



Risk Management Update July 2013

GENERAL SOLICITATION OF PRIVATE FUNDS – IT HAS FINALLY ARRIVED

Earlier this month, the Securities and Exchange Commission (“SEC”) adopted the long awaited amendments to Rule 506 of Regulation D and Rule 144A of the Securities Act of 1933 (“Securities Act”) that carry out the mandates of Section 201(a) of the Jumpstart Our Business Startups Act (“JOBS Act”), allowing issuers of private offerings to engage in certain general solicitation and advertising activities (“General Solicitation Rule”).¹

Simultaneous to this adoption, the SEC finalized a “disqualification” rule² and additionally proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act of 1933 (“Securities Act”).³ In a statement delivered at the SEC Open Meeting on July 10th, SEC Chairman Mary Jo White expressed the following:

“Taken together, these measures will, in my view, carry out the Congressional objective to permit general solicitation while at the same time prohibit the participation of bad actors and ensure that we have the information necessary to effectively monitor the market and adequately protect investors.”

Importantly, while the General Solicitation and disqualification rules are final, they do not become effective until 60 days from the date of publication in the federal register, which is anticipated to be in mid-September 2013. Until such time, private offerings relying on Rule 506 or Rule 144A cannot be marketed to the general public.

This Risk Management Update specifically focuses on how these newly adopted rules will affect private funds relying on Rule 506 under Reg. D and provides practical guidance and compliance tips for private fund issuers and advisers to consider prior to “going public.”

New Rule 506(c) – Allowing For General Solicitation

The General Solicitation Rule implements “Rule 506(c)”, which is a new exemption under Rule 506 of Regulation D. This exemption allows for the distribution of public communications regarding a private offering⁴ that relies upon the safe harbor protections of Rule 506 under Section 4(a)(2) of the Securities Act, so long as:

- 1) all terms and conditions of Rules 501, 502(a), and 502(d) of Regulation D are met;

¹ See SEC Release No. 33-9415 (Jul. 10, 2013), available at <http://www.sec.gov/rules/final/2013/33-9415.pdf>.

² See SEC Release No. 33-9414 (Jul. 10, 2013), available at <http://www.sec.gov/rules/final/2013/33-9414.pdf>.

³ See SEC Release No. 33-9416 (Jul. 10, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>.

⁴ The SEC confirmed in its Release that private funds relying on either Section 3(c)(1) or Section 3(c)(7) exclusions under the Investment Company Act are permitted to make offers and sales under the new Rule 506(c) exemption.

- 2) all purchasers meet the accredited investor definition⁵; and
- 3) the issuer takes reasonable steps to verify that investors do meet the definition.

Not surprisingly, while these steps may appear rather easy, there are a number of factors to consider and requirements to follow prior to and after claiming a Rule 506(c) exemption. For example, under current Rule 506 offerings, an issuer is only required to have a *reasonable belief* that a purchaser meets the accredited investor definition. When claiming the new Rule 506(c) exemption, the issuer must take reasonable steps (discussed further below) to verify that all investors meet such definition.⁶

Additionally, as part of the General Solicitation Rule, the SEC amended Form D, which provides certain notice-type information that is filed electronically by an issuer of a private offering relying on an exemption under Reg. D.⁷ The revisions to Form D change the current Rule 506 box in Item 6 to read “Rule 506(b)” and add a new “Rule 506(c)” box, which must be checked by issuers that will be relying on the new general solicitation exemption. Notably, the proposed amendments to Regulation D issued by the SEC at the same time as the adoption of the General Solicitation Rule propose to change the timing of the initial filing of Form D to at least 15 calendar days *before* engaging in any general solicitation activity for that private fund. Currently, the Form D must be filed initially within 15 days *after* the first sale of securities in the offering.⁸

Now, let’s take a look at the requirements that must be adhered to in order to satisfy the exemptions in Rule 506(c), and its differentiation from the current Rule 506(b) requirements.

Requirement #1-Adhering to Rule 501, Rule 502(a) and Rule 502(d): Rule 506(b) offerings must adhere to the mandates of Rules 501 and 502 of the Securities Act. Consequently, pursuant to Rule 506(c), offerings will NOT be subject to:

- Rule 502(b) because all purchasers in new Rule 506(c) offerings must be accredited investors; and
- Rule 502(c) because it prohibits general solicitation and advertising of Reg. D offerings.

