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# white paper

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## SEC Approves General Solicitation in Private Offerings and Proposes Further Regulation D Amendments

July 2013

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On July 10, 2013, the U.S. Securities and Exchange Commission (SEC) issued a series of three releases—referred to in this White Paper as the General Solicitation Release,<sup>1</sup> the Bad Actors Release,<sup>2</sup> and the Proposing Release<sup>3</sup>—that address the provisions of the Jumpstart Our Business Startups Act (JOBS Act)<sup>4</sup> relating to general solicitation and general advertising in certain private offerings and provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)<sup>5</sup> relating to the disqualification of bad actors from Rule 506 offerings. Rule changes were adopted that may facilitate private offerings, but the proposed rule changes, if adopted, will impose additional requirements on private offerings. This White Paper discusses the SEC's three releases, including their impact on the private funds industry, which relies heavily on the private offering rules under the U.S. federal securities laws.

In the General Solicitation Release, the SEC amended Rule 506, Form D, and Rule 144A under the Securities Act of 1933 (Securities Act) and made conforming amendments to Regulation M under the Securities Exchange Act of 1934 (Exchange Act) to implement the JOBS Act provisions. Section 201(a)(1) of the JOBS Act requires the SEC to amend Rule 506 of Regulation D under the Securities Act to permit general solicitation and general advertising in a new private offering exemption under Rule 506, as long as all of the purchasers of the offered securities are accredited investors<sup>6</sup> and the issuer takes reasonable steps to verify each purchaser's accredited investor status. Section 201(a)(2) of the JOBS Act requires the SEC to expand the availability of Rule 144A under the Securities Act to permit resale offers to be made by means of general solicitation and general advertising, provided that sales are made only to persons that the seller reasonably believes are qualified institutional buyers.<sup>7</sup>

In the Bad Actors Release, the SEC amended Rules 501 and 506 of Regulation D and Form D to implement section 926 of the Dodd-Frank Act, which requires the SEC to adopt rules that prohibit using the Rule 506 exemptions for any securities offering in which certain felons and other bad actors are involved.

In the Proposing Release, the SEC proposed additional amendments to Form D, Rule 507, and Rule 156 under the Securities Act and proposed a new rule, Rule 509, and a new temporary rule, Rule 510T, under the Securities Act. These proposals are designed both to enhance the SEC's ability to evaluate the development of market practices under the new private offering exemption under Rule 506(c), which permits general solicitation and general advertising, and to address concerns about investor protection. The proposals would require issuers to file reports on Form D to provide advance notice of, or report the termination of, an offering in reliance on new Rule 506(c) and would require issuers to disclose certain information about the issuers and the securities being offered. In addition, issuers would have to include certain disclosures in general solicitation materials used for private offerings that rely on Rule 506(c) and provide copies of such materials to the SEC for a two-year period.

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

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

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

4. The JOBS Act was signed into law on April 5, 2012 and was the result of bipartisan legislation aimed at easing access to capital for small businesses by removing certain regulatory requirements. The JOBS Act can be viewed in its entirety at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>. Sections 201(a)(1) and (2) of the JOBS Act require the SEC to adopt rules permitting general solicitation and general advertising no later than 90 days after enactment of the JOBS Act.

5. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, available at <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>. Section 926 requires the SEC to adopt the rules that disqualify an issuer from relying on Rule 506 when certain felons and other "bad actors" are involved within one year after the date of enactment of the Dodd-Frank Act.

6. An "accredited investor" is defined in Rule 501(a) under Regulation D. See *infra* note 15. The SEC has requested comments on whether the definition of "accredited investor" should be changed in the Proposing Release, which is discussed further herein.

7. A "qualified institutional buyer" is defined in Rule 144A(a)(1) as various identified institutional investors, including (i) an insurance company, investment company, company, partnership, or trust, as long as it is acting for its own account or the accounts of other qualified institutional buyers and owns in the aggregate and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity; (ii) any dealer registered pursuant to section 15 of the Exchange Act, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least \$10 million of securities of issuers that are not affiliated with the dealer; (iii) any dealer registered pursuant to section 15 of the Exchange Act that is acting in a riskless principal transaction on behalf of a qualified institutional buyer; and (iv) any bank, savings and loan association, or other institution referenced in section 3(a)(4)(A) of the Securities Act that, in the aggregate, owns and invests on a discretionary basis at least \$100 million in securities of unaffiliated entities and that has an audited net worth of at least \$25 million.

