitting the person as an investor in the fund*. Private funds relying on Rule 506(c) must insist that a prospective investor provide additional supporting information as to its accredited investor status.

In adopting Rule 506(c), the SEC confirmed that what is "reasonable" in terms of the steps an issuer takes to verify a person's accredited status is based on the particular facts and circumstances of each transaction. The factors to be considered under this "principles-based approach" include:

- 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; ***and***
- the nature of the offering, such as the manner in which the purchaser was solicited to participate.[6]

In an attempt to provide issuers with additional guidance on the verification requirement, the final amendments to Rule 506 include a non-exclusive, non-mandatory list of means by which issuers may verify the accredited investor status of natural persons.[7] As such, use of any one of the

verification methods listed below will ensure the issuer has met the "reasonable steps to verify" requirement for a natural person purchaser, provided that the issuer does not have actual knowledge that the purchaser is in fact not an accredited investor:

- when verifying an investor's status on the basis of income, reviewing copies of any Internal Revenue Service (IRS) form that reports income for the two most recent years. This includes, but is not limited to, a Form W-2, Form 1099, Schedule K-1 of Form 1065, and a copy of a filed Form 1040. The issuer must also obtain written representation from the investor that the investor reasonably expects to maintain the income level necessary to qualify as an accredited investor in the current year;
- when verifying an investor's status on the basis of net worth, reviewing one or more copies of the following documentation, dated within three (3) months, and obtaining a written representation from the investor 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 deposits, and tax assessments and appraisal reports issued by independent third parties; and for liabilities, a credit report from at least one of the nationwide consumer reporting agencies;
- obtaining written confirmation from a third-party, such as a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant, that said third-party has taken reasonable steps to verify that the purchaser is an accredited investor and has determined that the purchaser is in fact an accredited investor; ***or***
- with regard to any prior purchaser of an issuer's securities in a Rule 506(b) offering where the purchaser still holds the issuer's securities, obtaining a certificate from the purchaser stating that at the time of the new Rule 506(c) sale that he or she qualifies as an accredited investor.

The SEC initially declined to provide such a list in its August 2012 proposal based on concerns that it would prove impractical and burdensome, and would ultimately limit the flexibility by which issuers could devise reasonable methods to verify a purchaser's status as an accredited investor. However, the SEC ultimately chose to include the non-exclusive list in response to a host of commenters who requested greater specificity on Rule 506(c)'s verification requirement.

Advisers to private funds engaging in general solicitation or advertising in compliance with Rule 506(c) should amend their subscription documents and subscription procedures to include requests for at least one of the documents listed above from prospective investors as part of the subscription process. Alternatively, private funds may use different means to verify a person's accredited status; however, in doing so, the private fund would not benefit from the presumption afforded by using one of the above methods.

Given the multitude of types of accredited investors, it is likely that private funds will use different methods of verification for different types of investors—particularly, private fund managers may develop different verification methods applicable to entities versus natural persons. The SEC has not provided a list of verification methods applicable to entities.

How are Existing Private Fund Investors Treated if the Fund Makes a Subsequent Rule 506(c) Offering?

In the event a private fund decides to undertake a new offering of its securities under new Rule 506(c), existing accredited and non-accredited investors that purchased private fund securities under Rule 506(b) may remain investors in the private fund without the need for any additional verification (enhanced or otherwise) of status. Further, existing accredited investors that participated in the prior Rule 506(b) offering can also participate in the new Rule 506(c) offering simply by reaffirming their accredited investor status through self-verification—the private fund is not required to comply with the enhanced verification standards applicable to new investors in the Rule 506(c) offering.

On the other hand, while non-accredited investors may remain in the Private Fund, they would not be able to participate in a new Rule 506(c) offering, absent a change in their accredited investor status and compliance with the enhanced verification requirements.

Amendment to Form D

In connection with the Rule 506 amendments, the SEC also adopted amendments to Form D to add a separate check box in Item 6 for issuers to indicate whether they are claiming an exemption under Rule 506(c). In a separate release, the SEC proposed additional amendments to the form, which are discussed below.

Preservation of Records

Any issuer relying on an exemption from the registration requirements of the federal securities laws (such as Rule 506) has the burden of demonstrating that it was entitled to rely on such exemption. Accordingly, private funds engaging in general solicitation or advertising under Rule 506(c) must retain adequate records that document the steps taken to verify an investor's accredited status, regardless of what factors are considered in the fund's diligence process.

