Schulte Roth&Zabel

Alert

The SEC's JOBS Act Rulemaking: What It Means for Private Fund Managers

July 24, 2013

The U.S. Securities and Exchange Commission took three significant actions on July 10, 2013:

Final Rules

1. **The SEC approved final rules implementing the Congressional mandate under the Jumpstart Our Business Startups Act (the "JOBS Act") to lift the ban on general solicitation and advertising in private securities offerings made in reliance on Rule 506 or Rule 144A of the Securities Act;[1] and**

2. **The SEC approved final rules disqualifying so-called "bad actors" from Regulation D securities offerings, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2]**

These final rules will be effective 60 days after they are published in the Federal Register.

Allowing for general solicitation in private offerings has the potential to significantly alter capital-raising by private fund managers. The SEC's final rules provide for a strict "opt-in" approach, requiring fund managers to choose — with respect to *each* fund offering — whether to engage in a general solicitation by checking a box on the revised Form D. Managers will only be in a position to opt-in to general solicitation if they take reasonable steps, as required by the final rules, to verify that all investors meet the accredited investor standard. The final rules provide for both a "principles-based" approach to verification — which takes into account the surrounding facts and circumstances, including the nature of the investor and the size of the investment — as well as specific examples of documentation that will provide sufficient verification that individuals meet the accredited investor tests. In addition, managers seeking to use general solicitation in connection with private fund offerings must be in compliance with any other applicable regulatory requirements, including those of foreign countries and of the Commodity Futures Trading Commission.

With this potential liberalization of the offering process comes concerns about the potential for fraud. There are existing anti-fraud rules applicable to private fund marketing materials, and those rules will continue to apply to any marketing materials used as part of a general solicitation. The SEC has stated that OCIE examinations will in particular focus on compliance by managers using general solicitation. The SEC has also proposed new rules to address fraud concerns, including changes to the private offering process that would apply both to funds offered using a general solicitation, as well as to all privately offered funds.

---

[1] "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings."

[2] "Disqualification of Felons and Other 'Bad Actors' from Rule 506 Offerings."

Proposed Rules

3. The SEC proposed for comment rules regarding changes to Form D filing requirements and content and other aspects of private offerings under Rule 506 (the "Proposed Rules").

The Proposed Rules would penalize managers for failing to comply with the Form D filing requirement in an offering under Regulation D by barring them from using Rule 506 for new fund offerings for one year.[3] This proposed bar rule would apply to Form D filings for all Rule 506 offerings, *not just those that use general solicitation*. The Proposed Rules also would make the "sales literature" rule (Rule 156 under the Securities Act), which currently applies to registered investment companies, also applicable to all private funds. Finally, under the Proposed Rules, private funds electing to engage in an offering that utilizes general solicitation or advertising would be required to supply all written general solicitation materials to the SEC (for, at least, an initial two-year period) and to include certain required disclosures and legends in such materials.

The Proposed Rules — which were approved for proposal by a split SEC vote of 3–2 — will be subject to a 60-day comment period commencing on the date of publication in the Federal Register. Because of their breadth and implications for private funds, and because many of the provisions of the Proposed Rules apply to traditional Regulation D offerings as well as the new offerings using general solicitation, these proposals merit a great deal of thought; comments may be prepared and sent to the SEC at any point during the comment period.

I. General Solicitation

A. Removal of the Prohibition on General Solicitation

Rule 502(c) of Regulation D and Rule 144A(d)(1) of the Securities Act contained prohibitions against general solicitation and general advertising for offerings made pursuant to Regulation D and Rule 144A, respectively. As mandated by the JOBS Act, the SEC removed these restrictions, provided that, for Regulation D offerings, the issuer takes "reasonable steps to verify" that the investors are accredited investors.[4] Firms relying on Regulation D and desiring to engage in general solicitation would rely on new Rule 506(c),[5] which includes a new verification requirement. The Proposed Rules contain additional requirements which would also accompany reliance on new Rule 506(c).

---

[3] "Amendments to Regulation D, Form D and Rule 156 under the Securities Act."

[4] Amended Rule 144A retains the "reasonable belief" standard, but without the additional "reasonable steps" verification requirement regarding the qualified institutional buyer status of the investors.

[5] Excerpts of the text of new Rule 506(c) follow:

(c) Conditions to be met in offerings not subject to limitation on manner of offering

(1) General conditions

To qualify for exemption under this section, sales must satisfy all the terms and conditions of §§ 230.501 and 230.502(a) and (d).

(2) Specific conditions

(i) Nature of purchasers. All purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors.

