SEC Proposes Rules to Eliminate the Prohibition Against General Solicitation and Advertising in Certain Private Securities Offerings – Private Investment Funds Perspective

August 31, 2012

On April 5, 2012, the U.S. Congress enacted The Jumpstart Our Business Startups Act (the "JOBS Act"), a package of capital access reforms intended, among other things, to facilitate the ability of companies to raise capital in private offerings without registration with the Securities and Exchange Commission (the "SEC"). The JOBS Act directed the SEC to amend its rules to permit general solicitation or general advertising in connection with private offerings of securities under Rule 506 of Regulation D ("Rule 506")[1] under the Securities Act of 1933 (the "Securities Act") provided that that all purchasers of the securities are accredited investors (because either they fall within one of the categories of persons who are accredited investors or the issuer reasonably believes that they meet one of the categories at the time of sale) and the issuer had taken reasonable steps to verify that all purchasers of the securities are accredited investors.[2]

On August 29, 2012, the SEC proposed rules (the "Proposed Rules") to implement these provisions of the JOBS Act.[3] The SEC seeks public comments on the Proposed Rules for 30 days following the date of their publication in the Federal Register. Following the review of comments by the SEC, the final rules will be issued. Since private investment funds typically rely on Rule 506 in connection with their fundraisings in the United States, we anticipate that the final rules, assuming that they are substantially similar to the Proposed Rules, will allow for greater flexibility in the United States fundraising process by relaxing existing regulatory requirements on publicity. This memorandum focuses on the aspects of the proposed changes to Rule 506 that are relevant for private investment funds.

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1 Rule 506 permits private placements of securities without a dollar ceiling as long as the conditions of the safe harbor are met. One of the current conditions is that there can be no general solicitation or general advertising in connection with the offering (the "Existing Safe Harbor"). Examples of general solicitation or general advertising include newspaper/magazine ads, television/radio broadcasts, seminars whose invitees are invited by general solicitation and publicly available websites.

2 Under the Proposed Rules, if an offering uses general solicitation or general advertising, the securities offered will not be able to be purchased by up to 35 non-accredited investors as is allowed under the Existing Safe Harbor.

3 For the full text of the release proposing the rules please see: http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

THE PROPOSED RULES

Under the Proposed Rules, a private investment fund will have the ability to use general solicitations and general advertising to offer its securities.[4] However, in order to take advantage of this ability it will be required to meet a higher threshold of verification regarding the accredited investor status of each of its investors by taking "reasonable steps to verify that purchasers of its securities are accredited investors." While the SEC considered whether to require issuers to use specified methods of verification, it expressly decided against doing so. Instead, the SEC opted for an approach that gives issuers and market participants flexibility and stated that whether the steps taken by an issuer are "reasonable" would be a determination based on the particular facts and circumstances of each offering and each purchaser. The SEC indicated that issuers would be able to consider a number of factors when determining the reasonableness of the steps to verify that a purchaser is an accredited investor. Some examples of these factors include: (1) the nature of the purchaser and the type of accredited investor that the purchaser claims to be; (2) the amount and type of information that the issuer has about the purchaser; and (3) 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. Possible verification techniques include checking third party databases and publicly available documentation, receipt of letters from accountants or broker dealers and review of W-2 or other tax forms. Issuers that use a third-party verification method such as a database of pre-screened accredited investors created by a reliable third party (e.g., a registered broker-dealer) may reasonably rely on such third-party verification.

As an example of the application of these factors, the SEC stated that if an issuer solicits new investors through a website accessible to the general public or through a widely disseminated email or "social media" solicitation, the SEC does not believe that an issuer would have taken reasonable steps to verify accredited investor status if the issuer 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. By the same token, the SEC acknowledged that if the terms of the offering require a high minimum investment amount, then it may be reasonable for the issuer to take no steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by the issuer or by a third party, absent any facts to the contrary. The SEC also stated that it would be important for an issuer to retain adequate records that document the steps taken to verify that all of its purchasers were accredited investors.