Knowledgeable Employees

Private funds that rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act are currently permitted to sell interests to their "knowledgeable employees" without counting such employees toward the 100-investor restriction or "qualified purchaser" requirements of Sections 3(c)(1) or 3(c)(7), respectively. However, the definition of "accredited investor" does not include "knowledgeable employees" that are not otherwise accredited. Accordingly, private funds relying on the new Rule 506(c) will only be permitted to sell interests in their funds to "knowledgeable employees" who are also "accredited investors." Stated differently, private funds that will permit non-accredited "knowledgeable employees" to invest will not be able to rely on new Rule 506(c).[8] As is currently the case, under Rule 506(b), up to 35 non-accredited investors (including non-accredited

"knowledgeable employees") may invest subject to increased informational requirements.

Considerations for Funds that Rely on CFTC Registration Exemptions

Absent additional guidance from the Commodity Futures Trading Commission (CFTC), it appears that advisers or sponsors of private funds that rely on exemptions from commodity pool operator (CPO) registration under Rules 4.7(b) and/or 4.13(a)(3) of the CFTC will continue to be prohibited from engaging in general solicitation or general advertising on behalf of such funds. This is because the amendments to Rule 506 were explicitly not extended to Section 4(a)(2) of the Securities Act and because Section 201(b)(2) of the JOBS Act only provides that offerings entailing general solicitation or advertising "shall not be deemed public offerings under the Federal securities laws" (*i.e.*, without reference to the Federal commodities laws). It is possible that the CFTC will issue interpretive guidance or rule amendments to address this inconsistency, which has been brought to the attention of the CFTC by various industry participants. Until such guidance is issued, advisers to private funds will need to consider whether each fund is relying on a CFTC exemption before engaging in general solicitation or general advertising.

Proposed Amendments to Form D

In connection with the Rule 506 amendments, the SEC also proposed amendments to Form D, which, according to the SEC, will better enable the agency to monitor and understand the impact of the new general solicitation and general advertising rules on the private placement market.[9] According to Commissioner Elisse B. Walter, the final amendments to Rule 506 and proposed amendments to Form D should be viewed as a "package" deal.[10] The SEC proposed the following amendments to Form D:

- *The advance filing of Form D for Rule 506(c) offerings, no later than fifteen (15) days prior to commencing general solicitation of the offering*. The issuer would be required to file an advance Form D that provides the information required by Items 1, 2, 3, 4, 6, 7, 9, 10, 12, and 16. The issuer would later be required to file an amendment providing the remaining information required by Form D as currently required by Rule 503.
- *The filing of a final amendment to Form D for all Rule 506 offerings, within thirty (30) calendar days after termination of the offering*. Currently, issuers are only required to file a closing amendment no later than thirty (30) days "after the last sale of securities" in the offering.
- *Expanded information requirements in Form D for all Rule 506 offerings*. Examples of additional information that would be required are the inclusion of the issuer's Internet address, if applicable, and the disclosure of the name and address of any person who directly or indirectly controls the issuer. For Rule 506(c) offerings, this would also include information on the types of general solicitation or general advertising used and the methods used to verify a purchaser's accredited investor status.
- *A disqualification of any issuer from using Rule 506 for future offerings until one (1) year has elapsed after the required Form D filings are made if they, or their predecessors or*

affiliates, failed to comply, within the past five (5) years, with the Form D filing requirements for a Rule 506 offering. The SEC asserts that this amendment is necessary to incentivize issuers to comply with the filing requirements. The proposal does, however, provide that Form D will be deemed timely filed if submitted within 30 calendar days after the required due date. The cure-period provision is intended to allow an additional period of time for an issuer to detect filing errors or shortcomings and make any required amendments.

Proposed Rules Relating to Content of General Solicitation or General Advertising Materials

In connection with the adoption of Rule 506(c), the SEC also proposed new Rules 509 and 510T and amendments to Rule 156.[11] The proposals are aimed at addressing the content of general solicitation or general advertising materials.

Proposed Rule 509 would require all issuers to include: (i) legends in any written general solicitation or general advertising materials used in a Rule 506(c) offering; and (ii) additional disclosures for private funds if such materials include performance data.

Proposed Rule 510T would require issuers, for the two-year period following the enactment of the rule, to submit to the SEC any written general solicitation materials used in Rule 506(c) offerings. Issuers would be required to submit the materials no later than the date of their first use, and the materials would not be publicly available. If adopted, proposed Rule 510T would impose a novel burden on private fund advisers whose marketing materials, unlike those of broker-dealers, are not required to be submitted to any authority.

