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Implications of Revisions to Regulation D for Private Fund Advisers

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On July 10, 2013, the Securities and Exchange Commission ("SEC") adopted final rules to implement Section 201(a) of the Jumpstart Our Business Startups Act ("JOBS Act"). The SEC's new Rule 506(c) permits the use of general solicitation and general advertising (together, "general solicitation") in offers and sales of securities under Rule 506 of Regulation D. The new rule requires that all purchasers of securities be accredited investors and that the issuer take reasonable steps to verify that purchasers are accredited investors.[1] In addition to adopting Rule 506(c), the SEC adopted Rule 506(d) to disqualify felons and other "bad actors" from participating in Rule 506 offerings. The new rules take effect 60 days after publication in the Federal Register.

The SEC also proposed amendments to Regulation D, Form D, and Rule 156 of the Securities Act of 1933 ("Securities Act"), which are designed to expand the information requirements for Form D. The proposed amendments would require filing Form D prior to the beginning of any general solicitation under new Rule 506(c), as well as filing an amendment to the previously filed Form D after the final closing. Notably, the proposed rules would disqualify an issuer from using Rule 506 for a year for failure to comply with Form D filing requirements. Under the proposed revisions, issuers would be required to include legends in their general solicitation materials that would inform investors of certain risks. The SEC also proposed a temporary rule that would require issuers to provide general

solicitation materials to the SEC. Finally, the SEC proposed to amend Rule 156 to apply the Rule's anti-fraud guidance to sales literature used by private funds relying on new Rule 506(c).

This client alert focuses on the implications of the SEC's actions for fund advisers—for a general discussion on the SEC's action regarding Regulation D and Rule 144A, please see O'Melveny's client alert entitled SEC Adopts Revisions to Regulation D and Rule 144A Allowing for General Solicitation and General Advertisement.

Adoption of Rule 506(c)

Rule 506 provides an exemption from registration under the Securities Act subject to a number of requirements. Pursuant to Rule 506(b), an issuer may sell securities to an unlimited number of "accredited investors," and no more than 35 non-accredited investors,[2] without any limitation on the offering amount, provided that the securities are not offered or sold through any form of general solicitation.[3] Most private fund offerings in the United States are made pursuant to Rule 506(b). New Rule 506(c) will permit private funds to claim an exemption from registration while marketing their securities via general solicitation, provided that: (1) the issuer takes "reasonable steps" to verify that investors are accredited investors; (2) all purchasers of securities are accredited investors; and (3) Rules 501, 502(a) and 502(d) are satisfied. Below are issues that private fund advisers may want to consider in connection with private fund offerings under Rule 506(c).

Reasonable Steps to Verify Accredited Investor Status

To take advantage of Rule 506(c), private fund advisers must consider which verification steps might be reasonable to establish accredited investor status using the SEC's principle based guidance for evaluating individual facts and circumstances and the non exhaustive list of verification methods in Rule 506(c). The guidance provides for consideration of the nature of the purchaser the amount and type of information that the issuer has about the purchaser, and the nature of the offering. The non-exhaustive list in Rule 506(c) includes methods based on reviewing income and net worth-related information for natural person investors, as well as reliance on limited third-party confirmation methods. Of note, there is also a grandfather provision for a natural person accredited investor who invested in a private fund prior to the effective date of Rule 506(c) and remains an investor. An issuer is deemed to satisfy the verification requirement in Rule 506(c) with respect to any such investor simply by obtaining a certification by the investor at the time of the sale in the Rule 506(c) offering that he or she qualifies as an accredited investor.

Fund advisers should review their subscription agreements and current procedures related to assessing the status of an investor. They might consider developing and implementing a policy of providing prospective purchasers with a questionnaire based on the non exclusive factors or a combination of the principle-based guidance. However, the SEC specifically

stated that an issuer will not have taken reasonable steps to verify accredited investor status if it required only that an investor check a box in a questionnaire or sign a form without gathering other information about the investor indicating accredited investor status.[5] Generally, the SEC indicated in the adopting release that the more information an issuer has suggesting that a potential investor is accredited, the less effort must be expended on verification. It also stated that if an issuer has actual knowledge that the purchaser is accredited, the issuer will not have to take any steps at all.

