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SEC Proposes Rules to Eliminate the Prohibition Against General Solicitation and Advertising for Hedge Funds and Other Private Funds

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On August 29, 2012, the SEC proposed amendments[1] to Rule 506 of Regulation D under the Securities Act of 1933, as amended (the 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 (the JOBS Act).[2] Section 201(a)(1) of the JOBS Act directed the SEC to revise 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]

Marketing of Private Funds

Most private funds (*i.e.*, hedge funds, private equity funds, venture capital funds, and other private investment funds) rely on the safe harbor provided by Rule 506 of Regulation D under the Securities Act to ensure that the offering of securities of the private fund are not subject to registration. Under Rule 506, an issuer 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.[4] The availability of the Rule 506 safe harbor is subject to a number of requirements, including a condition that the issuer, or any person acting on its behalf, not offer or sell securities through any form of "general solicitation or general advertising."[5]

As a result of the ban on general solicitation and general advertising, private funds have been subject to significant restrictions on communications with the public. For example, private funds typically have been advised not to establish websites (unless password protected), make public statements that reference the name of the fund (other than in regulatory filings), make presentations about the fund to an unscreened or large audience at a conference or industry event, give interviews to the financial press, etc. In addition, advisers and sponsors of private funds have established protocols to limit their marketing activities to people and institutions with whom the managers or sponsors have established pre-existing substantive relationships.[6]

If adopted, the proposed amendments to Rule 506(c) would eliminate the need for any private fund that complies with the Rule 506 safe harbor to restrict its marketing activities in this manner if the private fund satisfies certain new conditions. Specifically, new Rule 506(c) would permit general solicitation and general advertising by a private fund in connection with a Regulation D offering if the following conditions are met:

- 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.[7]

Funds Must Take "Reasonable Steps to Verify"

The most burdensome aspect of the proposed amendments 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 its interests are in fact accredited investors. In its proposing release, the SEC stated that what steps are "reasonable" would depend on the particular facts and circumstances of each transaction, taking into account the following factors:

The nature of the purchasers and the type of accredited investor that the purchaser claims to be. The steps necessary to verify a purchaser's accredited status will vary depending on the type of accredited investor that the purchaser claims to be. For example, the SEC noted that steps that may be reasonable to verify that an entity is accredited—such as, in the case of a broker-dealer purchaser, reviewing FINRA's BrokerCheck website—would necessarily be different from the steps that would be reasonable to verify whether a natural person is an accredited investor.[8]

The amount and type of information that the issuer has about the purchaser. The more information an issuer has about a purchaser's accredited status, the fewer steps the issuer would have to take to verify that status, and *vice versa*. Importantly, if an issuer has actual knowledge that a purchaser is an accredited investor, then the issuer would not have to take any steps at all to verify such purchaser's status.

The proposing release gives several examples of information on which issuers could rely:

- Publicly available information in filings with a federal, state or local regulatory body. For example:

  --If a purchaser is a named executive officer of an SEC registrant, the issuer could review the registrant's proxy statement to obtain the purchaser's annual compensation.
  --If a purchaser claims to be an eligible 501(c)(3) entity, the issuer could review the purchaser's tax returns to verify its total assets.

- Third-party information that provides "reasonably reliable evidence that a person" meets the Rule 501(a) accredited investor criteria. For example:

  --If a purchaser is a natural person, the issuer could review any Forms W-2 provided by the purchaser.
  --If a purchaser works in a field where trade publications disclose average annual compensation of employees, the issuer could review specific information regarding employees at the purchaser's level of seniority.

- Verification of accredited investor status by a third party, such as broker-dealer, attorney or accountant, if the issuer has a reasonable basis to rely upon such third-party verification.

The nature of the offering, such as the manner in which the purchaser was solicited to participate. A fund that solicits investors through a generally accessible public website or "through a widely disseminated email or social media" platform would need to take more stringent measures to verify an investor's accredited status than an issuer that solicits prospective investors from a database of pre-screened investors that is assembled by a reliable third party, such as a registered broker-dealer. The SEC was careful to note that an issuer who solicited investors through a public website or through a widely disseminated electronic communication could not satisfy the "reasonable steps to verify" requirement by merely requiring an investor to check a box in a questionnaire or sign a form.[9] However, the SEC also "anticipate[s] that many practices currently used by issuers in connection with Rule 506 offerings would satisfy the verification requirement proposed for offerings pursuant to Rule 506(c)."

The SEC noted that a purchaser's ability to meet a high minimum investment amount might also play a significant factor. The SEC stated that in a case where the minimum investment was "sufficiently high" it may be reasonable for the issuer to take no steps to verify a purchaser's accredited investor status (other than to confirm that the purchaser's cash investment is not being financed by the issuer or a third party)[10] absent any other facts that cast doubt on whether the purchaser is actually an accredited investor.