The proposed amendments to Rule 156 under the Securities Act would extend the guidance contained in the rule, which currently only applies to registered investment companies, to the sales literature of private funds.

As adopted, Rule 506(c) does not provide any guidance on the content of marketing materials used in connection with general solicitation and general advertising activities. Nonetheless, the use of such materials by private fund advisers will be subject to the general antifraud provisions of the federal securities laws and, specifically, Rule 206(4)-8 under the Investment Advisers Act of 1940 (Advisers Act). Rule 206(4)-8(a) makes it a fraudulent, deceptive or manipulative act, practice or course of business under the Advisers Act for any adviser 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.”

The SEC requested comments on proposed Rules 509 and 510T and on the proposed amendments to Rule 156. Among other things, the SEC requested comments on whether all issuers should be required to include the proposed legends in written general solicitation materials, whether the legends should require specific wording, and whether the legends would be helpful in mitigating concerns regarding fraudulent statements in written general solicitation materials. Comments must be received by September 23, 2013.

[1] The text of the final amendments is available at http://www.sec.gov/rules/final/2013/33-9415.pdf. On July 10, 2013, the SEC also adopted: (1) an amendment to Rule 506 of Regulation D that bans convicted felons and other "bad actors" from reliance on the safe-harbor provision of Rule 506 in securities offerings; and (2) final amendments to Rule 144A,which allows securities sold under the exemption to be offered to persons other than qualified institutional buyers ("QIBs"), including by means of general solicitation and general advertising, as long as securities are sold only to QIBs or to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. For a more detailed discussion of these amendments, please see http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=10737421791.

[2] The text of the JOBS Act is available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf. In particular, Section 201(a)(1) of the JOBS Act directed the SEC to revise its rules promulgated under Regulation D of the Securities Act to: (i) permit general solicitation and general advertising in an unregistered securities offering if all purchasers of securities sold in the offering are accredited investors, and (ii) require the issuer in such an offering to take reasonable steps to verify a purchaser's status as an "accredited investor," using methods to be determined by the SEC.

[3] Rule 506 also allows an issuer to offer and sell its securities to up to 35 non-accredited investors subject to certain other sophistication criteria and substantially higher informational requirements as set forth in Rule 502(b). As described herein, new Rule 506(c) requires that all purchasers of the issuer's securities be accredited investors. Accordingly, any issuer that offers and sells its securities to non-accredited investors will continue to be subject to the prohibition in Rule 502(c) on the use of general solicitation or general advertising.

[4] Private funds have also typically relied on one of two exclusions from the definition of "investment company" under the Investment Company Act of 1940: Section 3(c)(1), which applies to privately offered funds whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 beneficial owners, and Section 3(c)(7), which applies to privately offered funds whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," as defined in the Investment Company Act of 1940 and the rules thereunder. The SEC previously stated that a privately offered fund may make a general solicitation under then-proposed Rule 506(c), but a private fund making such a general solicitation would still need to comply with the restrictions on the number or types of investors under Section 3(c)(1) or Section 3(c)(7), as applicable.

[5] These terms and conditions are not changed by Rule 506(c). Rule 501 includes the definition of "accredited investor" and certain other definitions. Rule 502(a) establishes rules relating to the integration of offerings and Rule 502(d) establishes rules relating to resale restrictions on securities acquired in a Regulation D offering.

[6] For a more detailed discussion of the principles-based approach, please see http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=110251.

[7] The SEC limited the application of the non-exclusive list to natural persons because it believes there is the greatest potential for participation by non-accredited investors in offerings involving natural persons as purchasers. The non-exclusive list is to be used in conjunction with the principles-based framework for establishing reasonableness.

[8] See “How are Existing Private Fund Investors Treated if the Fund Makes a Subsequent Rule 506(c) Offering?”.

[9] The text of the proposed amendments is available at http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

[10] In her opening remarks at the SEC’s July 10, 2013 meeting, Commissioner Elisse B. Walter noted that the “bad actor” ban, as well as the proposed changes to Form D, are necessary to protect investors from the risks of lifting the ban on general solicitation and general advertising.

[11] The text of the proposed amendments is available at http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

Authors

Timothy F. Silva

PARTNER

Chair, Investment Management Practice

timothy.silva@wilmerhale.com

+1 617 526 6502