CLIENT UPDATE

SEC ADOPTS JOBS ACT RULES ELIMINATING BAN ON GENERAL SOLICITATIONS IN CERTAIN PRIVATE OFFERINGS

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The Securities and Exchange Commission ("SEC") last week adopted amendments to Rule 506 of Regulation D and to Rule 144A under the Securities Act of 1933 ("Securities Act") that eliminate the ban on "general solicitation" and "general advertising" of securities offerings conducted under those rules. The amendments significantly liberalize the restrictions on publicity in connection with offers of securities made in reliance on the rules and will permit issuers – including operating companies and private equity and hedge funds – to more broadly solicit investors and publicize their offerings. Issuers should proceed with caution, however, as industry standards and best practices develop.

The rule changes were mandated by the Jumpstart Our Business Startups Act ("JOBS Act") and will become effective 60 days following their publication in the Federal Register. The rule changes were adopted in substantially the form proposed by the SEC in August 2012 with one important addition, the inclusion by the SEC in amended Rule 506 of four non-exclusive methods that issuers may use to verify the accredited investor status of natural persons.

In addition, the SEC (i) adopted rules mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") prohibiting certain felons and other bad actors from utilizing Rule 506, and (ii) proposed new amendments to Regulation D, Form D and Rule 156 intended to enable the SEC to evaluate the development of market practices in Rule 506 offerings and help address concerns of an increase in fraudulent market activity. The proposed amendments to Rule 156 reflect an increased SEC focus on private fund marketing.

GENERAL SOLICITATIONS AND ADVERTISING

The historical ban on general solicitation and advertising has meant, among other things, that a corporation, limited partnership or other issuer making a private offering under Rule 506 or an offering under Rule 144A has not been permitted to advertise the offering in a newspaper or on the Internet, speak to the press or at public conferences about the offering or make offering documents available online except on a password-protected basis.

Under amended Rule 506(c), issuers (including privately owned businesses and private equity and hedge funds) will be permitted to utilize general solicitation or advertising to offer their securities (including stock and limited partnership interests) for sale without registration under the Securities Act if:

- at the time of the sale of the securities, all of the purchasers are, or the issuer reasonably believes them to be, accredited investors;
- the issuer takes "reasonable steps" to verify that the purchasers are accredited investors; and
- all of the terms and conditions of Rule 501 and Rules 502(a) and 502(d) of Regulation D are satisfied.

Similarly, the amendments to Rule 144A provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

Accordingly, issuers satisfying these requirements will be able to offer their securities for sale through (i) newspaper, magazine, Internet and other forms of advertising; (ii) speaking to the press or at public conferences about the offering; (iii) mentioning the offering and investment returns on their websites; (iv) publishing tombstones while an offering is ongoing (such as after a first closing of the sale of interests in a private fund that

expects to have multiple closings); (v) making offering documents available by mass mailings and online (without any requirement for password protection); and (vi) marketing to persons without worrying about the traditional requirement that there be a substantive, pre-existing relationship. Similarly, these forms of solicitation and advertising will be permitted in connection with resales of securities to QIBs pursuant to amended Rule 144A without the concern of losing the exemption from registration.

VERIFICATION OF ACCREDITED INVESTOR STATUS

An issuer making an offer using a general solicitation must take "reasonable steps" to verify that each purchaser is an accredited investor or qualified institutional buyer, as applicable. This requirement is separate from and independent of the requirement that sales be limited to accredited investors (or to those investors that the issuer reasonably believes to be accredited investors), and must be satisfied even if all purchasers happen to be accredited investors. Under amended Rule 506(c), issuers may satisfy the reasonable steps requirement by using any of the identified non-exclusive methods of verifying accredited investor status for natural persons or by using the principles-based framework for verification described in the rule release.

Non-Exclusive Verification Methods

Amended Rule 506(c) includes four specific non-exclusive methods of verifying accredited investor status for natural persons that will be deemed to satisfy the verification requirement. These methods include:

- Income: For a potential purchaser (and his or her spouse, if relying on joint income), reviewing copies of any IRS form that reports income including, but not limited to, Form W-2, Form 1099, Schedule K-1 and Form 1040, for the two most recent fiscal years and obtaining a written representation from such person that he or she reasonably expects to reach the necessary income level during the current year;
- Net Worth: For a potential purchaser (and his or her spouse, if relying on joint net worth), reviewing one or more specified types of documentation dated within the prior three months and obtaining a written representation from such person that all liabilities necessary to determine his or her net worth have been disclosed. Acceptable documentation includes (i) for assets: bank statements, brokerage and other statements of securities holdings, certificates of deposit and tax assessments and appraisal reports of independent third parties, and (ii) for liabilities: a consumer credit report from a nationwide consumer reporting agency;

- Third-Party Written Confirmation: Obtaining written confirmation from a registered broker-dealer, SEC-registered investment advisor, attorney or a certified public accountant that such person has taken reasonable steps to verify and has determined that the potential purchaser is an accredited investor; and
- Certain Current Accredited Investors: For natural persons that had invested in an issuer as an accredited investor prior to the effective date of amended rule 506 and remain invested, obtaining a certification by such person that he or she qualifies as an accredited investor.