The proposed amendments to Rule 156 would extend the antifraud guidance contained in that rule to the sales literature of private funds.

Although the adopted amendments would enhance an issuer's ability to conduct private placements and, accordingly, achieve Congress's goal in enacting the JOBS Act to facilitate capital formation, the proposals, if adopted, would impose regulatory burdens on the private offering process that could diminish the usefulness of the adopted amendments. Given that, we expect the SEC will receive adverse comments from market participants. We anticipate that the SEC, in determining how to respond to such adverse comments, will seek to balance the concern that the elimination of the prohibition on general solicitation and general advertising will result in an increase in fraudulent activities against the concern that the adoption of the proposals will hinder capital formation.<sup>8</sup>

The amendments set forth in the General Solicitation Release and the Bad Actors Release become effective on September 23, 2013. Additionally, comments on the Proposing Release are due to the SEC by September 23, 2013.

## General Solicitation Release: Amendments to Rule 506, Form D, and Rule 144A

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### Background

Rule 506(b) is a "safe harbor" rule adopted in 1982<sup>9</sup> that, subject to compliance with its conditions, provides for an exemption from registration of an offer and sale of securities based on section 4(a)(2) of the Securities Act, which exempts transactions by an issuer not involving any public offering. Rule 506(b) is available for sales of securities (with no limit as to dollar amount) to (i) accredited investors and (ii) no more than 35 other investors, provided the issuer reasonably believes that such investors have such knowledge and experience in financial and business matters that the investors are capable of evaluating the merits and risks of the prospective investment.<sup>10</sup> One condition to relying on the Rule 506(b) safe harbor is that the issuer and any person acting on its behalf cannot offer or sell the securities by any form of general solicitation or general advertising.<sup>11</sup> The Rule 506(b) safe harbor is unaffected by the amendments to Rule 506 set forth in the General Solicitation Release, and issuers, therefore, may still rely on Rule 506(b) for private placements that meet the conditions, including the prohibition on general solicitation and general advertising.

Since its adoption in 1990, Rule 144A has provided a nonexclusive safe harbor for resales of securities that were not registered under the Securities Act as long as various conditions are met, including that both offers and sales are only made to qualified institutional buyers.<sup>12</sup> The amendments to Rule 144A set forth in the General Solicitation Release eliminate these restrictions on offers, thereby permitting general solicitation and general advertising in connection with the resale of unregistered securities under Rule 144A.

### Rule 506

In the General Solicitation Release, the SEC adopted Rule 506(c), which permits general solicitation and general advertising in offerings of securities that are not registered under the Securities Act, provided that sales of such

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8. The SEC staff has developed a work plan to monitor the use of Rule 506(c). The work plan is described in the antepenultimate and penultimate paragraphs of part I of the Proposing Release.

9. Securities Act Release No. 33-6389, Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982).

10. The knowledgeable-investor standard is based on the investor's knowledge and experience, either alone or together with a purchaser representative.

11. Rule 502(c) of Regulation D.

12. Securities Act Release No. 6862, Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, 55 Fed. Reg. 17,933 (Apr. 30, 1990).

securities are made only to accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors. This reasonable verification requirement is a separate, independent condition to the availability of the exemption provided by Rule 506(c). If an issuer uses general solicitation or general advertising but fails to take reasonable steps to verify the eligibility of the investors, Rule 506(c) will not be available and the issuer will not be able to rely on Rule 506(b) or section 4(a)(2) for the offering.

