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INVESTMENT MANAGEMENT ALERT

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SEC Adopts Final Rules on Amendments to Rule 506 Private Placement Exemption: *Impact on Private Funds and Other Issuers*

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On July 10, 2013, the Securities and Exchange Commission ("SEC") adopted an amendment (the "Solicitation Amendment")[1] to Rule 506 of Regulation D ("Rule 506"), the ubiquitous and widely used safe harbor exemption from registration of securities purchased and sold under the Securities Act of 1933, as amended (the "Securities Act"). The Solicitation Amendment eliminates the prohibition against "general solicitation" and "general advertising" for offerings made under Rule 506, provided that: (i) an issuer reasonably believes that all purchasers in such an offering are accredited investors; (ii) an issuer takes reasonable steps to verify that all purchasers in such an offering are accredited investors; and (iii) certain other conditions are met. The SEC was mandated last year to adopt the Solicitation Amendment as part of the Jumpstart Our Business Startups Act (the "JOBS Act"). The Solicitation Amendment will go into effect September 23, 2013, at which time an issuer may engage in all forms of general solicitation, subject to the conditions described below.

Background on Rule 506

Rule 506 was promulgated by the SEC under Section 4(a)(2) of the Securities Act (formerly Section 4(2)). In its current form, Rule 506 allows issuers to offer and sell securities to investors who qualify as "accredited investors" (as defined under Rule 501 of Regulation D) and up to 35 non-accredited investors,[2] without having to file a registration statement, subject to certain restrictions, such as a prohibition against offering the securities by "general solicitation or general advertising."[3]

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1 See SEC Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12 "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings" at http://www.sec.gov/rules/final/2013/33-9415.pdf.

2 Although technically issuers could sell to non-accredited investors in a Rule 506 offering, issuers rarely avail themselves of this option as they are often hampered by significant information requirements under Rule 502(b) (akin to public company disclosure contained in a registration statement filed with the SEC).

3 Rule 502(c) does not define general solicitation and general advertising, but the rule provides non-exhaustive examples including "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; …and [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising."

The Solicitation Amendment

The Solicitation Amendment creates a new Rule 506(c) which will allow private funds and other issuers to use general solicitation or general advertising to offer and sell securities to the public, provided that the following conditions are satisfied:

1) the issuer takes reasonable steps to verify that purchasers of the securities are accredited investors;
2) either all purchasers of securities are accredited investors because they fall within one of the enumerated categories included in the definition of accredited investor in Rule 501 or the issuer reasonably believes that all purchasers are accredited investors at the time of sale; and
3) all terms and conditions of Rule 501 and Rules 502(a) (integration of offerings within six months of another offering) and 502(d) (limitations on resales; and placement of restricted securities legend on either the securities certificate or another document) are satisfied.

Issuers who do not plan to engage in a general solicitation may continue to utilize the existing Rule 506 safe harbor which will now be designated a Rule 506(b) offering. A Rule 506(b) offering will remain subject to the prohibition against general solicitation and general advertising. Accordingly, issuers may choose to conduct either a Rule 506(b) or Rule 506(c) offering.

In connection with the adoption of the Solicitation Amendment, the SEC has adopted a revision to Form D adding a new check box in Item 6 to identify whether the issuer is relying on either Rule 506(b) or Rule 506(c), effectively requiring issuers to declare at the time of an offering whether they intend to engage in general solicitation in connection with the offering.

Reasonable Steps to Verify Accredited Investor Status

The SEC will require that issuers take "reasonable steps to verify" that purchasers are accredited investors and has provided a non-exclusive list of four verification methods for natural persons (which safe harbor verification methods do NOT extend to entities) that, if used, will be deemed to satisfy the verification requirement in Rule 506(c) (unless the issuer or its agent has knowledge that a purchaser is NOT an accredited investor). The specific methods of verification for natural persons are as follows:

1) reviewing copies of any Internal Revenue Service ("IRS") form[4] that reports income (e.g., Form W-2, Form 1099, Schedule K-1 on Form 1065 and Form 1040) for the past two

4 A person could provide a redacted version of an IRS form so as to disclose only information regarding annual income and to avoid disclosure of personally identifiable information.

years along with a written representation from such person that he or she expects to reach the income level necessary to qualify as an accredited investor during the current year[5];

2) reviewing financial records, such as bank statements, brokerage statements, appraisal reports issued by independent third parties and consumer reports dated within the prior three months, along with a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed;
3) 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 has, within the prior three months, taken reasonable steps to verify and has verified that the purchaser is an accredited investor[6]; or
4) obtaining a certification from an existing investor that participated in a previous Rule 506(b) offering of the issuer prior to the effective date of the Solicitation Amendment (certifying that such person remains an accredited investor at the time of sale in the Rule 506(c) offering) (the "Grandfathering Provision").

