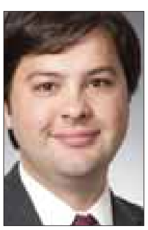
New Regulation D General Solicitation and "Bad Actor" Disqualification: Considerations for Private Funds

Nathaniel Marrs
Latham & Watkins LLP

Barton Clark
Latham & Watkins LLP



Samuel Jackson
Latham & Watkins LLP

OFFERINGS OF PRIVATE INVESTMENT FUND INTERESTS routinely rely on Rule 506 of the Regulation D "safe harbor" from registration under the Securities Act of 1933. Historically, such offerings have been strictly required to avoid any "general solicitation" or "general advertising." On July 10, 2013, the Securities and Exchange Commission amended Regulation D to provide an additional option to allow general solicitation in certain Regulation D offerings.[1] The SEC also added a disqualification rule that amended Regulation D to disqualify offerings involving certain felons and other "bad actors" (broadly defined) from relying on Regulation D.[2] The amendments and new rules became effective September 23, 2013.

Repeal of General Solicitation Prohibition

Section 4(a)(2) of the Securities Act provides an exemption from Securities Act registration for transactions by an issuer "not involving any public offering." Regulation D under the Securities Act provides a nonexclusive "safe harbor" for compliance with Section 4(a)(2).[3] Private funds most commonly rely on Regulation D and, accordingly, have been required to avoid any form of general solicitation.[4, 5]

The recent amendments to Regulation D added a new safe harbor option (New Rule 506(c)) to allow general solicitation without requiring registration under the Securities Act.[6] The SEC has confirmed a private fund that uses New Rule 506(c) can continue to rely on the exclusions from "investment company" status pursuant to Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.[7]

New Rule 506(c) allows issuers to engage in such activities without Securities Act registration if they meet all the following requirements:

- All terms and conditions of Rule 501 (definitions), Rules 502(a) (the integration rules), and 502(d) (limitations on resale) are satisfied.
- All purchasers of securities are accredited investors.
- The issuer has taken reasonable steps to verify that all purchasers of securities are accredited investors.

New Rule 506(c) requires the issuer to "verify" the accredited investor status of all purchasers, whereas before, other Rule 506 offerings have required the issuer to have a "reasonable belief" that its investors were accredited.[8] As a matter of market practice, private fund sponsors have typically relied on accredited investor status representations, often via "check-the-box" responses to subscription questionnaires. If the sponsor's reliance was reasonable, it was not required to take additional steps to establish actual knowledge that its investors were, in fact, accredited investors.

In contrast, New Rule 506(c) provides that an issuer must "have taken reasonable steps to verify" the accredited investor status of its investors. Verification requires additional diligence by the issuer, beyond requiring its investors to confirm such qualification.[9] This requirement is "separate from and independent of the requirement that sales be limited to accredited investors." It is not sufficient for an issuer to show that, in fact, all its investors were indeed accredited.[10]

1. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12, July 10, 2013 (the "Rule 506(c) Release").
2. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, SEC Release No. 33-9414; File No. S7-21-11, July 10, 2013 (the "Bad Actor Release").
3. 17 CFR 230.500-508, referred to as Rules 500-508. Rule 506 does not limit the amount of securities offered or sold. Rules 504 and 505 are limited to offerings up to $1 million or $5 million, respectively.
4. Section 3(c)(1) or 3(c)(7) funds are generally referred to as "private funds."
5. Rule 502(c). In general, for purposes of any Rule 506 offering (other than New Rule 506(c)), neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of "general solicitation," such as advertisements, articles, notices, or other communications published in written media, television or radio, or any seminar or meeting whose attendees have been invited by any general solicitation.
6. Rule 506(c).
7. Rule 506(c) Release at 49. The SEC has not commented as to whether pooled investment funds that intend to rely on other Investment Company Act exceptions, such as Section 3(c), (5(c), may rely on New Rule 506(c).
8. Rule 506(b)(2)(i); Rule 506(a)(2).
9.The SEC stated that it does "not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, 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." Rule 506(c) Release at 33-34.
10. Rule 506(c) Release at 26.