(ii) Verification of accredited investor status. The issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors. The issuer shall be deemed to take reasonable steps to verify if the issuer uses, at its option, one of the following non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such person is not an accredited investor:

(A) In regard to whether the purchaser is an accredited investor on the basis of income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

(B) In regard to whether the purchaser is an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written

1. Verification Requirement

The SEC retained the principles-based approach for the verification process that it articulated in the proposing release.[6] The SEC described these principles as "interconnected and . . . intended to help guide an issuer in assessing the reasonable likelihood that a purchaser is an accredited investor — which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status." The SEC indicated that requiring specified methods of verification is impractical, given the numerous ways in which a purchaser can qualify as an accredited investor and the wide range of verification methods. As part of a principles-based approach, the SEC would expect a firm to look at factors such as:

- The nature of the purchaser;
- The amount of information the firm has about the purchaser; and
- The nature of the offering (e.g., how the individual was solicited and the minimum investment amount).

For example, the SEC indicated that where the minimum subscription requirement is sufficiently high (e.g., requiring a minimum that is higher than the accredited investor net worth standard), the likelihood of that purchaser satisfying the definition may make it reasonable to take fewer verification steps and to simply confirm that the purchaser did not borrow the investment amount.[7] The SEC stated: "[t]he 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."

The SEC also included in the final rule examples of verification steps which could be used to verify that an individual meets the accredited investor test. The list of methods provided in the non-exclusive safe harbor includes: (i) reviewing an investor's tax forms or bank statements and credit reports; (ii) obtaining confirmation from a third party (e.g., broker-dealers,

---

representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:

(1) With respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and

(2) With respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies; or

(C) Obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor:

(1) A registered broker-dealer;

(2) An investment adviser registered with the Securities and Exchange Commission;

(3) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or

(4) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.

(D) In regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of paragraph (c) of this section and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

[6] "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," 77 FR 54464 (Sept. 5, 2012).

[7] On this particular point, the SEC stated: "For example, if the terms of the offering require a high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor may be sufficiently high such that, absent any facts that indicate that the purchaser is not an accredited investor, it may be reasonable for the issuer to take fewer steps to verify or, in certain cases, *no additional steps* to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by a third party." [Emphasis added.]

investment advisers, attorneys, accountants, etc.); or (iii) for additional subscriptions, simple re-confirmation by the investor.

A private fund manager intending to engage in general solicitation should consider what methods it will be using to verify investor status. The methods used should be addressed in the firm's compliance manual (and several service providers have stated that they intend to offer accredited investor verification services). Regardless of the particular procedures adopted, records of the steps taken by the fund manager or a service provider to verify investor status should be maintained and available for examination. The SEC has made clear that it is not enough for the investor to be, in fact, an accredited investor; the issuer must have taken reasonable steps to verify this. (As discussed below, the SEC is also proposing to require that firms specify in their Form D filings which verification methods they are using.)

2. Additional Requirements

The SEC is also requiring firms to specifically indicate on the Form D whether they are relying on Rule 506(c) (allowing general solicitation), or Rule 506(b) (which replaces the current "Rule 506" option and which would be used where there will be no general solicitation), but not both. This is important as fund managers will need to determine at the outset whether they wish to engage in general solicitation and take on the additional requirements, such as the accredited investor verification process (and potentially other additional requirements which the SEC is proposing, as discussed below), or whether they prefer to pursue a traditional offering, without general solicitation and its accompanying requirements. The opt-in/opt-out to the general solicitation option can be done on a fund-by-fund basis. It is also worth noting that fund managers choosing to use Rule 506(c) and engage in general solicitation will no longer be able to accept any non-accredited investors for that offering, unlike Rule 506(b), which still allows up to 35 non-accredited investors. Accordingly, private fund managers will need to identify in advance situations where prospective investors may qualify as "qualified purchasers" under the Investment Company Act but not satisfy the accredited investor test under the Securities Act (e.g., certain "knowledgeable employees").

3. The Transition

For ongoing offerings under Rule 506 that commenced before the effective date of the final rules (i.e., 60 days after they are published in the Federal Register), a fund manager may choose to continue the offering as either a Rule 506(b) or Rule 506(c) offering, despite the offering not previously having been in compliance with Rule 506(c) (e.g., the manager not having taken the new verification steps for existing investors). Fund managers may also choose to continue offering a fund under Rule 506(b) after the effective date and later switch to a Rule 506(c) offering.

The SEC also indicated that it will be closely monitoring the market to see what firms are doing to take advantage of the removal of the general solicitation ban and what steps are being taken to meet the verification requirement. Modifications to the rules in the future may be necessary, depending on what the SEC observes.