Where an issuer does not rely on one of the four verification methods enumerated above, Rule 506(c) requires that an issuer make an objective determination based on the facts and circumstances of each purchaser and transaction when determining what reasonable steps to take to verify a potential purchaser's accredited investor status. The SEC has highlighted a number of factors that issuers should consider, including: (i) the nature of the purchaser and the type of accredited investor the purchaser claims to be; (ii) the amount and type of information the issuer has about the purchaser; and (iii) the nature of the offering, including how the purchaser was solicited and the terms of the offering (e.g., minimum investment amount). The SEC has noted that checking a box in a questionnaire or signing a form, absent other information about the purchaser indicating accredited investor status, may not be sufficient to constitute reasonable steps to verify accredited investor status. The private fund industry presently relies (solely, in most instances) on this form of "self-certification" by investors. In the commentary for the Grandfathering Provision, the purpose of the verification mandate is to "…require the verification of the accredited investor status of only prospective purchasers who come to the issuer as a result of the issuer's general solicitation activities."[7] As such, it appears (although not reaffirmed by the SEC) that the private fund industry can continue to utilize only self-certification in respect of Rule 506(b) offerings. The SEC comment does call into question, however, whether or not fund managers can continue to rely solely

5 With respect to persons who seek to qualify based on joint income, an issuer will be required to obtain written representations from such persons and their spouse.
6 An issuer could rely on the verification of accredited investor status by a person or entity other than one of the aforementioned parties; provided that any such third party takes reasonable steps to verify that purchasers are accredited investors, has determined such purchasers are accredited investors and the issuer has a reasonable basis to rely on such verification.
7 See Solicitation Release at page 26.

on self-certification for Rule 506(c) offerings by an investor about whom a fund manager or its agents have no other additional information that is useful in determining eligibility. Notably, the SEC did state in the Solicitation Amendment that the ability of a purchaser to satisfy a sufficiently high minimum investment amount may be taken into consideration in verifying accredited investor status. The SEC did not, however, offer a view as to what constitutes a sufficiently high minimum investment amount (comments from private fund industry sources suggest that the number be 50% of the requisite net worth or total assets thresholds for natural persons and entities).

As noted in the Solicitation Amendment, the issuer has the burden of demonstrating its offering is entitled to an exemption from registration under the Securities Act. Issuers that do not take reasonable steps to verify accredited investor status (even if all purchasers are in fact accredited investors) will be deemed to not satisfy the requirements of Rule 506(c). Accordingly, to ensure compliance with Rule 506(c), issuers and their verification service providers must retain adequate records regarding steps taken to verify a purchaser was an accredited investor.

Existing Rule 506 Offerings - Transition to Rule 506(c) Offering

Issuers that commenced a Rule 506 offering prior to the effective date of the Solicitation Amendment may choose to continue an ongoing offering under either Rules 506(b) or (c). If, following September 23, 2013, the effective date of the Solicitation Amendment, the issuer decides to utilize Rule 506(c), any general solicitation which occurs subsequent to September 23, 2013 will not affect the exempt status of offers and sales of issuer securities which occurred prior to September 23, 2013 in reliance on Rule 506(b). However, once a general solicitation has been made to potential investors in an offering, the issuer will no longer be able to avail itself of the Rule 506(b) exemption from registration.

Impact on Private Funds

Sponsors of private funds will be able to utilize Rule 506(c) without jeopardizing their ability to rely on either one of the two exclusions from the definition of “investment company” in Sections 3(c)(1) and 3(c)(7) under the Investment Company Act of 1940 (the “Investment Company Act”). Although the Investment Company Act precludes private funds from relying on such exclusions if a public offering of their securities is made, the SEC has affirmed that it interprets the JOBS Act to permit general solicitation and general advertising in a Rule 506(c) offering and that such offerings satisfy the non-public offering condition in the Investment Company Act exclusions under Sections 3(c)(1) and 3(c)(7) thereunder.

The SEC has confirmed that only Rule 506(c) offerings may utilize general solicitation; issuers that conduct private placements under Section 4(a)(2) will still be subject to the prohibition

against general solicitation. Sponsors should consider whether or not parallel funds relying on the statutory exemption (which private funds may be limited to "friends and family") could be subject to integration with the Rule 506(c) offering and thus invalidate the Section 4(a)(2) exemption which does not permit general solicitation activities.

Fund managers must also be cognizant of their fiduciary obligations to investors in pooled investment vehicles. Under Rule 206(4)-8 under the Investment Advisers Act of 1940, an investment adviser to a pooled investment vehicle is prohibited from making an untrue statement of a material fact or omitting to state a material fact necessary to make the statements made not misleading to any investor or prospective investor. The SEC has urged investment advisers to make sure they have policies in place that prevent the use of fraudulent or materially misleading private fund advertising and should make appropriate amendments to these policies if they intend to engage in general solicitation on behalf of the private funds they manage.

