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Considerations For Private Funds After Lift Of Ad Ban

Law360, New York (July 11, 2013, 4:15 PM ET) -- At an open meeting held on July 10, 2013, the U.S. Securities and Exchange Commission voted to adopt a previously proposed rule that will lift the ban on general solicitation in certain types of private securities offerings, including many offerings of interests in venture capital, private equity, real estate, hedge and other types of private investment funds.

For many private fund managers, the new rule will substantially increase the scope of permitted fundraising activities. Even for those fund managers that do not intend to conduct a general solicitation in connection with their fundraising activities, the new rule may reduce the risks associated with inadvertent "foot faults" under prior rules. It is expected that the new rule will materially change the fundraising landscape for the private fund industry, and particularly will facilitate use of the Internet and traditional press as means to communicate information about offerings of fund interests.

The SEC also voted to (1) adopt rules that prohibit private placements by certain "bad actors" and (2) propose for public comment a variety of rules that would seek to limit opportunities for abuse of the new rule and enhance the ability of SEC staff to monitor activities pursuant to, and compliance with, the new rule.

This article describes the new rule and certain related issues, but does not discuss the "bad actor" prohibition or the additional rules.

Background

The Jumpstart Our Business Startups Act was signed by President Obama on April 5, 2012. Among other things, it directs the SEC to eliminate the prohibition against general solicitation and general advertising in private securities offerings conducted pursuant to Rule 506 of Regulation D or Rule 144A under the Securities Act of 1933).

General solicitation has never been precisely defined for purposes of the Securities Act, although various forms of guidance indicate that it includes advertisements published in newspapers and magazines, communications over broadcast television and radio, seminars whose attendees have been invited by general solicitation and communications via unrestricted websites. Other potential forms of general solicitation include press interviews and email marketing campaigns.

The JOBS Act directed the SEC to issue final rules eliminating the prohibition against general solicitation within 90 days after enactment of the JOBS Act (i.e., by July 4, 2012). The SEC issued proposed rules on

Aug. 29, 2012. The proposed rule generated significant controversy, particularly expressed as concern that eliminating the prohibition against general solicitation will lead to increased fraud against investors.

The new rule is substantially identical to the proposed rule, except as described below.

The New Rule

Under the new rule (identified as Rule 506(c)), fund managers generally will be permitted to engage in all forms of communication to prospective investors, including forms of communication traditionally viewed as general solicitation. However, to benefit from the new rule, an offer and sale of fund interests must satisfy the following conditions:

1. All investors actually admitted to the fund must qualify as "accredited investors"[1] or the fund manager must reasonably believe that they so qualify; and
2. The fund manager must take reasonable steps to verify the accredited status of each investor actually admitted to the fund.

Under the new rule, whether a fund manager has taken "reasonable steps" to verify the accredited status of each investor will be an objective determination, based on all facts and circumstances, which may include factors such as the nature of the investor, the amount and type of information known by the fund manager concerning the investor and the nature of the offering. In contrast to the proposed rule, the new rule will provide a non-exclusive list of verification methods that will be deemed sufficient. In general, mere self-verification by a prospective investor (e.g., checking a box on a subscription agreement to represent that the investor is accredited) will not be deemed sufficient. We anticipate that a variety of third-party service providers will offer verification services in a rapidly evolving marketplace.

The new rule will not eliminate Rule 506(b), which will remain as an alternative for private placements. Rule 506(b) will continue to include a prohibition against general solicitation, but also will continue to permit the issuance of fund interests to not more than 35 non-accredited investors who meet certain "sophistication" requirements and receive certain information about the offering. Fund managers will be entitled to rely upon Rule 506(b) or the new rule in connection with any particular offering (assuming that the requirements of the applicable rule are satisfied).[2]

The new rule will not eliminate long-standing prohibitions against fraudulent or misleading communications, nor will it eliminate other requirements for private placements (such as those arising under Rules 501 and 502) or specific rules under the Investment Advisers Act and similar laws relating to advertisements by registered investment advisers.

Specific Concerns for Fund Managers

The prohibition against general solicitation in private fund offerings has been in place for decades and has been built into the assumptions and expectations of many different regulatory regimes at state, federal and international levels. It may be many months before the implications of the new rule under other regulatory regimes are identified and addressed.[3]

As part of Rule 506, the new rule will preempt many state securities or "blue sky" laws, including their respective prohibitions on general solicitation. However, many state securities regulators expressed concern about the impact of the proposed rule on investor protections and may seek to address their concerns at the state level, consistent with such preemption. Moreover, alternative state exemptions for private offerings that avoid federal Form D filings (notably, in New York) may be unavailable for offerings that incorporate general solicitation.

Many private fund managers rely upon exemptions from regulation by the Commodities Futures Trading Commission (such as the de minimis exemption available to fund managers with limited trading in commodity interests or the disclosure and reporting exemption for commodity pool operators and commodity trading advisors who deal with certain qualified eligible persons). Absent further guidance from the Commodities Futures Trading Commission, these exemptions may be unavailable to fund managers who conduct general solicitations.

The new rule clearly does not override the private placement regimes of other countries, and it is possible that various types of general solicitation conducted within or from the United States (such as use of unrestricted websites) may be deemed a violation of the private placement rules in another country (at least to the extent that a citizen or resident of such country is actually admitted to a fund).

For many fund managers, the new rule may serve primarily as a "safety net" to limit the potential consequences of inadvertently breaching the prohibition against general solicitation in connection with an offering otherwise intended to comply with Rule 506(b).

The new rule will not be limited to offerings of fund interests. Thus, fund managers should anticipate that portfolio companies may conduct general solicitations as part of their own fundraising efforts.

It is expected that the new rule will greatly facilitate the efforts of some companies to operate Internet "portals" that match private issuers with potential investors.

The new rule will take effect 60 days after publication in the Federal Register.

—By Jonathan Axelrad, Matthew L. Giles and Brynn D. Peltz, Goodwin Procter LLP

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[1] The qualifications for accredited investor status are set forth in Rule 501(a)(1)-(8). In general, an individual may be an accredited investor if such individual has (i) annual income exceeding $200,000 per year (or $300,000 per year collectively with a spouse) or (ii) net worth (individually or collectively with a spouse) in excess of $1 million (disregarding the net value of a primary residence).

[2] The New Rule includes an amendment to Form D, pursuant to which an issuer must indicate via checkbox whether it is relying upon Rule 506(b) or the New Rule, and language in the adopting release indicates that only one of the two possible boxes may be checked at the same time for the same offering. Presumably, if the facts warrant, an amended Form D could be filed, although the adopting release does not provide definitive guidance on this point.

[3] It currently seems clear that reliance on the New Rule will not cause a fund to be deemed an "investment company" under the Investment Company Act of 1940.