The SEC Proposes Rules to Remove Prohibitions on General Solicitation and General Advertising in Certain Regulation D Offerings

The Jumpstart Our Business Startups Act enacted on April 5, 2012 (the "JOBS Act"), directed the Securities and Exchange Commission (the "SEC") to amend Rule 506 of Regulation D ("Rule 506"), promulgated under Section 4(a)(2) (previously Section 4(2)) of the Securities Act of 1933, as amended (the "Securities Act"), to allow issuers to engage in "general solicitation" and "general advertising" in offerings made under Rule 506, so long as all purchasers of the securities in such offerings are accredited investors. On August 29, at the conclusion of an unusually contentious open meeting, the SEC proposed an amendment to Rule 506 to implement these provisions of the JOBS Act. If adopted as proposed, the amendment will provide certain hedge funds, private equity funds and other private funds (as well as other issuers making Regulation D offerings) with substantially more freedom in marketing fund interests. Similarly, these proposed changes might allow sponsors of publicly offered mutual funds that also manage private funds to integrate further the marketing and distribution of their registered and unregistered products. However, significant questions remain regarding what steps fund sponsors may be required to take under new Rule 506(c) to verify that investors in Rule 506(c) offerings are "accredited investors," the status of Regulation S offshore offerings where issuers have engaged in general advertising or general solicitation in connection with a simultaneous Regulation D offering, and the extent to which Commodity Futures Trading Commission ("CFTC") regulations may continue to constrain the ability of private fund sponsors to engage in general advertising and general solicitation. This alert summarizes proposed Rule 506(c) and considers outstanding issues relevant to private fund sponsors.

Restrictions under Current Rule 506

Private fund offerings in the United States are typically made in reliance on Rule 506, which effectively limits participation in most such offerings to "accredited investors,"[1] and requires that issuers satisfy certain other general conditions. Rule 502(c) currently prohibits an issuer relying on a Rule 506 exemption from using any form of "general solicitation" or "general advertising" to market the securities. Rule 502(c) does not define the terms "general solicitation" or "general advertising," but the rule states that these may include, but are not limited to, "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising." The SEC has also confirmed that the use of unrestricted websites constitutes general solicitation and general advertising.

Proposed Rule 506(c)

The SEC has proposed adopting new Rule 506(c),[2] which would allow issuers to use general solicitation or general advertising to offer and sell securities under Rule 506 provided that:

[1] Technically, up to 35 non-accredited investors can purchase securities in a Regulation D offering under Rule 506(b). However, selling to non-accredited investors requires that fund sponsors confirm the knowledge and experience of such investors (or their purchaser representatives), and imposes burdensome information requirements on the fund sponsor.

[2] Proposed Rule 506(c) would be in addition to, rather than in place of, Rule 506(b). As a result, issuers could elect not to engage in general solicitation or general advertising and, by so doing, retain the ability to sell interests to up to 35 non-accredited investors (subject to compliance with the other requirements of Regulation D) and to forego the verification requirement set forth in Rule 506(c).

1. the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors;

2. all purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or because the issuer reasonably believes that they do at the time of the sale of securities; and

3. all terms and conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied (amongst other things, those rules establish when offers and sales must be integrated for purposes of Regulation D, and restrict the resale of securities acquired in a Regulation D offering).

Although Congress seemingly directed the SEC to establish methods by which issuers could satisfy the verification requirement set forth above, Rule 506(c) simply repeats the statutory language on verification from the JOBS Act, and the SEC explicitly declined in the proposing release to set forth specific verification steps that issuers must take. Instead, the SEC noted in the release that "[w]hether the steps taken are 'reasonable' would be an objective determination, based on the particular facts and circumstances of each transaction," and set forth the following factors as guidance for issuers to consider when determining the reasonableness of their verification procedures:

1. the nature of the purchaser and the type of accredited investor that the purchaser claims to be (for example, the SEC noted that more extensive verification would likely be required in the case of a natural person investor compared to a registered broker-dealer investor);

2. the amount and type of information that the issuer has about the purchaser (for example, the SEC suggested that less verification would be required with respect to an investor where the issuer has access to publicly available information about the investor, and suggested that third-party services might develop to facilitate verification for multiple issuers); 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 (for example, the SEC noted that less verification would be required where an issuer's minimum investment requirement was sufficiently high that only accredited investors could reasonably be expected to meet the requirement).

In connection with proposed Rule 506(c), the SEC also proposed a revision to Form D to add a new check box in Item 6 for issuers to indicate whether they are relying on the exemption in Rule 506(c). The SEC proposed this revision to Form D to allow it to monitor the use of the Rule 506(c) exemption, including the verification methods used by issuers relying on this exemption.

Finally, issuers should keep in mind the SEC's admonition for issuers to maintain adequate records to document the verification steps taken under proposed Rule 506(c) because "[a]ny issuer claiming an exemption from the registration requirements of Section 5 has the burden of showing that it is entitled to that exemption."

