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SEC Adopts JOBS Act Rules and Issues Additional Final and Proposed Rules Related to Regulation D Offerings

Investment Management Alert

OVERVIEW

In an open meeting on July 10, 2013, the Securities and Exchange Commission (SEC) issued final and proposed rules relating to offerings exempt from registration under the Securities Act of 1933 (Securities Act). The open meeting was split into three parts:

1. Discussion of final rules required by the Jumpstart Our Business Startups Act (the JOBS Act) eliminating the prohibition on general solicitation and advertising for offerings made under Rule 506 of Regulation D (Reg D) of the Securities Act and Rule 144A of the Securities Act (the Final JOBS Act Rules)[\[1\]](#). The vast majority of the discussion of the Final JOBS Act Rules related to the new Rule 506(c) of Reg D;
2. Discussion of new Rule 506(d) as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to disqualify certain felons and other “bad actors” from making offerings under Rule 506 of Reg D[\[2\]](#); and
3. Discussion of proposed rules amending Reg D, Form D and Securities Act Rule 156 (Rule 156) intended to enhance the SEC’s ability to evaluate issuers’ practices in Rule 506 offerings after the JOBS Act changes are effective (the Proposed Rules)[\[3\]](#).

The Final JOBS Act Rules passed by a vote of 4-1; Rule 506(d) passed by a 5-0 vote and the vote to issue the Proposed Rules passed by a 3-2 vote.

ANALYSIS

Final JOBS Act Rules

Advertising Ban Lifted

The most significant aspect of the July 10 rulemaking is the addition of new section 506(c) of Rule 506 lifting the ban on general solicitation and advertising in private offerings. Hedge funds and other private funds generally rely on the private offering exemption in Rule 506 to sell the interests in the funds. Prior to the enactment of Rule 506(c), the most basic concept of private offerings under Rule 506 had been that the offering must be “private.” General solicitation, including advertising, was not allowed. The general solicitation ban also restricted the ability of private fund managers to discuss their funds in the press or any widely distributed forum including the manager’s website and websites of third parties. New Rule 506(c) lifts the advertising ban for private fund managers willing to comply with its terms.

Specifically, Rule 506(c) provides that the prohibition against general solicitations and advertising (set forth in Rule 502) shall not apply to offers and sales of securities under Rule 506 so long as:

1. The terms of Rule 501[\[4\]](#), Rule 502(a)[\[5\]](#) and Rule 502(d)[\[6\]](#) are satisfied;
2. All purchasers of the securities are accredited investors; and
3. The issuer takes reasonable steps to verify that the purchasers are accredited.

Additional Verification that Investors are Accredited

As noted above, Rule 506(c) requires issuers making a general solicitation in a Rule 506 offering to take reasonable steps to verify that the purchasers are accredited investors. Rule 506(c) adopts a principles-based “facts and circumstances” approach to determine whether reasonable steps were taken to verify that the purchasers are accredited and also adds four non-exclusive “safe harbor” methods for determining that a natural person is accredited[\[7\]](#). The SEC’s release accompanying the rule states that the following factors should be considered under the facts and circumstances analysis:

1. The nature of the purchaser and the type of accredited investor the purchaser claims to be;
2. The amount and type of information that the issuer has about the purchaser; and
3. The nature of the offering (such as the manner in which the purchaser was solicited to participate) and the terms of the offering (such as the minimum investment amount).

The four non-exclusive “safe harbors” for determining that a natural person is accredited are[\[8\]](#):

1. Reviewing copies of IRS forms reporting income – including but not limited to Form W-2, Schedule K-1 and a copy of a filed Form 1040 – for the past two years along with obtaining a written representation from the investor that he or she has a reasonable expectation to reach the accredited investor income level for the current year;
2. Reviewing recent financial documents showing that the investor meets the accredited investor net worth requirement – such as bank statements, brokerage statements, certificates of deposit, tax assessments, and appraisal reports and a credit report (to demonstrate liabilities) – along with obtaining a written representation from the investor that all liabilities have been disclosed;
3. Obtaining a written confirmation from a registered broker-dealer, SEC registered investment adviser, licensed attorney or certified public accountant that such person has determined, using reasonable steps within the last three months, that the investor is accredited; and
4. For any investor who previously invested in an issuer’s Rule 506(b)[9] offering as an accredited investor prior to the effective date of Rule 506(c) and who remains an investor of the issuer, obtaining a certification by such person that he or she qualifies as an accredited investor at the time of the Rule 506(c) sale.