Fund managers wishing to engage in general solicitation should still consider the potential reach of their solicitation and advertising efforts. Although the SEC will now permit general solicitation, there are still many foreign restrictions in place which may restrict such activities. The SEC has indicated that securities offered pursuant to a Rule 506(c) offering are deemed to be "covered securities" and therefore state blue sky registration requirements do not apply.

B. General Solicitation Under CFTC Rules

Despite the SEC's removal of the restriction on general solicitation, it is still unclear whether CFTC rules would still restrict fund managers from general solicitation. Both exempt commodity pool operators ("CPOs") relying on the Rule 4.13(a)(3) *de minimis* exemption and registered CPOs relying on the Rule 4.7 exemption face uncertainty absent any further action taken by the CFTC or its staff.

Specifically, Rule 4.13(a)(3) contains a general restriction on marketing to the public as one of the requirements to be able to rely on the exemption. Rule 4.7 is only available if a fund is offered or sold "solely to qualified eligible persons."[8]

II. "Bad Actor" Disqualification

The Dodd-Frank Act mandated that the SEC adopt rules disqualifying securities offerings involving certain felons and "bad actors" from reliance on the Rule 506 private placement safe harbor regime. In adopting the final rule (the "Bad Actor Rule"), the SEC emphasized that adoption of this rule will provide additional investor protection from unscrupulous actors taking advantage of the removal of the ban on general solicitation and advertising.

The Bad Actor Rule mandates the disqualification of the following "covered persons:"

- Executive officers of the issuer and officers who participate in the offering;
- Beneficial owners of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- For investment funds, the fund's investment managers and their principals (including investment managers is an expansion on what was originally proposed by the SEC);[9]
- The issuer and any predecessor of the issuer or any affiliate of the issuer (which could have an impact on portfolio companies that are affiliates of private funds and on private funds that are affiliates of a portfolio company or another fund);
- Any promoter connected with the issuer in any capacity at the time of the sale; and
- Any person who has been or will be paid remuneration for solicitation of purchasers in connection with sales of the securities (and executives of the soliciting entity).

Notably, there is no standard that includes an individual as a covered person on the basis of control alone. In addition, not all officers are considered covered persons.

The Bad Actor Rule covers certain triggering events as disqualifications (unless the SEC or the authority issuing the judgment or order — which can be a state agency or non-U.S. authority — determines that there should not be a Rule 506 disqualification) such as: (i) securities-related felonies or misdemeanors; (ii) covered persons subject to certain orders or judgments of a court or the SEC, or other state or federal agencies;[10] and (iii) covered persons who were expelled from membership with a national securities exchange or association. Although the proposed rule did not do so, the final rule includes SEC cease and desist orders involving scienter-based charges and Section 5 violations to be triggering events.

In an important change from what was proposed, disqualifications will apply only for triggering events that occur after the effective date of the Bad Actor Rule. However, while previous triggering events will not disqualify the offering, they will be subject to mandatory disclosure in connection with any offering under Rule 506.

[8] The MFA submitted a letter to the CFTC in 2012 asking for clarification. See MFA letter "Harmonization of Compliance Obligations and The Jumpstart Our Business Startups Act and CFTC Regulations" (July 17, 2012).

[9] This includes the directors, executive officers, other officers participating in the offering, general partners and managing members.

[10] Specifically, orders, judgments or decrees of any court of competent jurisdiction, entered within five years before any sale in the offering that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice: (i) in connection with the purchase or sale of any security; (ii) involving the making of any false filing with the SEC; or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.

III. Proposed Amendments to Regulation D, Form D and Other Proposed Changes to Implement Investor Protection Concerns

In response to concerns about investor protection expressed in the comments to the proposal to remove the ban on general solicitation and advertising, and to help the SEC monitor how Rule 506(c) offerings affect the marketplace and what verification procedures are being used, the SEC also proposed a number of amendments to Regulation D and Form D to provide additional and more timely information about offerings.

A. Form D Revisions

1. Advance Form D Filings

An "Advance Form D" filing for a Rule 506(c) offering would be required to be made at least 15 days before the issuer engages in general solicitation or general advertising for such offering. Recognizing that the Advance Form D could be problematic in terms of inadvertent missteps in the offering process, the Proposed Rules ask for comments whether an Advance Form D should be permitted to be filed before a specific offering is contemplated.