Consistent with the SEC's initial proposal for the rule amendments,<sup>13</sup> the SEC explained, in the General Solicitation Release, that the requirement that an issuer take reasonable steps to verify that all of the purchasers are accredited investors necessitates a principles-based method of verification, under which an issuer must make an objective determination of whether it has taken reasonable steps based on the facts and circumstances of each purchaser and transaction. Among the factors that an issuer should consider are the following factors set forth by the SEC in both the Initial Proposal and the General Solicitation Release:

- *The nature of the purchaser and the type of accredited investor that the purchaser claims to be.* The SEC noted that the nature of the reasonable steps an issuer would take to verify accredited investor status "will vary depending on the type of accredited investor that the purchaser claims to be."<sup>14</sup> In the case of a broker-dealer, for example, merely checking the broker-dealer's status on the Financial Industry Regulatory Authority's (FINRA's) Broker Check website would be sufficient. In the case of a natural person, however, verifying accredited investor status "may pose greater practical difficulties as compared to other categories of accredited investors, particularly for natural persons claiming to be accredited investors based on the net worth test. These practical difficulties likely will be exacerbated by [natural persons'] privacy concerns about the disclosure of personal financial information."<sup>15</sup>
- *The amount and type of information that the issuer has about the purchaser.* The SEC stated that "[t]he more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it may have to take, and vice-versa."<sup>16</sup>
- *The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.* The SEC noted that "[a]n issuer that solicits new investors through a website accessible to the general public, through a widely disseminated email or social media solicitation, or through print media, such as a newspaper, will likely be obligated to take greater verification measures . . . than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third-party."<sup>17</sup> On the other hand, the SEC reiterated that a purchaser's ability to meet a high minimum investment amount could be relevant to an issuer's evaluation of the steps necessary to verify a person's accredited investor status. The SEC also noted that a minimum investment requirement that only an accredited investor could reasonably be expected to meet, with a direct cash investment that was not financed by a third party, "could be taken into consideration in verifying accredited investor status."<sup>18</sup>

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13. Securities Act Release No. 9354, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (Aug. 29, 2012), available at <http://www.sec.gov/rules/proposed/2012/33-9354.pdf> [hereinafter Initial Proposal].

14. General Solicitation Release, *supra* note 1, at 30.

15. *Id.* at 31. Under Regulation D's definition of an "accredited investor," a natural person is an accredited investor if his or her net worth, exclusive of his or her primary residence, exceeds \$1 million (subject to limited exclusions in calculating liabilities with respect to certain indebtedness secured by his or her primary residence). In addition, a person is an accredited investor if he or she had an individual income in excess of \$200,000 in each of the two most recent years or joint income with his or her spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

16. *Id.*

17. *Id.* at 33.

18. *Id.* at 34. The SEC's comment on minimum investment amounts seems somewhat more equivocal than its statement in the Initial Proposal. In that release, the SEC stated, "if an issuer knows little about [a natural person who is a] potential purchaser[,] . . . but the terms of the offering require a high minimum investment amount, then it may be reasonable for the issuer to take no steps . . . other than to confirm that the purchaser's cash investment is not being financed by the issuer or by a third party, absent any facts that may indicate that the purchaser is not an accredited investor." Initial Proposal, *supra* note 13, at 21. A large minimum investment was, at one time, sufficient to confer accredited investor status on a purchaser. As initially adopted, Regulation D included among the categories of persons who were accredited investors a natural person who purchases at least \$150,000 of the securities being offered, where the total purchase price did not exceed 20% of the

In response to comments that the proposed principles-based method of verification would not provide sufficient legal certainty that the verification requirement had been met, the SEC included in Rule 506(c) a nonexclusive and nonmandatory list of ways in which issuers can satisfy the verification requirement with respect to natural persons. Any of the following verification methods will be deemed to satisfy the verification requirement as long as the issuer does not have knowledge that the person is not an accredited investor:

- *Income level for accredited investor status.* An issuer may review an Internal Revenue Service form that reports the purchaser's income for the two most recent years—such as a Form W-2, Form 1099, Schedule K-1 to Form 1065, or Form 1040—and obtain a written representation from the purchaser with respect to the purchaser's expectation of reaching the income level necessary to qualify as an accredited investor during the current year.
- *Net worth level for accredited investor status.* An issuer may review documentation relating to the purchaser's net worth dated as of a date "within the prior three months"<sup>19</sup> and obtain a written representation from the purchaser that the purchaser has disclosed all liabilities necessary to make the net worth determination. Rule 506(c)(2)(ii)(B) specifies the following documentation that may be reviewed in this determination: (i) with respect to assets, bank statements, brokerage statements or other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and (ii) with respect to liabilities, a consumer report (credit report) from at least one of the nationwide consumer reporting agencies.<sup>20</sup>
- *Third-party verification.* The issuer may obtain a written confirmation from one of the following persons that the purchaser is an accredited investor based on the fact that such person or entity has conducted reasonable steps within the prior three months to verify the accredited status of the purchaser: a registered broker-dealer, an investment adviser registered with the SEC, 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 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.
- *Existing accredited security holder.* With respect to a person who purchased securities as an accredited investor in an issuer's Rule 506(b) offering prior to the effective date of Rule 506(c) and who continues to hold such securities, the issuer may obtain a written certification by such person at the time of the sale that he or she still qualifies as an accredited investor.