Private funds are often engaged in swap trading, futures and other commodity interest transactions which necessitate the investment adviser register or qualify for an exemption as a commodity pool operator ("CPO") under the Commodity Futures Trading Commission ("CFTC") rules and Commodity Exchange Act. However, the elimination of the general solicitation prohibition under the JOBS Act applies only to "federal securities laws" and it is unclear how Rule 506(c) offerings will impact the availability of certain exemptions from registration as a CPO. Regardless of its impact on these exemptions, registered CPOs and commodity trading advisers will still be subject to the CFTC rules on advertising.[8]

Finally, the SEC confirmed that a Regulation S offering of securities in an offshore fund (which are made outside the United States and require that there can be no directed selling efforts in the United States) concurrent with a Rule 506(c) offering of securities in an onshore fund - a side-by-side offering - would not be integrated. Thus, the use of general solicitation in the Rule 506(c) offering would not prevent an issuer from relying on Regulation S for the offer and sale of securities in the offshore fund.

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8 Generally, CFTC Rule 4.41 provides that: (a) no commodity pool operator or commodity trading advisor may advertise in a manner which: (i) employs any device, scheme or artifice to defraud any participant or client; (ii) involves any transaction, practice or course of business which operates as a fraud or deceit upon any participant or client; or (iii) refers to any testimonial, unless the advertisement or sales literature providing the testimonial contains certain disclosures; and (b) no person may present the performance of any simulated or hypothetical commodity interest account, transaction or series of transactions in a commodity interest of a commodity pool operator or commodity trading advisor unless accompanied by certain prominent disclaimers. Rule 4.41 applies to any publication, distribution or broadcast of any report, letter, circular, memorandum, publication, writing, advertisement or other literature or advice, whether by electronic media or otherwise, including information provided via internet or e-mail, the texts of standardized oral presentations and of radio, television, seminar or similar mass media presentations. Rule 4.41 applies regardless of whether the commodity pool operator or commodity trading advisor is exempt from registration under the Commodity Exchange Act.

Disqualification from Rule 506: "Bad Actors"

The SEC adopted amendments to Rule 506 (the "Bad Actor Amendment")[9] to disqualify securities offerings involving certain "felons" and other "bad actors" from relying on the Rule 506 safe harbor (which includes both Rule 506(b) and Rule 506(c) offerings). Bad actors include the following persons to the extent that they have been subject to any one of the disqualifying events enumerated below:

1) the issuer (including its predecessors and affiliate issuers);
2) investment managers of private funds, directors, executive officers, other officers participating in the offering, general partners and managing members of such investment managers, and the directors and executive officers of the foregoing and their officers participating in the offering;
3) any beneficial owner of 20% or more of the issuer (as measured by voting power);
4) placement agents or other persons compensated for soliciting investors as well as general partners, directors, executive officers, other officers participating in the offering and managing members of the placement agent or other solicitor; and
5) promoters connected with the issuer at the time of sale.

Fund managers will want to conduct due diligence and seek additional representations from participants (including placement agents) in the offering (which may include the distribution of questionnaires by the issuer to such participants) to ensure they can make the appropriate certifications in the revised Form D.

The final rule provides a number of disqualifying events[10] which include the following:

1) SEC cease-and-desist orders barring or limiting such person from engaging in certain activities under federal securities laws;
2) SEC cease-and-desist orders entered into within the last five years in connection with violations of anti-fraud provisions of the federal securities laws;
3) criminal convictions in connection with the purchase and sale of a security, involving the making of a false claim to the SEC or arising out of the conduct of certain financial intermediaries. The criminal conviction must have occurred within ten years of the sale of securities (or five years in the case of the offer and sale of securities of the issuer and its predecessors and affiliated issuers);

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9 See SEC Release No. 33-9414; File No. S7-21-11 at http://www.sec.gov/rules/final/2013/33-9414.pdf.
10 Because securities sold under Rule 506 are "covered securities," state level bad actor disqualification rules do not apply.

4) court injunctions and restraining orders entered into within the last five years before any sale that at the time of the sale restrained or enjoined such person from engaging in or continuing to engage in any conduct or practice in connection with the purchase or sale of a security, involving the making of a false filing with the SEC or arising out of the conduct of certain financial intermediaries;
5) final orders[11] from certain state and federal regulators (including the CFTC) that (i) bar a person from associating with a regulated entity in the business of securities, insurance or banking and that were in effect at the time of the sale, or (ii) find a violation of law or regulation that prohibits fraudulent, manipulative or deceptive conduct and that were entered within ten years before such sale; and
6) suspension or expulsion from membership in a self-regulatory organization for any act or omission that constitutes conduct inconsistent with just and equitable principles of trade, which would be disqualifying for the period of suspension or expulsion.