Effect of Proposed Rule 506(c) on the Offering of Private Funds

Verification Steps for Private Funds

Proposed Rule 506(c) does not contain any required methods or establish any safe harbor for issuers to follow in verifying the accredited investor status of purchasers. However, private fund sponsors should note the SEC's guidance from the proposed rule release that it "[does] not believe that an issuer would have taken reasonable steps to verify accredited investor status if it 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," where the issuer had solicited investors through a website, a widely disseminated e-mail or social media. Assuming the rule is adopted as proposed, private fund sponsors may need to consider whether their current practices for verifying accredited investor status, including standard representations and questionnaires included in subscription documents, should be modified or augmented if such sponsors intend to rely on proposed Rule 506(c). Private fund sponsors may also wish to weigh the costs and risks of such changes against the benefits of being able to conduct a general solicitation, and may decide in certain instances to continue relying on Rule 506(b).

Effect of Proposed Rule on Sections 3(c)(1) and 3(c)(7)

Congress did not make specific reference to privately offered funds or to exemptions from registration under the Investment Company Act of 1940, as amended (the "1940 Act") in drafting the JOBS Act's directive to remove the prohibitions on general solicitation and general advertising. However, Section 201(b) of the JOBS Act provides that "[o]ffers and sales exempt under [Rule 506] (as revised pursuant to [the JOBS Act]) shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." The SEC stated in the proposing release that it interprets Section 201(b) of the JOBS Act to permit private funds to use general solicitation and general advertising in connection with the offer and sale of securities under proposed Rule 506(c) and that such offer and sale would still qualify as a non-public offering for the purposes of Sections 3(c)(1) and 3(c)(7) under the 1940 Act.

Fund sponsors should note that Rule 506(c) was issued as a proposed rule, and not an interim final temporary rule. As a result, existing restrictions on general solicitation and general advertising continue to apply to private fund offerings in the U.S., pending adoption of the final rule.

Effect of Proposed Rule on Regulation S Offshore Offerings

The SEC's proposing release sought to address whether an issuer could use general solicitation or general advertising in reliance on proposed Rule 506(c) while simultaneously offering securities under Regulation S. Regulation S provides a safe harbor for offers and sales of securities outside of the United States provided that (1) the securities must be sold in an offshore transaction, and (2) there can be no directed selling efforts in the United States. Several commenters requested that the SEC consider amending the second safe harbor requirement under Regulation S ("no directed selling efforts in the U.S.") to clarify that general solicitation and general advertising that is permissible under proposed Rule 506(c) would not preclude an issuer from also relying on the safe harbor in Regulation S in connection with a simultaneous non-U.S. offering. Instead, the SEC merely reiterated prior guidance (provided by the SEC staff under a regime where "general solicitation" and "direct selling efforts" were often viewed as functional equivalents) that so long as foreign offerings and sales are made in compliance with Regulation S, such offerings and sales will not be integrated for the purpose of Regulation S with domestic offerings and sales made under proposed Rule 506(c). Uncertainty remains as to whether issuers will be able to conclude that foreign offerings and sales have, in

fact, been made in compliance with Regulation S where the issuer has engaged in general advertising or general solicitation activity in the U.S. in connection with a Regulation D offering. If no further assurance can be provided as to how an offshore issuer could conduct a general solicitation onshore without endangering the exemption for its parallel Regulation S offering, the main advantage of proposed Rule 506(c) may be unavailable for that issuer.

Separate Restrictions May Be Imposed by the Commodity Exchange Act

Finally, the proposing release does not seek to resolve any potential friction between proposed Rule 506(c) and CFTC rules under the Commodity Exchange Act, which does not constitute a federal securities law for purposes of the exemption from public offerings under the JOBS Act. Accordingly, CFTC rules may continue to constrain certain private fund sponsors from engaging in general advertising or general solicitation, even where proposed Rule 506(c) and Sections 3(c)(1) or 3(c)(7) of the Investment Company Act would otherwise permit them to do so. In particular, CFTC Rule 4.13(a)(3), which provides a "de minimis" exemption from registration as a commodity pool operator for fund sponsors engaged in swaps trading and other commodity interest transactions below certain thresholds, requires that "interests are offered and sold without marketing to the public in the United States." Therefore, issuers relying on Rule 4.13(a)(3) for exemption from CPO registration likely cannot use general solicitation or general advertising (which would presumably constitute "marketing to the public" for purposes of Rule 4.13(a)(3)) even if the issuer can rely on proposed Rule 506(c) for an exemption from registration under the Securities Act. Current CFTC rules do not impose the same limitations on fund sponsors that are registered commodity pool operators (CPOs), even where such CPOs are relying on the exemption established by CFTC Rule 4.7 from certain disclosure, reporting and recordkeeping requirements otherwise applicable to registered CPOs.

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Comments on proposed Rule 506(c) must be submitted to the SEC by no later than October 5, 2012. For more information on the proposed rule, please contact your regular Ropes & Gray attorney.