Documentation of Reasonable Steps

In the adopting release, the SEC reminded issuers to maintain records that adequately document the verification steps taken, because the burden is on the issuers to demonstrate they were entitled to rely on the exemption with respect to a particular offering. This is particularly important given the "reasonable belief" standard in Rule 501(a), which the SEC affirmed would apply to offerings pursuant to Rule 506(c). Should information following an investor's participation indicate such investor was not an accredited investor, the fund must be able to demonstrate through its records that it had a reasonable belief that, based on the verification steps taken by the fund, the purchaser had accredited investor status at the time of the sale. The SEC stated that, under these circumstances, the issuer would not lose its ability to rely on the exemption in Rule 506(c). On the other hand, if an issuer or its agent had actual knowledge that the purchaser was not an accredited investor, the non-exclusive methods of verification would not provide protection from failure to satisfy the rule.

Change to Form D

Under current Rule 503 of Regulation D, an issuer conducting an offering pursuant to Regulation D must file a Form D for each new offering of securities no later than 15 calendar days after the first sale of securities in such offering. Rule 506(c) revises Form D by adding a box that must be checked if an issuer is claiming the new Rule 506(c) exemption. It should be noted that filers will not be able to check both the Rule 506(c) and the Rule 506(b) boxes at the same time for the same offering. Accordingly, private funds must determine prior to an offering whether they are engaging in general solicitation. In addition to the foregoing, the SEC proposed other revisions to Form D, which are discussed below.

Impact of Proposed Rule 506(c) on Exclusions in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act

Privately offered funds generally rely on one of two exclusions from the definition of "investment company" under the Investment Company Act—Sections 3(c)(1) and 3(c)(7). A fund may rely on one of these exclusions only if it does not make or propose to make a public offering of its securities. The SEC has traditionally viewed offerings pursuant to existing Rule 506 as non-public offerings for purposes of the exclusions in Sections 3(c)(1) and 3(c)(7). While Section 201(a) of the JOBS Act did not

reference privately offered funds, Section 201(b) expressly provides that offerings pursuant to Rule 506(c) would not be deemed to be public offerings with respect to federal securities law, even though the issuer engages in general solicitation. In the adopting release, the SEC indicated that this provision effectively permits funds to conduct general solicitations in connection with an offering under Rule 506(c) without losing the exclusions available in Sections 3(c)(1) and 3(c)(7).

Implications Regarding Advertising Content and Disclosure

Rule 506(c) enables fund advisers to communicate information about fund offerings on publicly-available websites and issue press releases during fundraising. The SEC did not address the content of fund advertisements in the adopting release outside of a reminder that private fund advisers are subject to the anti-fraud provisions in Rule 206(4)-8 of the Investment Advisers Act of 1940 ("Advisers Act"), which extend to an adviser's relationship with the investors in a private fund.[6] Advisers should be mindful that the advertising limitations in Rule 206(4)-1 of the Advisers Act of 1940 on the use of past performance or testimonials in fund advertisements remain in place, too. Fund advisers registered as broker-dealers, or those that use broker-dealers to help solicit fund investors, should be cognizant of FINRA regulations on communications with the public and private fund marketing materials. In addition, such advisers may want to identify in Form PF and their Supplemental Brochure to SEC Form ADV that the private funds they advise engage in Rule 506(c) offerings to identify that they conduct general solicitation and advertising with respect to fund offerings.

Implications for Non-U.S. Fund Advisers and Regarding Solicitation in Foreign Jurisdictions

Non-U.S. fund advisers seeking to rely on the foreign private adviser exemption SEC registration should consider the impact that general solicitation activities in the United States may have on their U.S. regulatory obligations. In particular, general solicitation may impact the ability of non-U.S. advisers to rely on an exemption from registration in the U.S. as an investment adviser. The foreign private adviser exemption, among other things, prohibits non-U.S. advisers from generally holding themselves out to the public in the U.S. as investment advisers. General fund solicitation to U.S. investors, depending upon the nature and content, could cause a private fund adviser to "hold itself out to the public" in a manner inconsistent with the registration exemption. As such, private fund advisers seeking to rely on the foreign private adviser exemption would need to carefully consider their activities, and any representations regarding their activities, with respect to any offering made in reliance upon Rule 506(c).