The disqualification from reliance on Rule 506 will not apply if the authority issuing the judgment, order or other triggering directive in writing determines and advises the SEC (either in the judgment, order or other triggering directive or separately to the SEC or its staff) that it should not apply. Because disqualification will not arise under those circumstances, no waiver will be required from the SEC.

An issuer will only be disqualified for events that occur after the effective date of the Bad Actor Amendment (September 23, 2013). Notwithstanding the foregoing, it will be mandatory that all disqualifying events that occur prior to the effective date be disclosed in writing by the issuer to prospective investors in the offering.

The Bad Actor Amendment also provides the SEC with the ability to grant a waiver of disqualification if it determines that an issuer has shown good cause that it is not necessary under the circumstances that the Rule 506 exemption be denied.

Proposed Amendment: Modifications to Form D and Other Disclosure and Reporting Requirements Triggered by Rule 506(c)

The SEC has proposed a number of amendments to Regulation D, Form D and Rule 156 under the Securities Act[12] which if adopted would:

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11 Limited to orders under statutory authority - including rules and regulations - that provides for notice and an opportunity for hearing.
12 See SEC Release No. 33-9416; No. 34-69960; No. IC-30595; File No. S7-06-13 "Amendments to Regulation D, Form D and Rule 156" at http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

- require issuers relying on Rule 506(c) to file Form D not later than 15 days prior to engaging in a general solicitation;
- require issuers to file a final amendment to Form D within 30 days of terminating a Rule 506(c) offering;
- expand information requirements for Form D to include information relating to the issuer, the securities offered and certain details about investors participating in the Rule 506(c) offering;
- automatically disqualify issuers for one year for any new offering if they fail to comply within the last five years with all Form D filing requirements in a Rule 506 offering[13];
- apply Rule 156, which interprets the antifraud provisions of federal securities laws as it relates to sales literature used by registered investment companies, in a like manner with respect to general solicitation activities in Rule 506(c) offerings by private funds;
- require securities legends in general solicitation materials which disclose potential risks to investors and require certain other legends and disclosures for private funds; and
- require on a temporary basis that issuers submit their written general solicitation materials to the SEC on a nonpublic basis.

Comments on the proposed amendments are due September 23, 2013.

Conclusion

In light of the Solicitation Amendment and the proposed amendments described immediately above, private funds and other issuers will need to pay careful attention to the regulatory costs of complying with Rule 506(c) offerings before undertaking general solicitation activities in connection with private placements of private fund interests or other securities. We expect the regulatory expense to verify accredited investor status under a Rule 506(c) offering will be significant and deter smaller issuers with fewer resources from undertaking such activities. The proposed amendments described above also seem to indicate that the SEC will be carefully scrutinizing issuers engaged in general solicitations under Rule 506(c). Although general solicitation materials will be submitted on a non-public basis, the SEC has not indicated what it intends to do with such material (which could include utilizing such materials in a related or unrelated enforcement action against the issuer). Additional regulatory scrutiny may develop at the state regulator level with more state level enforcement actions. Many state regulators have voiced their displeasure regarding the JOBS Act and the elimination of the prohibition on general solicitation activities under Rule 506. For instance, on

13 The disqualification would only apply to a new offering for a period of one year from the date that all required Form D filings of the issuer have been made or if the offering has terminated, following the filing of a closing amendment. Issuers would not have to look back beyond the effective date of new Rule 507(b). New Rule 507(b) would have a 30 day cure period for an issuer's first failure to make a Form D filing on a timely basis with respect to a particular offering, and the SEC would have the right to grant waivers upon a showing of good cause.

July, 10, 2013, the North American Securities Administrators Association ("NASAA"), issued a statement expressing disappointment over the SEC's lifting of the ban on general solicitation and advertising for what NASAA describes as "highly speculative and sometimes fraudulent private placement offerings investments" before it adopted appropriate limits, guidance and investor protections. NASAA believes that the SEC's action needlessly puts investors in harm's way, noting that private placement offerings are the most common product leading to enforcement actions by state securities regulators.

We would expect many private fund managers will proceed cautiously with Rule 506(c) offerings and ultimately avoid becoming first adopters of general solicitation activities until there are some cost efficiencies (perhaps by the development of third party service verification providers) with verifying accredited investor status, greater acceptance by federal and state regulators of the notion of general solicitation in Rule 506 offerings and more certainty from the SEC in respect of the compliance requirements with undertaking a Rule 506(c) offering (e.g., implementing the amendments to Form D proposed in the latest SEC release).

Questions or Comments?

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