Summarily, Rule 501 contains the definitions of all the terms used in Reg. D, and more specifically, the definition of accredited investor. Rule 502(a) generally provides a six (6) month safe harbor pertaining to integration for successive Reg. D offerings, and Rule 502(d) gives securities sold under a Reg. D exemption (with certain exceptions) the status of being acquired under Section 4(a)(2) of the Securities Act (exempts registration of securities not involved in public offerings).

⁵ See § 230.501(a) of the Securities Act, available at <http://www.sec.gov/answers/accred.htm>.

⁶ The General Solicitation Rule specifically preserves the right for issuers to rely (or continue to rely) on the current Rule 506 exemption, which has been renumbered to Rule 506(b).

⁷ See <http://www.sec.gov/answers/formd.htm>.

⁸ For additional current requirements regarding Form D filings, see <http://www.sec.gov/info/smallbus/secg/formdguide.htm>.

Requirement #2 – Purchasers must meet the accredited investor definition: A private fund relying on Rule 506(c) can only have accredited investors (as such term is defined in Rule 501(a) of the Securities Act) in the fund. If the issuer chooses to continue to rely, or in the case of a new offering, elect to rely on Rule 506(b), then the private fund can have up to 35 non-accredited investors. An issuer of a private fund currently relying on Rule 506(b) can elect to continue the offering of the private fund under Rule 506(c) so long as it then meets the three (3) requirements of Rule 506(c)⁹. However, an issuer cannot retroactively rely on Rule 506(c) if general solicitation was inadvertently used prior to the reliance on Rule 506(c).

Requirement #3 – Taking reasonable steps to verify accredited investor status: As mentioned above, under Rule 506(b), an issuer only needs to have a reasonable belief that an investor is accredited. For new Rule 506(c) offerings, the issuer must take “reasonable steps” to verify that each purchaser meets the definition of accredited investor enumerated under Rule 501(a). As typical with the SEC, whether or not the issuer took reasonable steps is going to be based on the facts and circumstances of each purchase.¹⁰

In the rule release, the SEC provides a few examples of verification considerations (mainly principals based) and specifically states that they would not believe that an issuer had taken reasonable verification steps if they only required the purchaser to check a box in a questionnaire or sign a form and did not have any backup documentation to help substantiate the declaration of the purchaser. Importantly, Rule 506(c) contains four non-exclusive verification methods covering natural persons, that if used, the issuer would be deemed to have met the verification requirements of the rule. This includes:

- 1) Reviewing copies of tax returns or other IRS forms that include income;
- 2) Obtaining documentation of purchaser’s net worth;
- 3) Receiving written confirmation from a broker-dealer, SEC registered investment adviser, attorney, or CPA; or
- 4) For Rule 506(b) offerings that are switching to Rule 506(c), obtaining a written certification from each accredited investor at the time of purchase.

Issuers will be responsible for documenting their verification process and maintaining the documents collected, as they carry the burden of proof of adherence to the verification requirement.

⁹ The SEC clarified in the General Solicitation Rule release that “If an issuer chooses to continue the offering in accordance with requirements of Rule 506(c), any general solicitation that occurs after the effective date will not affect the exempt status of offers and sales of securities that occurred prior to the effective date in reliance on Rule 506(b).”

¹⁰ Without taking these steps, the SEC noted that the Rule 506(c) safe harbor would not be available “unless the issuer has actual knowledge that the purchaser meets one or more of the Rule 501 enumerated categories.”

Summary of New Disqualification Rule

This new rule prohibits an issuer from relying on a Rule 506 exemption if the issuer or any “covered person” had a “disqualifying event” (both terms are defined in the rule) that happened after the rule takes effect. However, any disqualifying event that occurred before the effective date must be disclosed to investors. Please note that the term “covered person” includes third party solicitors.

Practical Tips for Private Fund Issuers and Advisers That Will Rely on Rule 506(c)

1. Train employees on the new Rule 506(c) requirements, especially marketing and sales personnel.
2. Adopt written policies and procedures regarding general solicitation and verification requirements.
3. Implement internal controls to help ensure verification documentation containing non-public information is maintained in a secure location in accordance with the firm’s privacy and safeguarding steps.
4. Review procedures and processes at least annually to determine continued compliance with requirements of Rule 506(c).

Conclusion

Prior to taking the final step into the world of general solicitation, be sure to determine if the state you will be marketing in has issued any regulations that may be applicable and be sure to take appropriate steps to pre-qualify, as needed, those you intend to solicit.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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