Fund advisers should also be mindful of general solicitation activities in foreign jurisdictions. Each foreign jurisdiction has its own marketing requirements and limitations. If fund advisers begin making Rule 506(c) offerings, they should exercise diligence and determine whether their

general solicitation activities affect their offering activities in other jurisdictions.

Availability of Existing Rule 506, Section 4(a)(2) and Regulation S

Private funds still have the ability to engage in non-public offerings pursuant to Rule 506(b). In its adopting release, the SEC preserved Rule 506(b), which permits issuers to offer and sell securities to a limited number of sophisticated non-accredited investors and an unlimited number of accredited investors, provided such issuers do not undertake general solicitation activities. Once a general solicitation has been made to investors, however, an issuer is precluded from relying on Rule 506(b). Private fund advisers that are concerned about the impact of general solicitation on the regulatory status of their fund's offering in the United States can continue to engage in exempt offerings of securities to U.S. investors. For an ongoing offering under Rule 506 that commenced before the effective date of Rule 506(c), issuers may choose to continue the offering after the effective date in accordance with the requirements of either Rule 506(b) or Rule 506(c). If an issuer chooses to continue the offering in accordance with the 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).

In determining whether to conduct an offering pursuant to Rule 506(c), private fund advisers should be mindful of the relationship between Rule 506(c) and Section 4(a)(2) of the Securities Act. In the adopting release, the SEC specifically stated that the revisions to Regulation D affect only Rule 506 and not Section 4(a)(2) offerings generally. In other words, Section 4(a)(2), which exempts private offerings from the registration requirements of the Securities Act, will not be available for a failed Rule 506(c) offering because an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption cannot engage in public communications to solicit investors. Private fund advisers may have to revise their private placement memorandums to disclose their selection of either Regulation D or Section 4(a)(2) as the basis for the exemption, depending on the solicitation and advertising approach taken.

Fund advisers will also retain the availability of Regulation S. Regulation S provides a safe harbor for offers and sales of securities outside of the United States, and includes both an issuer and a resale safe harbor. To comply with the safe harbor, securities must be sold in an offshore transaction, and there can be no "directed selling efforts" in the United States. Fund advisers, therefore, frequently make concurrent unregistered offerings inside and outside the United States based on Rule 506 and Regulation S, respectively. In the SEC's adopting release, it reaffirmed its position that concurrent offshore offerings conducted in compliance with Regulation S will not be integrated with domestic unregistered offerings that are conducted in accordance with Rule 506, as amended.

Securities issued in Rule 506(c) offerings will be deemed "covered securities" for purposes of the Securities Act, meaning that state "blue sky" registration requirements will not apply to securities offered in Rule 506(c) offerings.

Implications for Commodity Pool Operators

Private fund sponsors should be aware of potential outstanding issues with respect to commodity pool operators ("CPO"), which are subject to registration with the Commodity Futures Trading Commission ("CFTC"). For example, certain exemptions from CPO registration provided in CFTC Rule 4.13 are available only if the commodity pools are not marketed to the public.[8] Consequently, a private fund that invests in securities and commodities and conducts general solicitation pursuant to the Rule 506(c) safe harbor from registration may be ineligible for exemptive relief with the CFTC. The CFTC is aware of this issue and a solution is said to be forthcoming.

Adoption of Bad Actor Rules

The SEC also acted to fulfill its obligation under Section 962 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to prevent felons and other "bad actors" from being involved in Rule 506 offerings by amending Rules 501 and 506 of Regulation D, and Form D ("Bad Actor Rules"). Under the Bad Actor Rules, the following are covered persons:

- the issuer (i.e., the fund), its predecessors and affiliate issuers;
- any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of any such investment manager