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Implications of the SEC's Proposed Revisions to Regulation D for Fund Advisers

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On August 29, 2012, the Securities and Exchange Commission ("SEC") proposed revisions to Rule 506 of Regulation D to implement Section 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act"). The proposed Rule would permit general solicitation and general advertising in offers and sales of securities pursuant to the exemption in new Rule 506(c) whereby the issuer takes reasonable steps to verify that all purchasers of the securities are accredited investors.[1]

While the proposed rule requires issuers to take "reasonable steps" to verify investors qualify as accredited investors, it does not define reasonable. The SEC noted in the proposing release that whether or not steps taken are reasonable will be facts and circumstances-based. However, the SEC enumerated the following non-exhaustive factors issuers should consider when determining the reasonableness of the steps taken to verify accredited investor status: (1) the nature of the purchaser and the type of accredited investor the purchaser claims to be; (2) the amount and type of information the issuer obtains regarding the purchaser; (3) the nature of the offering; and (4) the terms of the offering.

New Rule 506(c) would have several implications for private fund advisers. Below are issues such advisers may want to consider in connection with private fund offerings under the new Rule.

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 new Rule 506 would not be deemed to be public offerings solely because the issuer engages in general solicitation and advertising. In the proposing release, the SEC indicated that this provision effectively permits funds to make a general solicitation in connection with an offering under new Rule 506(c) without losing the exclusions available in Sections 3(c)(1) and 3(c)(7).

Implications for Fund Advisers Generally

Proposed new Rule 506(c) would enable fund advisers to communicate information about fund offerings on publicly available websites and issue press releases during the fundraising provided that reasonable steps are taken to verify that purchasers in the offering are accredited investors. Advisers to funds that rely on new Rule 506(c) should revise their policies and procedures to include offerings under the new Rule and funds' general solicitation and advertising activities. 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. The SEC did not address the content of fund advertisements in the release so advisers should be mindful that the limitations on use of past performance or testimonials in fund advertisements remain in place. Finally, fund advisers registered as broker-dealers, or that use broker-dealers to help solicit fund investors, should be cognizant of SRO regulations. In particular, broker-dealers who solicit on behalf of fund advisers will continue to be subject to the communication and advertisement rules of FINRA (*e.g.*, FINRA Rule 2210 regarding communications with the public).

Implications for Non-U.S. Fund Advisers

Non-U.S. fund advisers that seek to rely on the foreign private adviser exemption from the Investment Advisers Act should consider the impact that general solicitation and advertising 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 Investment Advisers Act provides that non-U.S. advisers that satisfy certain criteria may be exempt from SEC-registration as an investment adviser. This 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 and advertising to U.S. investors, depending upon the nature and content, could cause an adviser to private funds 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 new Rule 506(c).

Existing Rule 506 and Section 4(a)(2) Exemptions Would Still Be Available

Private funds managed by advisers seeking to rely on the foreign private adviser exemption, as well as other private fund advisers, would still have the ability to engage in non-public offerings pursuant to existing Rule 506. In its proposal, the SEC preserves as proposed Rule 506(b) the existing Rule 506 that permits issuers to offer and sell securities to a limited number of sophisticated non-accredited investors and an unlimited number of accredited investors provided it does not undertake general advertising or solicitation activities. Private fund advisers that are concerned about the impact of general solicitation and advertising on their regulatory status in the United States could therefore continue to engage in exempt offerings of securities to U.S. investors.

Private fund advisers would also still have the ability to engage in offerings pursuant to Section 4(a)(2) of the Securities Act. In its proposal, the SEC specifically mentioned that the proposed revisions to Regulation D affect only the Rule 506 safe harbor and not Section 4(a)(2) offerings, which permit non-public offerings to be exempt transactions. With the proposed revision, however, private fund advisers potentially will 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.

Reasonable Steps to Verify Investor Status

Private fund advisers should consider what verification steps might be reasonable to establish accredited investor status given the facts and circumstances.[2] In most cases, standard representations in subscription agreements should satisfy the proposed requirement. Even so, fund advisers might consider developing and implementing a policy of providing prospective purchasers with a questionnaire based on the non-exclusive factors mentioned in the SEC's release. The SEC specifically stated that solely checking a box or signing a form that represents an investor is accredited would not be sufficient. Generally, the SEC has indicated in the release that the more information an issuer has suggesting a potential investor is accredited, the less effort that must be expended on verification.

Documentation of Reasonable Steps

In the proposing release, the SEC reminded issuers to maintain records adequately documenting the verification steps taken because the burden is on 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 new Rule 506(c). Should information following a purchaser's investment indicate that the purchaser was not, in fact, an accredited investor, the fund would want to be able to demonstrate through its records that it had a reasonable belief the purchaser had accredited investor status at the time of the purchase based on the verification steps taken by the fund. The SEC stated that, under these circumstances, the issuer would not lose its ability to rely on the exemption in proposed Rule 506(c).

Changes to Form D

Form D is the notice to the SEC of an offering of securities made without registration in reliance upon on exemption provided by Regulation D. Form D must be filed for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering. The proposal will revise Form D by adding a box that must be checked if an issuer is claiming the new Rule 506(c) exemption.

Implications for Commodity Pool Operators

Private funds should be aware of potential outstanding issues with respect to commodity pool operators who are subject to registration with the Commodity Futures Trading Commission ("CFTC"). Certain exemptions from registration and registration requirements included in CFTC Rules 4.7 and 4.13 are available only if the commodity pools are not marketed to the public. Consequently, a private fund that invests in securities and commodities and that conducts general solicitation and advertising pursuant to the new Rule 506(c) exemption from registration may be ineligible for exemptive relief with the CFTC.

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O'Melveny & Myers is available to advise funds and fund advisers on the JOBS Act and proposed rules to implement it. For questions, please contact the attorneys listed above or any other O'Melveny & Myers attorneys with whom you ordinarily work on related matters.

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[1] To rely on the proposed Rule, issuers would still be required to satisfy the terms and conditions of Rule 501 and 502(a) and (d).
[2] The SEC did not address the issue of whether "knowledgeable employees" of an adviser who invest in a private fund pursuant to Rule 3c-5 of the Investment Company Act must qualify as accredited investors for the fund to use general solicitation or advertising.

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