Principles-Based Verification

To the extent that a particular offering will be conducted in a manner that precludes reliance on the verification safe harbor, then whether the steps taken are "reasonable" will be based on the particular facts and circumstances of each transaction. Specifically, the SEC noted the following factors to be considered in connection with accredited investor status: (i) the nature of the purchaser and the type of accredited investor that the purchaser claims to be; (ii) the amount and type of information that the issuer has about the purchaser; (iii) the nature of the offering (such as the manner in which the purchaser was solicited to participate in the offering); and (iv) the terms of the offering (such as a minimum investment amount). The adopting release notes that these factors are interconnected and are intended to help guide an issuer in assessing the reasonable likelihood that a purchaser is an accredited investor. Thus, after consideration of the relevant facts and circumstances, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status, and vice versa.

For example, the adopting release suggests that private offerings with a low minimum investment amount involving natural persons who are solicited through a publicly available website most likely would require heightened verification procedures. By contrast, private offerings to large institutional investors making significant investments (such as offerings to pension plans making multi-million dollar capital commitments to a private fund) or offerings involving solicitation of investors from a database of pre-screened accredited investors maintained by a reasonably reliable third party may require limited verification procedures. In particular, the SEC indicated that the ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors could reasonably be expected to meet it, with a direct cash investment that is not financed by the issuer or by any third party, could be taken into consideration in verifying accredited investor status.

Reasonable Belief; Reliance on Third-Party Verification

The definition of accredited investor continues to include a requirement that the issuer must have a reasonable belief that the investor satisfies the tests to qualify as an accredited investor at the time of the sale of the securities. Issuers are entitled to rely on third-party verifications of accredited investor status so long as the issuer has a reasonable basis to rely on such verification. The SEC noted that requiring only that a person check a box in a questionnaire or sign a form, absent other information indicating that a purchaser is an accredited investor, will not be deemed reasonable steps by the issuer or a third party acting on its behalf to verify a purchaser's status.

PRIVATE OFFERINGS WITHOUT GENERAL SOLICITATION

The SEC reconfirmed that an issuer may continue to conduct offerings under the existing Rule 506(b), without engaging in a general solicitation, if for example, it wants to sell securities to sophisticated persons who are not accredited investors, it wants to avoid the accredited investor verification requirements required under Rule 506(c), or it is concerned about other issues that a general solicitation might raise, such as an increased risk of investor claims, dissemination of proprietary information more broadly than the issuer desires or the possible failure to qualify for a private placement exemption (or increased exposure to securities regulation and oversight) in another country where it is also seeking to raise capital.

In addition, we note that the amended rules only impact offerings conducted in accordance with Rule 506(c) and 144A. Even after the effective date of the rules, an issuer relying on the Section 4(a)(2) exemption for transactions not involving a public offering that is conducting a securities offering that does not fall within the Rule 506(c) safe harbor will still be restricted in its ability to make general solicitations or advertisements.

PRIVATE FUNDS

The SEC reconfirmed in the adopting release that the amendments to Rule 506 will permit private funds (including hedge funds, venture capital funds and private equity funds that typically rely on Rule 506 to offer and sell their interests) to engage in offerings using general solicitation in accordance with Rule 506(c) without becoming subject to regulation under the Investment Company Act of 1940. Private funds generally rely on the exclusions from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, which exclude issuers making or proposing to make a public offering. The SEC stated that general solicitation or general advertising will not be deemed a public offering for purposes of these exemptions.

For private fund sponsors that have registered with the CFTC and rely on CFTC Rule 4.7 or CFTC Rule 4.13(a)(3), the CFTC has not provided guidance as to whether permitted general solicitation under Rule 506(c) will be deemed to be "marketing to the public," which is currently prohibited under these CFTC rules. Absent future guidance from the CFTC, fund sponsors relying on these CFTC rules may not be able to use general solicitation under Rule 506(c).