Other Items Addressed in the Final JOBS Act Rules Release

Private Funds. The Final JOBS Act Rules Release specifically addresses the impact of Rule 506(c) on private funds such as hedge funds, private equity funds and venture capital funds and confirms that private funds may rely on new Rule 506(c). Specifically, the release confirms that offers and sales of securities under Rule 506(c) are permitted by private funds relying on the exclusions from the definition of investment company in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the Investment Company Act).[10] The SEC does note in the release that it is mindful of commenters’ concerns regarding investor protection issues arising from private funds using Rule 506(c) and states that it will monitor the development of private fund advertising to determine whether any further action is necessary (see the discussion of the Proposed Rules below for a description of further action the SEC is considering). The release also notes that advisers to private funds remain subject to the antifraud provisions of Rule 206(4)-8 under the Investment Advisers Act of 1940.[11]

Form D Change. Along with enacting Rule 506(c), the SEC revised Form D to add a new field for issuers to indicate whether they are claiming an exemption under Rule 506(c).

Reasons for Pause

While Rule 506(c) opens the door for private fund advertising, each private fund manager will have to consider whether advertising makes sense for its business. Each manager will have to determine if the benefits of advertising and general solicitations outweigh the cost of taking reasonable steps to verify that each investor is accredited and potentially complying with the additional requirements of the Proposed Rule discussed below. Private fund managers should also confirm that their current fund offerings rely on Rule 506 and that new Rule 506(c) makes sense for their investor base.

Additionally, while most private funds rely on Rule 506 of Reg D, a fund may have the fallback option of relying on the statutory exemption in Section 4(a)(2) of the Securities Act (previously Section 4(2)). Section 4(a)(2) exempts from registration “transactions by an issuer not involving any public offering.” Reg D is a set of rules under the Securities Act (including Rule 506) that set forth a safe harbor for complying with Section 4(a)(2). Previously, if a private fund made an offering that failed to meet the requirements of the Rule 506 safe harbor, the fund could potentially still fall back on the statutory exemption in Section 4(a)(2) because there was no public offering of the fund. This remains the case for issuers relying on Rule 506(b). However, if a private fund or other issuer advertises its offering in reliance on new Rule 506(c), the fallback option of Section 4(a)(2) will not be available if the requirements of Rule 506(c) are not met.

Finally, many private fund managers rely on an exclusion from registration as a commodity pool operator (CPO) under Section 4.13(a)(3) of the Part 4 Regulations of the Commodity Futures Trading Commission (CFTC). Section 4.13(a)(3) has its own prohibition on marketing to the public in the United States. However, unlike Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, Section 4.13(a)(3) has never been tied to Rule 506 and is not part of the “other federal securities laws” modified by the JOBS Act. Similarly, many private fund managers are registered as CPOs but operate their private funds that are commodity pools under an exemption in Section 4.7 of the Part 4 Regulations. Section 4.7 exempts a registered CPO from certain disclosure rules and other CFTC requirements. However, Section 4.7 requires that the CPO sell the pool in an offering exempt under Section 4(a)(2) of the Securities Act; a private fund manager who is registered as a CPO would therefore not be able use Rule 506(c) for a fund that is operating under Section 4.7. Industry groups have petitioned the CFTC to amend its Part 4 Regulations for harmonization with the JOBS Act changes, but the CFTC has not yet taken any action on the issue. Barring action by the CFTC, private fund managers relying on Section 4.13(a)(3) or Section 4.7 will likely have to: a) continue to refrain from advertising, b) withdraw the 4.13(a)(3) or 4.7 exemption and comply with the relevant CFTC regulations in order to advertise or c) drop the 4.13(a)(3) or 4.7 exemption and refrain from trading futures in any advertised private funds.

Rule 506(d)

New Rule 506(d), required by Section 926 of Dodd-Frank, disqualifies securities offerings from relying on Rule 506 if any

felons or other bad actors are involved in the offering. The final rule defines several disqualifying events for issuers and covered persons. The final rule also provides an exception from disqualification if an issuer can show that it did not know, and could not have known, that a disqualification existed after conducting a reasonable factual inquiry.

Rule 506(d) will apply only to sales made after its effective date. However, for offerings that are underway when Rule 506(d) becomes effective, Rule 506(d) will apply to sales made after the effective date of the rule.

Along with enacting Rule 506(d), the SEC revised Form D to add a certification by Rule 506 issuers that the offering is not disqualified under Rule 506(d).

The Proposed Rules

The Proposed Rules would make a number of changes to Reg D, Form D and Securities Act Rule 156. The SEC states in its proposing release that the Proposed Rules are intended to enhance its ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to advertise and engage in general solicitations under new Rule 506(c). Specifically, the Proposed Rules would have the following effects if enacted as proposed:

1. Form D would have to be pre-filed in any Rule 506(c) offerings. The pre-filing would have to be made 15 days before the issuer engages in a general solicitation. Currently, issuers are required to file an initial Form D within 15 days after the first sale of a security. Issuers relying on Rule 506(c) would also have to file an amended Form D within 15 days after the first sale of a security. Issuers relying on Rule 506(b) would not be impacted by the new filing requirements and deadlines.
2. Issuers would also have to file a closing amendment to Form D after the termination of any Rule 506 offering. This would apply to all Rule 506 issuers and not just those relying on Rule 506(c).
3. General solicitation materials used in a Rule 506(c) offering would be required to contain certain legends and other disclosures. Private funds making a Rule 506(c) offering would also be required to include a legend disclosing that the securities being offered are not subject the protections of the Investment Company Act. Private funds making a Rule 506(c) offering would also have to make additional disclosures in any written general solicitation materials containing performance information.
4. Issuers would be required to temporarily submit written general solicitation materials used in a Rule 506(c) offering to the SEC. This temporary requirement would apply to all issuers relying on Rule 506(c) and not just to private funds. The Proposed Rules require these submissions for 2 years. Failure to make the required submission of advertising materials would disqualify an issuer from relying on Rule 506 in the future.
5. Issuers would be disqualified from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, failed to comply with the Form D filing requirements of a Rule 506 offering within the past five years. This would apply to all Rule 506 issuers and not just those relying on Rule 506(c).
6. Form D would be amended to require issuers to include additional information about Rule 506 offerings. All 506 offerings would need to make additional disclosures regarding: a) the issuer's website (if any); b) additional information regarding the percentage of purchasers of the offering that are accredited investors and natural persons; c) the percentage of the offering used to repurchase securities, pay offering expenses, acquire assets, finance acquisition of other businesses, provide working capital and discharge debts and d) the names and SEC file numbers of any SEC registered investment advisers providing advice to the issuer if the issuer is a pooled investment vehicle. Additionally, those issuers relying on Rule 506(c) would be required to disclose: a) information regarding the issuer's control persons; b) the types of general solicitation used and c) the methods of verifying that all investors are accredited.
7. Finally, Rule 156 would be amended to extend its antifraud guidance to the sales literature of private funds. Rule 156 provides guidance on the types of information in sales literature that could be misleading for purposes of the federal securities laws, including Section 17(a) of the Securities Act and Section 10(b) for the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Currently, Rule 156 applies only to the sales literature of registered investment companies. The Proposed Rules also update Rule 156 to add additional manner and content restrictions that would apply only to the written general solicitations of private funds.

Additionally, in its request for comments on the Proposed Rules, the SEC specifically solicits public comment on potential updates to the definition of accredited investor.

CONCLUSION

With the passage of Rule 506(c), private fund managers now have the ability to widely advertise their products so long as they are willing to follow the accredited investor verification requirements of Rule 506(c) and jump through any additional hoops imposed by a 1) final version of the Proposed Rules and/or 2) any additional regulatory scrutiny the SEC may direct towards Rule 506(c) issuers. The ultimate impact of the JOBS Act on the investment management industry will likely depend on whether private fund managers – along with all other issuers relying on Rule 506(c) (including those small businesses the JOBS Act was designed to benefit) – determine these hoops are too high or too numerous to offset the benefit of advertising their funds.

Rule 506(c) and Rule 506(d) will be effective 60 days after their publication in the Federal Register. Comments on the Proposed Rules are due 60 days after its publication in the Federal Register. If you have any questions or concerns, please contact your regular Drinker Biddle lawyer and we would be happy to assist you.

[1] See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415; (Jul. 10, 2013) <http://www.sec.gov/rules/final/2013/33-9415.pdf>

[2] See Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9414; (Jul. 10, 2013) <http://www.sec.gov/rules/final/2013/33-9414.pdf>

[3] See Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Release No. 33-9416; (Jul. 10, 2013) <http://www.sec.gov/rules/proposed/2013/33-9416.pdf>

[4] Rule 501 sets forth the definitions of terms used in Reg D.

[5] Rule 502(a) relates to integration of offerings.

[6] Rule 502(d) provides that Reg D offerings are generally “restricted securities.”

[7] The release accompanying the JOBS Act Rules clarifies that the principles-based method of verification is intended to provide issuers with the flexibility to address the particular circumstances of an offering while the safe harbors are intended to provide methods of verification for those issuers seeking greater certainty.

[8] An issuer may not rely on a safe harbor in Rule 506(c) if it or its agent has knowledge that the investor is not an accredited.

[9] This refers to an offering made under Rule 506 without any general solicitation or advertising.

[10] The Investment Company Act requires every securities investment fund to register with the SEC as an investment company unless an exemption applies. Both of the exemptions from this registration requirement that private funds rely on, Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, also prohibit a “public offering” of the fund’s interests. Some commenters had suggested that the restrictions on “public offerings” in Sections 3(c)(1) and 3(c)(7) should still apply after the Job Act Rules were enacted, therefore effectively nullifying the JOBS Act’s impact on private funds. The Final JOBS Act Rules release clarifies that this is not the case. This position conforms with the SEC’s previous guidance that any offering that is a private offering under Rule 506 is also a private offering for 3(c)(1) and 3(c)(7) and also with the JOBS Act provision stating that a private offering under Rule 506 will not be deemed to be a public offering for purposes of “other federal securities laws” due to advertising now allowed under the JOBS Act.

[11] See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628 (Aug. 3, 2007) <http://www.sec.gov/rules/final/2007/ia-2628.pdf>