New Rule 506(c) sets forth a nonexclusive list of methods that issuers may use to verify accredited investor status: [11]

- If an investor is deemed to qualify as accredited based on its annual income, the issuer may review any IRS tax form that reports the investor's income for the previous two years, provided the sponsor receives a written representation from the investor stating that the investor expects to reach a qualifying level of income during the current year.
- If an investor is deemed to qualify as accredited based on net worth, the issuer may review financial documents dated within the previous three months related to such investor's assets (e.g., bank statements, brokerage statements, certificates of deposit, tax assessments, and third-party appraisal reports) and liabilities (e.g., a report from a nationwide consumer reporting agency), provided the sponsor receives a written representation from the investor stating that all liabilities necessary to make a determination of net worth have been disclosed.
- An issuer may rely on written confirmations as to accredited status from certain agents of potential investors, including registered broker-dealers, registered investment advisors, licensed attorneys, and certified public accountants, assuming such attorneys or accountants are in good standing in their relevant jurisdictions.
- For any investor that purchased securities in an issuer's pre-amendment Rule 506 offering as an accredited investor and continues to hold such securities, such issuer, to the extent it desires subsequently to make an offering under New Rule 506(c), may verify such investor's status by obtaining a certification from that investor.

For any given New Rule 506(c) offering, the appropriate verification diligence steps will depend on the facts and circumstances surrounding the particular offering and the potential investor, including the nature of the purchaser and the type of accredited investor the purchaser claims to be, the amount and type of information that the issuer has about the purchaser, and the nature of the offering.[12] The SEC has indicated that it expects a market to develop for private firms to offer certification/verification services in support of offerings under New Rule 506(c). In any event, an issuer and any verification service provider will need to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor.[13]

Considerations for Private Funds

New Rule 506(c) raises a number of practical issues for private fund sponsors. The new investor verification process may require greater disclosure from potential investors regarding their personal financial circumstances. Sponsors may prefer alternatives to pursuing such disclosure, and investors may not be willing to provide it. While the SEC expects third-party firms to develop alternative verification procedures over time, and such firms may represent a more tactful approach for verification, such an approach will become an additional cost to the fund-raising process.

New Rule 506(c) also appears to be less flexible compared to traditional Rule 506 offerings. If a nonaccredited investor participated in a New Rule 506(c) offering, and the issuer could not establish that it took reasonable verification steps and had a reasonable basis to believe the purchaser was an accredited investor, then the offering would not qualify for New Rule 506(c).[14] Because the issuer would presumably have engaged in general solicitation, it would not be able to "fall back" on other private offering exemptions under Regulation D or Section 4(a)(2) generally. By contrast, up to 35 nonaccredited investors may participate in a traditional Rule 506 offering (subject to certain information delivery requirements). Moreover, if an offer-

11. New Rule 506(c)(2)(ii)(A)-(D).
12. New Rule 506(c) Release at 27-28.
13. New Rule 506(c) Release at 28-29.
14. New Rule 506(c) Release at 43-44.
15. Rule 500(c) provides that an issuer's failure to satisfy all the terms and conditions of Rule 506(b), the traditional Rule 506 exemption, shall not raise any presumption that the exemption provided by Section 4(a)(2) of the Securities Act is not available.
16. Broadly speaking, most US managers of private funds with more than $150 million in commitments are required to register under the Investment Advisers Act of 1940.
17. Under Rule 206(4)-8 of the Advisers Act, an adviser to pooled investment funds may not "[m]ake any untrue statement of material fact or omit to state a material fact necessary to make the statements … not misleading …" or "engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative …"
18. New Rule 506(c) Release at 51-52.
19. The exemption for commodity pool operators under CFTC Rule 4.13(a)(3)(i) requires that interests in the pool be "offered and sold without marketing to the public" in the US.
20. Amendments to Regulation D, Form D, and Rule 156, SEC Release No. 33-9416; No. 34-69960; No. IC-30595; File No. S7-06-13, July 10, 2013.
21. Bad Actor Rule(1).

ing does not meet the requirements under traditional Rule 506, the offering expressly remains eligible for another exemption under Section 4(a)(2).[15]

In addition, New Rule 506(c) does not alter a variety of additional regulatory regimes that govern marketing communications by investment funds. For example, the general antifraud provisions of Section 206 of the Investment Advisers Act of 1940, and the rules and lore thereunder, will apply to New Rule 506(c) offerings.[16] These include requirements for advertising and the presentation of investment performance.[17] The SEC specifically indicated that it will monitor and study the development of private fund advertising to review whether to take further regulatory action.[18] Also, a private fund that intends to trade in derivatives will need to address its status under applicable commodities regulations. A commonly used exemption from full-scale commodities registration requires that the fund not engage in a public offering.[19]