The SEC also reaffirmed guidance provided in the Initial Proposal that the "reasonable belief" standard continues to apply to the determination of accredited investor status. Although the concept of "reasonable belief" is included in section 201(a)(2) of the JOBS Act in connection with general solicitation in Rule 144A offerings, the concept is not included in the requirement of section 201(a)(1) that all purchasers in a Rule 506 offering involving general solicitation must be accredited investors. Nevertheless, the SEC noted that the definition of an "accredited investor" remains unchanged following enactment of the JOBS Act and continues to include persons who meet one of the specified categories of accredited investors as well as persons the issuer reasonably believes meet one of the specified categories.<sup>21</sup>

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person's net worth at the time of sale, or joint net worth with the person's spouse, and where the consideration paid was within specified forms of consideration. This category was rescinded in 1988.

19. Presumably, the three-month period is intended to precede the date of the sale of securities to the purchaser.

20. Instructions 2 and 3 to Rule 502(c)(2)(ii)(A)–(C) provide that, where a person qualifies as an accredited investor based on joint income or net worth with that of the person's spouse, the issuer would be deemed to satisfy the verification requirement by reviewing the document applicable to both spouses and obtaining written representations from both spouses. In addressing the documentation that could verify a person's accredited investor status based on net worth, the SEC stated, with respect to liabilities, that "we are requiring a consumer report and a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed." General Solicitation Release, *supra* note 1, at 38 (emphasis added).

21. In reaching this conclusion, the SEC noted its belief that the difference in the JOBS Act's statutory language reflects the different manner in which the reasonable belief standard was included in Regulation D and Rule 144A, as initially adopted, and not a congressional

However, despite the fact that the “reasonable belief” standard continues to apply to the determination of an investor’s accredited investor status, the **separate verification requirement in Rule 506(c) presents formidable additional challenges, at least to U.S. issuers.** Issuers operating outside the United States, however, may have adjusted to the private placement rules of many other countries that require similar verification steps. Among the challenges that U.S. issuers will face are the following:

- *The ability to rely on investor representations appears to be limited.* The SEC stated, in the General Solicitation Release, that it does “not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.”<sup>22</sup> While the SEC focused on an obvious example of insufficient verification, it did not provide any indication that representations of an investor, by themselves, could be sufficient to satisfy the verification requirement (except in the narrow exception for existing accredited investors discussed above). An examination of the nonexclusive and nonmandatory methods of verification included in Rule 506(c) suggests that investor representations can be used in only limited ways.<sup>23</sup> It is not clear if even a highly detailed questionnaire seeking information regarding an investor’s education, investment experience, and financial and business sophistication would be sufficient to satisfy the verification requirement.
- *The verification requirement must be satisfied even if the investor is, in fact, an accredited investor.* In addressing the “reasonable steps to verify” requirement, the SEC stated that “[t]his requirement is separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors.”<sup>24</sup> Therefore, the failure to take reasonable steps to verify an investor’s accredited status will result in the unavailability of the Rule 506(c) exemption.
- *An issuer’s failure to satisfy the requirements of Rule 502(c) will likely result in a violation of the registration provisions of the Securities Act.* In many instances, it may be possible for an issuer to rely on the traditional private placement principles under section 4(a)(2) to establish the availability of an exemption from the registration provisions, even if the issuer has failed to comply with Rule 502(b). This is not the case with a Rule 506(c) offering because, outside of the context of Rule 506(c), an exemption under section 4(a)(2) is not available if an issuer has engaged in general solicitation or general advertising. As a result, the failure to take reasonable steps to verify a person’s accredited investor status will likely result in a violation of the registration provisions of the Securities Act.