2. Amendments to Form D Filings

For Rule 506 offerings, amendments would be required to be filed not later than 15 days after the first sale of securities (which is the current timing requirement for Form D and which would remain the standard for Rule 506(b) offerings). Amendment filings (currently required annually and for material changes) continue to be required for all Rule 506 offerings. In addition, for Rule 506(c) offerings as well as 506(b) offerings, which do not involve general solicitation — a closing Form D filing would be required within 30 days after termination of the offering. The amended Form D would require the following additional information for *all* Rule 506 offerings (in addition to the current requirements):

- Website address;
- Industry group affiliation (private funds will now be required to fill out the information fields indicating whether they are a hedge, private equity, venture capital or other investment funds);
- Aggregate net asset value ranges for private funds (although fund managers can request that this information not be made available to the public if they have not otherwise made the information publicly available);
- The number of accredited and non-accredited investors, whether they are natural persons or legal entities, and the amount raised from each category of investors;
- The number of investors who qualified as accredited investors on the basis of income, net worth, status at the fund manager (e.g., director, executive officer or general partner of issuer or its general partner), or other;
- Whether a broker-dealer was used in connection with the offering and whether general solicitation materials were filed with FINRA; and
- Identification of registered investment advisers and exempt reporting advisers who function directly or indirectly as a promoter.

3. Additional Information for Rule 506(c) Offerings

Form Ds filed with respect to Rule 506(c) offering would also be required to:

- Specify the type of general solicitation used (i.e., mass mailings, email, social media, print media etc.);
- Identify individuals who directly or indirectly control the issuer; and
- Provide the methods used to verify accredited investor status.

B. Penalty Provisions

The SEC also proposed to disqualify an issuer from relying on Rule 506 for one year for any future offerings if it did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering.[11] There are however, several mitigating factors. First, the disqualification would not apply to the offering for which the issuer failed to make the required Form D filing (the "Non-Compliant Offering"), or any other offering being conducted simultaneously with the Non-Compliant Offering. Second, this only applies to Form D filings required to be filed after the effective date of a final rule. Third, the SEC is also proposing a limited 30-day "cure period."[12] Finally, the SEC also could waive the disqualification under certain circumstances.[13] Private fund managers should note that this proposed bar on using a Rule 506 offering can be triggered by an affiliated fund having engaged in a Non-Compliant Offering or by a portfolio company affiliated with the fund having engaged in a Non-Compliant Offering.

C. Additional Requirements for Offerings Using General Solicitation

The SEC also proposed additional requirements (in proposed Rule 509) for firms that will engage in general solicitation. However, unlike the new Form D proposed requirements, proposed Rule 509 would only lead to a disqualification from use of Rule 506 if the SEC obtains a court injunction for failure to comply with Rule 509. The proposed Rule 509 requirements include:

1. Submission, on a temporary basis (for two years after the effective date of the new rules), of written general solicitation materials used in Rule 506(c) offerings to the SEC no later than the date of first use (the materials will not be available to the public); and

2. A requirement that written general solicitation materials used in Rule 506(c) offerings (but not Rule 506(b) offerings) include certain prominent legends and other disclosures such as:

    - The offering is restricted to accredited investors;
    - The SEC has not passed upon the merits of or approved the offering;
    - The securities being offered are not subject to the Investment Company Act;
    - Legal restrictions on transfer and resale;
    - The riskiness of the investment; and
    - If performance data is used, the limitations of relying on performance data (this should also include a telephone number or a website where an investor may obtain current performance data). When providing such data, a fund manager would use the most recent performance data based on the last valuation.

The SEC indicated that the precise wording of the legends may vary, but they must be clear and easy to understand. Practically speaking, we note that it may be difficult to include the legends in some general solicitation materials (such as online and social media).

The SEC is also proposing to extend to all private offerings, including those not marketed using general solicitation under Rule 506(c), the anti-fraud guidance regarding "sales literature" contained in Rule 156, which currently only applies to sales literature used by investment companies. This would require managers to review their fund marketing material for consistency with Rule 156. In its release regarding the Proposed

[11] The SEC would not require looking back prior to the effective date of a final rule. The look-back period would only require determining if, during the five-year period *after* the Proposed Rules are effective, there was a failure to file a Form D (or required amendment).

[12] A cure period of 30 days would be available to address inadvertent errors, but would only be available for an issuer's first failure to timely file a Form D or Form D amendment in connection with that offering. For a continuous offering, this cure would have very limited use (as it can only be used once).

[13] Further, the SEC is also considering if there should be a different filing deadline for the Advance Form D where there is an inadvertent general solicitation prior to filing, as well as whether Advance Form D filings should be permitted even if no specific offering is commenced to avoid the issue of inadvertent general solicitations.

Rules, the SEC highlighted concerns about fraud, but did not discuss the existing anti-fraud requirements under the Advisers Act, including the rules governing private fund advertising (Rule 206(4)-1) and communications with investors and prospective investors (Rule 206(4)-8), as well as the existing body of no-action correspondence on these issues.

We will be in further contact with additional developments regarding these important changes.

Authored by Brad L. Caswell, Brian T. Daly, Marc E. Elovitz, Jacob Preiserowicz and Paul N. Roth.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

New York
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC
Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com