Finally, the SEC has proposed further amendments to Regulation D, including a temporary rule to require that all "written general solicitation materials" for any New Rule 506(c) offerings be provided to the SEC no later than at the time of first use.[20] While such submissions are proposed to be confidential, and the rule would lapse after two years, such a requirement can be expected to make New Rule 506(c) less attractive. The proposed amendments would also require the filing of a final amendment to Form D within 30 calendar days after the termination of any Rule 506 offering—not simply those under New Rule 506(c)—which filing would set forth the total amount of funds raised.

"Bad Actor" Disqualification From Regulation D

Regulation D now includes a disqualification provision at Rule 506(d) with respect to all Rule 506 offerings, not simply those relying on New Rule 506(c). Such disqualification is triggered if specified disciplinary events have occurred with respect to any of the following "covered persons":[21]

- The issuer and its predecessors or affiliated issuers
- Directors, executive officers, or participating officers of the issuer or of the general partner or managing member of the issuer

- A beneficial owner of 20% or more of the issuer's outstanding voting equity (based on voting power), which appears to include the larger investors in many private funds [22]
- An investment manager of a pooled investment fund, any general partner or investment manager of such pooled investment fund, and directors, executive officers, or participating officers of the investment manager or of the general partner or managing member of the investment manager
- A promoter connected with the issuer at the time of sale
- A "compensated solicitor" that is paid for solicitation of purchasers for the offering, including any placement agent or "finder," and any general partner or managing member of such solicitor and directors, executive officers, or participating officers of a compensated solicitor or of the general partner or managing member of the compensated solicitor

The disciplinary events that give rise to Bad Actor Rule disqualification include the following:[23]

- Being convicted of a felony or a misdemeanor connected with (1) the purchase/sale of any security, (2) false filings with the SEC, or (3) the business of being an underwriter, a broker, a dealer, a municipal securities dealer, an investment advisor, or a compensated solicitor in the previous ten years (or, in the case of the issuer itself or its predecessors or affiliated issuers, in the previous five years)
- Being subject to an order, a judgment, or a court decree that restrains or enjoins the covered person from engaging in any conduct connected with (1) the purchase/sale of any security, (2) false filings with the SEC, or (3) the business of being an underwriter, a broker, a dealer, a municipal securities dealer, an investment advisor, or a compensated solicitor in the previous five years
- Being subject to an order of a state securities commission; a state bank, savings association, or credit union examining authority; a state insurance commission; a federal banking agency; the Commodity Futures Trading Commission; or the National Credit Union Administration, in each case that (1) bars the covered person from associating with an entity that any such authority regulates or engaging in one of the regulated businesses or (2) constitutes a final order in connection with a violation of law or regulation relating to fraud, manipulation, or deceptive conduct in the previous ten years
- Being subject to an SEC order that (1) suspends the covered person's registration as a broker, a dealer, a municipal securities dealer, or an investment adviser; (2) places limitations on the "activities, functions, or operations" of the covered person; or (3) bars the covered person from participating in or associating with a penny stock offering
- Being subject to an SEC order that directs the covered person to cease and desist from committing any violation of (1) any scienter-based antifraud provision of the federal securities laws or (2) Section 5 of the Securities Act (the provision prohibiting sale of unregistered securities through interstate commerce), in each case within the previous five years
- Being suspended or expelled from, or being banned from associating with a registered member of, any registered national securities exchange or securities association for any act or omission "constituting conduct inconsistent with just and equitable principles of trade"
- Having filed (as a registrant or an issuer), or being named as an underwriter in, any filed registration statement or Regulation A offering statement that, within five years before such sale, was the subject of a stop order or an order suspending the Regulation A exemption, or currently being the subject of an investigation or proceeding to determine whether such a stop order or suspension should be ordered
- Being subject to a United States Postal Services false representation order within the previous five years, or currently being subject to a temporary restraining order or preliminary injunction from the USPS, for conduct related to a scheme or device for obtaining money or property through the mail via false representations

However, these disqualifying events do not include the following:[24]