Although it has always been important that issuers document their reasonable basis to rely on the Rule 506(b) safe harbor, issuers should be particularly careful to document their verification process given that a reasonable verification process is an independent condition of Rule 506(c). Evidence of the reasonableness of the verification steps will be important to enable the issuer to justify its reliance on Rule 506(c) against future claims from investors or in response to regulatory inquiries or examinations. In the General Solicitation Release, the SEC clarified that, even if an issuer sells to a person who is not an accredited investor, the issuer will retain the ability to rely on Rule 506(c) so long as it had a reasonable belief that such person was an accredited investor at the

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intent to eliminate the reasonable belief standard from Regulation D’s definition of an “accredited investor.” General Solicitation Release, *supra* note 1, at 43.

22. *Id.* at 33–34.

23. It appears that investor representations would be able to be relied upon in three ways: (1) in connection with a determination of a natural person’s net income, an investor representation can be provided with respect to his or her reasonable expectation of reaching the income level in the current year, in addition to other documentation with respect to a person’s net income in the two most recent years; (2) in connection with a determination of a natural person’s net worth, an investor can represent that the investor has disclosed all relevant liabilities, but a credit report is also necessary; and (3) in connection with persons who invested in a Rule 502(b) offering prior to the effective date of Rule 502(c), an investor can provide a representation as to its continued status as an accredited investor.

24. *Id.* at 26.

time of sale.<sup>25</sup>

## Form D

In the General Solicitation Release, the SEC also amended Form D primarily to require issuers to indicate whether the form is being filed to report an offering in reliance upon either Rule 506(b) or Rule 506(c). Issuers should not check both boxes.<sup>26</sup> This amendment to Form D will enable the SEC to monitor reliance on Rule 506(c) and private offerings made under Regulation D generally. Once an issuer has engaged in general solicitation or general advertising, it will not be able to rely on the Rule 506(b) safe harbor for that offering.<sup>27</sup>

Although issuers that rely on Regulation D, including Rule 506, are required to file a Form D no later than 15 calendar days after the first sale of securities in the offering, the SEC noted, in the General Solicitation Release, that it believes that issuers may not always be filing notices of sales on Form D, perhaps because the filing of a Form D is not a condition to the availability of the exemption under Regulation D. Among the proposed amendments to Form D that are discussed below is an amendment to condition prospective reliance on Rule 506(c) on complying with the Form D filing requirements of Rule 503.

## Rule 144A

A Rule 144A offering is generally regarded as a primary offering of securities by an issuer to one or more financial intermediaries—commonly known as the “initial purchasers”—in a transaction that is exempt from registration pursuant to section 4(a)(2) or Regulation S<sup>28</sup> under the Securities Act, followed by the resale of those securities by the initial purchasers to qualified institutional buyers in reliance on Rule 144A.<sup>29</sup> Rule 144A(d)(1) provides that, to qualify for the use of the exemption in Rule 144A, offers as well as sales must be made to qualified institutional buyers. The amendments to Rule 144A delete the references in the rule to “offered” and “offeree.” Because Rule 144A does not expressly prohibit general solicitation and general advertising, these deletions effectively expand the availability of the Rule 144A safe harbor to permit the general solicitation of purchasers and the general advertising of the offering as long as all of the purchasers pursuant to the offering are either qualified institutional buyers or persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers.

By footnote in the General Solicitation Release and in response to a commenter’s request, the SEC confirmed that the general solicitation and general advertising permitted in Rule 144A resales by an initial purchaser from the issuer will not affect the ability of an issuer to rely on section 4(a)(2) or Regulation S for the initial sale of securities to the initial purchaser.<sup>30</sup> The General Solicitation Release also confirmed that the use of general solicitation in a Rule 144A or Rule 506(c) offering will not impact the availability of the Regulation S safe harbor

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25. See *id.* at 43–44 (“If a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, we believe that the issuer will not lose the ability to rely on Rule 506(c) for that offering, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale.”).

26. See *id.* at 46 (“We are of the view that an issuer will not be permitted to check both boxes at the same time for the same offering.”).