Given the weight placed by the SEC on the manner of offering, solicitation, and minimum investment amount, it is possible that the burden for verification for a Section 3(c)(7) fund, which typically does not accept small investments, could be lower than that applicable to a Section 3(c)(1) fund.

Preservation of Records

The SEC noted that 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. Therefore, if the amendments are adopted as proposed, private funds engaging in general solicitation or advertising 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.

Amendment to Form D

The SEC also proposed a revision to Form D to add a separate field or check box for issuers to indicate whether they are claiming an exemption under Rule 506(c) and, therefore, whether the private fund or other issuer filing the Form D proposes to engage in general solicitation or general advertising in connection with the unregistered offering.

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. In practice, this means that private funds can sell interests to knowledgeable employees regardless of whether such employees are "accredited investors." Under proposed Rule 506(c), however, private funds that engage in a general solicitation in an offering will only be permitted to sell interests in their funds to "knowledgeable employees" who are also "accredited investors." The SEC specifically declined to revise Rule 501(a) to include "knowledgeable employees" in the definition of "accredited investor," although some commentators had proposed that it do so.

Considerations for Funds that Rely on CFTC Registration Exemptions

Another open issue is whether advisers or sponsors of private funds that rely upon exemptions from commodity pool operator (CPO) registration under Rules 4.7(b) and 4.13(a)(3) of the Commodity Futures Trading Commission (CFTC) will be eligible to engage in general advertising or solicitation if the amendments to Rule 506 are adopted.[11] CFTC Rule 4.7(b) provides an exemption from certain requirements for CPOs (and commodity trading advisors) with respect to offerings to "qualified eligible persons" as defined under CFTC Rule 4.7(a)(3), and CFTC Rule 4.13(a)(3) requires, in part, that interests in funds be "offered and sold without marketing to the public in the United States." In the adopting release for Rule 4.7, the CFTC noted that in order to qualify for the exemption under Rule 4.7, the offering of the interests of the commodity pool would have to be done "in a manner consistent with the initial marketing limitations applicable to a private offering under [Section 4(a)(2)] of the Securities Act."[12] 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 appears that advisers or sponsors of private funds relying on the exemptions under Rules 4.7(b) and/or 4.13(a)(3) will continue to be prohibited from engaging in general advertising or general solicitation on behalf of such funds without additional rulemaking or guidance from the CFTC.

Request for Comments

Among other things, the SEC requested comments on what constitutes "reasonable steps to verify" in light of current practices by private funds and other issuers, what kind of information is reasonable to request from investors, and whether the SEC should articulate more specific guidelines, such as a minimum dollar investment that would establish a presumption that an investor is accredited. Comments are due within 30 days after the proposal is published in the

Federal Register, which effectively means that comments will be due the first week of October.

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[1] The text of the proposing release is available at http://sec.gov/rules/proposed/2012/33-9354.pdf.

[2] The text of the JOBS Act is available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

[3] In addition, Section 201(a)(2) of the JOBS Act directed the SEC to revise Rule 144A to allow 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 persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

[4] Rule 506 also allows the 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, the proposed amendments to Rule 506(c) would require 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.

[5] Private funds also typically rely 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 confirmed in the release that a privately offered fund may make a general solicitation under proposed Rule 506(c), but a private fund making such a general solicitation would still need to comply with the restrictions on the number and types of investors under Section 3(c)(1) or Section 3(c)(7), as applicable.

[6] The SEC staff has indicated that an issuer would not contravene the prohibition against general solicitation if the issuer has a pre-existing substantive relationship with an offeree. The SEC staff has also issued guidance on the use of intermediaries to establish pre-existing substantive relationships, as well as the use of the Internet in Regulation D offerings. Use of procedures by private funds relying on this guidance has become commonly accepted practice. *See, e.g.*, IPONET (July 26, 1996); Lamp Technologies, Inc. (May 29, 1998).

[7] These terms and conditions would not be changed by the proposed amendments. 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.

[8] The SEC did, however, acknowledge the practical difficulties associated with verifying that a natural person meets the annual income or net worth thresholds prescribed by Rule 501(a) and in doing so, suggested that issuers examine the facts and circumstances of each natural person by analyzing the other factors described below.

[9] This point could have implications for private funds that wish to engage in general solicitations but currently conduct investor eligibility status only through the use of a questionnaire in a subscription agreement.

[10] It is unclear how a fund would confirm whether or not a purchaser financed the purchase of interests, as the SEC did not provide any guidance on this point.

[11] The same analysis applies to managers or sponsors of private funds relying on CFTC Rule 4.13(a)(4), which has been rescinded and will no longer be available after December 31, 2012.

[12] *See 57 FR 34853* (Aug. 7, 1992).

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