- Convictions, orders, judgments, decrees, suspensions, expulsions, or bars that occurred or were issued before September 23, 2013
- Events the SEC has determined to waive
- Convictions, orders, and actions in which the issuing court or regulator authority, prior to the issuance, has advised in writing that Bad Actor Rule disqualification should not occur

22. Whether a limited partner in a typical private fund should be deemed to hold a "voting security" is for this purpose applied based on whether security holders have the ability, currently or on a contingent basis, to control or significantly influence the management and policies of the issuer. Bad Actor Release at 20. Securities that confer the right to remove the board of directors "or equivalent controlling persons" of an issuer—which would appear to include the general partner of a private fund—would be considered "voting securities."
23. Bad Actor Rule (1)(i)-(viii).
24. Bad Actor Rule(2)(i)-(iv).

■ Instances in which the issuer can show it did not know and, within its exercise of reasonable care, could not have known that there was a disqualification under the Bad Actor Rule.

Whether an issuer can show that it has exercised reasonable care in assessing potential disqualification is determined in light of the facts and circumstances of the particular case.[25] An issuer will in any event be required to make factual inquiry into whether any disqualifications exist. The nature and scope of the inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants. The use of questionnaires or certifications, perhaps accompanied by contractual representations, covenants, and undertakings, may be sufficient in some cases, particularly if no information or other factors suggest bad actor involvement.[26] If circumstances give an issuer reason to question the veracity or accuracy of responses to its inquiries, the issuer would be required to undertake additional inquiry.[27]

Additional Look-Back Disclosure

Although disciplinary events that arose prior to the effectiveness of the Bad Actor Rule will not trigger disqualification, issuers must fully disclose to each purchaser of securities, a reasonable time prior to sale, any preexisting events that would constitute disqualifying events but for the fact that they arose before September 23, 2013, unless the issuer can show that it did not know and, in the exercise of reasonable care, could not have known of the existence of the undisclosed matter.[28] The SEC expects issuers to "give reasonable prominence to the disclosure of prior disciplinary events."[29] Failure to comply with this disclosure requirement would prevent an issuer from relying on Regulation D.[30]

Additionally, Form D has been amended to require a certification by the issuer that, if relying on Regulation D, such issuer is not disqualified (and not otherwise exempted) for a reason set forth in the Bad Actor Rule.

25. Instruction to Bad Actor Rule(2)(iv).
26. Bad Actor Release at 66.
27. Bad Actor Release at 67.
28. Rule 506(e). Instruction to Rule 506(e) indicates that an issuer will not be able to establish that it exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist.
29. Bad Actor Release at 77.
30. Ibid.
31. Bad Actor Release at 68.

Considerations for Private Funds

The new disqualification and disclosure requirements raise a number of considerations for private fund sponsors. For example, any placement agent of a private fund would be a "covered person." Accordingly, private fund sponsors should establish the disciplinary history of any placement agent at the time of engagement. This may involve additional representations as well as other diligence steps.

In addition, while "covered persons" includes "affiliated issuers," such issuers are not further described in either the Bad Actor Rule or the SEC's releases. Absent further definition, an "affiliated issuer" could potentially include portfolio companies controlled by or under common control with a private fund. If so, the scope of compliance monitoring would increase substantially.

Finally, a Bad Actor Rule disqualification event could arise at any point, even after a private offering has begun. Often, private fund offerings take up to a year or more to complete, so a fund could launch permissible fund-raising and later find itself disqualified—on a going-forward basis—by the Bad Actor Rule because of a later-arising disciplinary event involving a covered person. For continuous, delayed, or long-lived offerings, the issuer should take steps to exercise reasonable care in the discovery of disqualifying acts, including by updating its factual inquiry on a reasonable basis.[31] Private funds and their sponsors should consider implementing broad and ongoing internal diligence and self-monitoring programs to both detect and address bad actors, as well as to establish a due diligence defense.

Conclusion

Private fund sponsors will likely weigh the benefits of New Rule 506(c) offerings against the further compliance requirements, particularly as to verification of investors. Some issuers may take a wait-and-see approach, gauging the development of market standards and practices, while contemporaneously conducting traditional Regulation D offerings. In any event, the "bad actor" disqualification regime calls for closer—and ongoing—vigilance by funds and their sponsors irrespective of the means by which an offering is conducted. ■

Nathaniel Marrs and Barton Clark are Partners and Samuel Jackson is an Associate with Latham & Watkins LLP.