27. The SEC gave limited guidance, however, on the opposite situation—where an issuer commences a Rule 506(b) offering and then wishes to convert the offering by relying instead on Rule 506(c). The SEC’s guidance applies only to Rule 506(b) offerings commenced prior to the effective date of Rule 506(c). The SEC stated that, if an issuer commenced a Rule 506(b) offering before the effective date of Rule 506(c) and then continues the offering after the effective date 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).” *Id.* at 19. We believe this means that the offers and sales prior to the effective date of Rule 506(c) would be required to comply only with the conditions of Rule 506(b), which do not include the reasonable steps to verify requirement and permit sales to nonaccredited investors.

28. Regulation S is a “safe harbor” rule that articulates conditions that, if satisfied, would result in offers and sales of securities being deemed to take place outside of the United States and, therefore, not be subject to the registration requirements under the Securities Act.

29. *Id.* at 8.

30. *Id.* at 55 n.172. The issuer will be able to participate in the initial purchaser’s selling efforts like any other person acting on behalf of the seller to assist that seller in the sales of securities, including through a general solicitation or general advertising. Any solicitations of offers to buy by any person on behalf of the initial purchaser will be eligible for the Rule 144A safe harbor as long as all of the conditions of Rule 144A are met, including that all of the purchasers in the Rule 144A offering are qualified institutional buyers.

for a concurrent unregistered offering outside the United States.<sup>31</sup>

It has been common for issuers to conduct offerings in reliance on Regulation S concurrently with a private offering in the United States conducted in accordance with section 4(a)(2), Rule 506, or Rule 144A. This practice developed as a result of language in Regulation S, as well as specific SEC guidance in the release adopting Regulation S, which states that “[o]ffshore transactions made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act,” even if undertaken contemporaneously.<sup>32</sup>

The General Solicitation Release also answered commenters’ concerns as to whether it remains possible to satisfy the Regulation S requirements that (1) securities sold without a Securities Act registration must be sold in an offshore transaction and (2) there can be no directed selling efforts in the United States. Nevertheless, we believe that, absent further guidance from the SEC, general solicitation in a Regulation S offering must be segregated from general solicitation in a U.S. offering such that the Regulation S solicitation will satisfy the “no directed selling efforts” requirement. With regard to Internet postings, providing separate uniform resource locators (URLs) containing information directed to specifically disparate audiences should be helpful. In the case of Internet postings in the context of a Regulation S offering, compliance with guidance previously provided by the SEC would be prudent.<sup>33</sup>

In connection with the amendments to Rule 144A, the SEC amended Regulation M under the Exchange Act to also eliminate the references to “offered” and “offerees” in the provisions related to the exceptions in Regulation M concerning transactions in Rule 144A securities.<sup>34</sup> Since its adoption in 1996, Regulation M has provided exceptions intended to permit transactions in securities eligible for resale under Rule 144A during a distribution of such securities.<sup>35</sup> The amendment eliminates the condition to reliance on this exception in Regulation M that all offers are made solely to qualified institutional buyers, consistent with the amendments to Rule 144A.

## Bad Actors Release: Disqualification of Bad Actors from Rule 506 Offerings

### Background

Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that prohibit the use of the Rule 506 exemption for any securities offering in which certain felons and other “bad actors” are involved. This section also requires the new rules to be “substantially similar” to the bad actor disqualification provisions of Regulation A (another exemption from registration for certain small offerings) and to also cover certain additional disqualifying events set forth in section 926. In May 2011, the SEC proposed amendments to Rule 506 to disqualify issuers from relying on the safe harbor from registration under the Securities Act if the issuer (including any predecessors and successors) and various other covered persons had been involved in certain specified disqualifying events. The other covered persons set forth in the proposed rule were directors, officers, general partners, or managing members of the issuer; 10% shareholders; promoters; and distribution participants acting within the time periods specified for each disqualifying event.

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31. *Id.* at 57.

32. Securities Act Release No. 6863, Offshore Offers and Sales, 55 Fed. Reg. 18,306 (Apr. 24, 1990).

33. See Securities Act Release No. 7516, Use of Internet Web Sites To Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore (Mar. 23, 1998), available at <http://www.sec.gov/rules/interp/33-7516.htm>.