Importantly, the Proposed Rules make clear that the verification obligation does not override the "reasonable belief" standard contained in the Rule 501 definition of an accredited investor. If an issuer takes reasonable steps to verify that a purchaser is accredited, and therefore reasonably believes the purchaser is accredited, the exemption will not be lost because the purchaser is not in fact accredited.

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[4] A fund relying on the Proposed Rules will not be required to establish a "pre-existing relationship" with investors as may be required in some circumstances under the Existing Safe Harbor.

An issuer must notify the SEC that it is taking advantage of the ability to use general solicitations and general advertising by noting that it is doing so in its Form D filing by way of checking a new separate box that will be added to Form D.[5]

NO CHANGES TO THE EXISTING SAFE HARBOR

The Proposed Rules are almost as important for what they do not change as for what they do change. Notably, the existing safe harbor for offerings not using any general solicitation or general advertising is unchanged and remains available as is without the need to comply with the new verification requirement. In addition, at this time the SEC is not imposing any format or content limitations on general solicitations or general advertising. Finally, the SEC did not propose any change in the definition of an "accredited investor" that is eligible to invest in offerings that use general solicitation or general advertising.[6]

INTERACTION WITH OTHER REGULATORY FRAMEWORKS

In order not to be required to register as an "investment company" under the Investment Company Act of 1940 ("1940 Act"), private investment funds generally rely on one of the exclusions from the definition of investment company provided by the 1940 Act, typically Section 3(c)(1) ("100 holders" exclusion) or Section 3(c)(7) ("qualified purchaser" exclusion). While under the 1940 Act these exclusions cannot be relied upon if a private investment company makes a public offering of its securities, the SEC confirmed that private investment funds will be able to use general solicitations and general advertisements in accordance with the Proposed Rules without losing either of the private fund exclusions under the 1940 Act. The SEC also confirmed prior advice that an offering in the United States under amended Rule 506 employing general solicitation or general advertising does not impact the ability of an issuer to conduct a concurrent offshore offering under Regulation S under the Securities Act.

Following recent changes in regulation of commodities pool operators and commodity trading advisors as a result of the Dodd-Frank Act, many private investment funds intend to rely on Rule

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[5] To the extent that an issuer which has already filed its Form D wishes to take advantage of this ability, an amendment to Form D may be required.

[6] Section 413 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") requires the SEC to conduct a comprehensive study of whether the definition of an accredited investor should be "adjusted or modified for the protection of investors, in the public interest, and in light of the economy" four years after enactment (i.e., by December 2014). The Comptroller General is charged with conducting a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds and report to Congress by December 2013. These mandates, coupled with concerns expressed by some SEC Commissioners, industry watchdogs and numerous states securities commissions and ongoing investor losses in fraudulent offerings, may result in changes to the definition of accredited investor and may result in limitations on, or specific disclosure requirements for, advertisements and other forms of general solicitation.

4.13(a)(3) under the Commodity Exchange Act of 1936, which provides a registration exemption for commodity pool operators that use commodity interests on a limited basis, if the pool is offered only to accredited investors, knowledgeable employees and certain "qualified eligible" persons. However, Rule 4.13(a)(3) includes a restriction against "marketing to the public." Accordingly, absent future guidance from the Commodities Futures Trading Commission to the contrary, private investment funds that have any commodities interests (including most swaps not related to a specific security) in their portfolios may not be able to take advantage of the Proposed Rules.

Sponsors of private investment funds that intend to engage in general solicitation and general advertising permitted by the Proposed Rules should note that any such communications are subject to the anti-fraud provisions of the federal securities laws (including Rule 10b-5 under the Securities Exchange Act of 1934 and Rule 206(4)-8 under the Investment Advisers Act of 1940), as well as other provisions of the Investment Advisers Act of 1940, such as the advertising rules and the recordkeeping rules. In addition, we expect that the SEC will carefully scrutinize the content and use of such communications in connection with the SEC's periodic audits of registered investment advisers.

Given that the Proposed Rules will be under Rule 506, private investment funds that rely on the Proposed Rules should, under current law, still be able to avail themselves of state securities laws ("blue sky") preemption.

The impact of the Proposed Rules on other areas of regulation will require study as the final rules are adopted.

Please contact any of the members of our Private Funds group for more information.

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000