SEC Monitoring; Proposed Amendments to Rule 156

In response to commenters' concerns that private funds engaging in general solicitation may raise investor protection concerns, the SEC indicated that it will be monitoring developments in private fund advertising and related activities of investment advisors. The SEC highlighted in the final rules release that antifraud provisions of the federal securities laws continue to apply and that the SEC may bring enforcement action in connection with private fund offerings. Perhaps to emphasize this point, in connection with the SEC's proposed rulemaking discussed below, the SEC also proposed amendments to Rule 156 under the Securities Act which would extend the antifraud provisions relating to sales literature used by registered investment companies to the sales literature used by private funds. Rule 156 sets forth certain factors that should be taken into account in assessing whether sales literature could be misleading for purposes of the anti-fraud provisions of the Securities Act and Securities Exchange Act of 1934 (for example, representations about past or future investment performance of an investment company that could be misleading because the disclosure implies that future gain or income may be inferred from or predicted based on past investment performance).

While the general solicitation rule was the impetus for proposing to expand the scope of Rule 156, the SEC noted that the proposed amendments to Rule 156 would apply to all private funds – not just those engaged in general solicitation activity under Rule 506(c). Moreover, the SEC noted that it was of the view "that private funds should now be considering the principles underlying Rule 156 to avoid making fraudulent statements in their sales literature." Thus, private fund sponsors should assess their marketing materials to assure that factors set forth in Rule 156 have been addressed.

BAD ACTORS EXCLUDED FROM RULE 506 OFFERINGS

In connection with lifting the ban on general solicitations, the SEC adopted rules mandated by Dodd-Frank and initially proposed in May 2011 that prohibit the use of the Rule 506 exemption for securities offerings in which certain felons and other "bad actors" are involved. Under the final rules, an issuer may not rely on Rule 506 if the issuer or related

parties including, among others, its directors, certain officers, affiliated issuers and control persons (including general partners, managing members and greater than 20% beneficial owners), have been the subject of any of the enumerated disqualifying events. These events include certain criminal convictions, court injunctions and restraining orders, orders of the CFTC and other state and federal (but not foreign) agencies and regulatory bodies based on fraudulent, manipulative or deceptive conduct and scienter-based SEC cease-and-desist orders.

PROPOSED RULE MAKING

The SEC has proposed several changes to Regulation D, Form D and, as discussed above, Rule 156, intended to enable the SEC to monitor the use of and activities associated with amended Rule 506. These proposals, which aroused a certain amount of controversy among the Commissioners, are now subject to a 60-day comment period.

Among other things, the proposed rules would require issuers relying on Rule 506(c) to engage in general solicitation to:

- file a Form D not later than 15 calendar days before commencing the general solicitation and to update the Form D information within 30 days of completing the offering (under current rules, issuers must only file a Form D within 15 calendar days of the first sale under the offering);
- provide additional information on Form D, including: expanded issuer information; the name and address of any person who directly or indirectly controls the issuer (as well as 10% equity owners that are not otherwise control persons); identification of the issuer's website; information with respect to the securities offered, types of investors and the use of proceeds of the offering; information on the types of general solicitation used; and the methods used to verify accredited investor status;
- include certain legends and disclosure in written general solicitation materials, including, with respect to performance data included in such materials by private funds, the period for which performance is presented and the fees and expenses reflected in such performance data to the extent not deducted;
- submit written general solicitation materials to the SEC no later than the date of first use (although such materials would not be available to the general public and this rule requirement would be temporary and expire after two years); and
- for private funds, present any performance data included in written general solicitation materials as of the most recent practicable date considering the type of private fund and the media through which the data will be conveyed.

To address concerns that many issuers currently do not file a Form D in connection with Rule 506 offerings, the proposed rules would disqualify issuers from engaging in Rule 506 offerings for a period of one year, commencing once the required filings are made, for failure to comply in a timely manner with the Form D filing requirements of Rule 503 in connection with an offering under Rule 506. Only events that occur after the effective date of the rule amendment will trigger a disqualification. However, certain disclosures may be required with respect to pre-effective date disciplinary events.

In the proposing release, the SEC also requested comment on a wide range of matters that could have a significant impact on the utility of amended Rule 506(c) and the ability to raise capital in Regulation D offerings generally, including (i) whether content restrictions should apply to performance advertising by private funds, (ii) whether the use of performance claims by a private fund as part of a general solicitation be conditioned on a requirement that the private fund be subject to an audit by an independent accountant and (iii) the definition of accredited investor.

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Please do not hesitate to contact us with any questions.

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