34. Other amendments update the references in Rule 144A to sections 2(11), 2(13), 4(1), 4(2), 4(3)(A), and 4(3)(C) of the Securities Act to the applicable amended sections of the Securities Act: sections 2(a)(11), 2(a)(13), 4(a)(1), 4(a)(2), 4(a)(3)(A), and 4(a)(3)(C), respectively.

35. Securities Act Release No. 7375, Anti-manipulation Rules Concerning Securities Offerings (Dec. 20, 1996), available at <http://www.sec.gov/rules/final/34-38067.txt>.



## The Bad Actor Rule

At the same meeting in which Rule 506(c) was adopted, the SEC unanimously adopted the bad actor rule applicable to both the traditional Rule 506 safe harbor provision and new Rule 506(c) in substantially the form in which it was proposed in May 2011, with certain modifications. The new bad actor rule, which is included in paragraphs (d) and (e) of Rule 506, reflects four modifications from the proposed rule in that it

- narrows the categories of persons subject to disqualifications by (i) only including those officers who are executive officers and any other officers who participate in the Rule 506 offering, (ii) expanding the categories of fund-related persons to include investment managers and principals, and (iii) changing from 10% to 20% the beneficial ownership requirement for a disqualification based on voting power;
- expands the types of cease-and-desist orders that can cause a disqualification and includes Commodities Futures Trading Commission (CFTC) orders as disqualifying events;
- provides that an issuer will not be disqualified for disqualifying events that occurred prior to the effective date of the amendments but includes a requirement that an issuer provide, to each purchaser within a reasonable time prior to the sale, a written description of any such disqualifying event that occurred prior to the effective date of the rule; and
- provides an exception from disqualification if, before the relevant sale, the court or regulatory authority that entered the relevant order, judgment, or decree advises in writing that disqualification from Rule 506 should not arise as a consequence of the order, judgment, or decree.

The final rule identifies the following “disqualifying events”:

- Criminal convictions in connection with the purchase or sale of a security or the making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within five years of the proposed sale of securities in the case of the issuer, its predecessors, and affiliated issuers and within 10 years of the proposed sale of securities in the case of other covered persons.
- Court injunctions and restraining orders in connection with the purchase or sale of a security or the making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries. The injunction or restraining order must have occurred within five years of the proposed sale of securities.
- Final orders of the CFTC, federal banking agencies, the National Credit Union Administration, or state regulators of securities, insurance, banking, savings associations, or credit unions that
  - bar the issuer from associating with a regulated entity; engaging in the business of securities, insurance, or banking; or engaging in savings association or credit union activities; or
  - are based on a violation of any law or regulation prohibiting fraudulent, manipulative, or deceptive conduct and that were issued within 10 years of the proposed sale of securities.
- Certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons.
- SEC cease-and-desist orders that were issued within five years before the sale of securities and that ordered the covered person to cease and desist from committing or causing a violation or future violation of any scienter-based antifraud provision of the federal securities laws or section 5 (the basic registration provision) of the Securities Act.
- SEC stop orders and orders suspending the Regulation A exemption that were issued within five years of the proposed sale of securities and pending investigations or proceedings to determine whether a stop order or suspension order should be issued.
- Suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member.

- U.S. Postal Service false representation orders that were issued within five years before the proposed sale of securities and temporary or preliminary injunctions with respect to conduct alleged by the U.S. Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

The final rule provides an exception from disqualification when the issuer can show that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering.

The potential for bad actor disqualifications in Rule 506 offerings will require issuers, placement agents, and their counsel to include in their due diligence activities verification that none of the covered persons is subject to a disqualification. Likewise, selling agreements can be expected to include mutual representations regarding the absence of bad actor disqualifications.

## Proposing Release: Amendments to Regulation D, Form D, and Rule 156

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### Background

In the Proposing Release, the SEC proposed rules that will enable it to monitor the use of Rule 506 for private offerings, particularly the use of general solicitation and general advertising pursuant to Rule 506(c), and to address concerns that the increase in Rule 506 offerings resulting from the general solicitation/general advertising safe harbor may result in an increase in fraudulent activity in the Rule 506 market as well as an increase in unlawful sales of securities to nonaccredited investors. In addition, the proposed rules are intended to improve compliance with the Form D filing requirements.

### Form D Filings

#### **Advance-Notice Form D**

Currently, Rule 503 requires issuers that rely on Regulation D to file a notice-of-sale Form D no later than 15 calendar days after the first sale of securities in a Regulation D offering. The proposed rules would amend Rule 503 to require issuers to file a Form D no later than 15 calendar days prior to the use of general solicitation or general advertising in a private offering conducted in reliance on Rule 506(c) unless the notice-of-sale Form D has already been filed. The advance-notice Form D would be required to include disclosure of certain specified information, including information about the issuer and its related persons, identification of the exemption or exemptions being claimed for the offering and the use of the proceeds resulting from the offering, and, if available, information about the security to be offered and the persons receiving sales compensation. An issuer would be able to include in the advance-notice Form D all of the information required by Form D if it so chooses, in which case, the advance-notice Form D would also serve as the notice-of-sale Form D. An issuer could file the advance-notice Form D before it intends to conduct a specific offering so that it has the flexibility to use general solicitation when it conducts an offering.

#### **Amended Form D Filing**

The proposed rules would revise Rule 503 to require an issuer to amend its advance-notice Form D to provide the information required by Form D that the issuer was unable to include in the advance-notice Form D.

#### **Termination Amendment of Form D**

The proposed rules would also amend Rule 503 to require that issuers file a termination amendment to Form D within 30 calendar days after the termination or completion of any offering conducted in reliance on either Rule

506(b) or 506(c). Such final amendment would be required to provide information pursuant to the remaining disclosure items that were not applicable to the advance-notice Form D, including items pertaining to the offering amount, the total amount of securities sold, the types of general solicitation and general advertising used, and the methods used to verify that purchasers were accredited investors. This termination amendment would not be required if a prior Form D filing contained all required information and the issuer indicated (by checking the box) that such filing was a closing filing.

## Other Regulation D Proposals

### **Expanded Form D Disclosure**

The proposed rules would revise eight of the current disclosure items in Form D and would add six new disclosure items to the form. The existing requirements would be expanded to require the following from issuers engaged in Rule 506(c) offerings (and certain other offerings that are specified in the respective disclosure items):

- Disclosure of an issuer's publicly accessible website address, if any, for any offering that relies on Regulation D or section 4(a)(5)
- Identification and address of any person who controls the issuer
- A description of an issuer's industry group, if such group is not otherwise identified, for any offering that relies on Regulation D or section 4(a)(5)
- Disclosure regarding whether the Form D is an advance-notice Form D or a termination Form D amendment
- Identification of any trading symbol or security identifier for the offered securities for any offering that relies on Regulation D or section 4(a)(5)
- Specification of the number of accredited investors and nonaccredited investors that purchased in a Rule 506 offering, whether or not such purchasers are natural persons or legal entities, and the amount raised from each type of investor
- Additional details regarding the use of proceeds from a Rule 506 offering, including the percentage of proceeds used for repurchasing or retiring existing securities, paying offering expenses, acquiring assets or other businesses, working capital, or discharging indebtedness

With respect to any offering that relies on Regulation D or section 4(a)(5), instead of stating that the issuer declines to disclose information about the issuer's size, the proposed rules would permit an issuer to indicate that such information is not available to the public, if true. The SEC believes that an issuer that has included in the general solicitation materials its relevant size information—such as information about revenues or net asset value—or that has otherwise made size information public must include that information in its Form D.

The six new disclosure items would apply to both Rules 506(b) and 506(c) offerings, except as otherwise indicated, and would require disclosure with respect to the following:

- The number and types of accredited investors that participate in an offering
- The issuer's securities, including the exchange or other trading venue on which the securities are traded, or, if applicable, the issuer's Exchange Act file number and whether the securities offered in the Rule 506 offering are of the same class as the issuer's securities that are registered under the Exchange Act or convertible, exercisable, or exchangeable for such class
- Whether general solicitation materials were filed with FINRA, in cases where a registered broker-dealer was used in the offering
- For pooled investment funds advised by a registered investment adviser or an exempt reporting adviser, identification of each investment adviser that serves as a promoter for the issuer

- The forms of general solicitation that are used or will be used in a Rule 506(c) offering, such as mass mailings, emails, public websites, social media, print media, and broadcast
- The methods used or that will be used to verify that investors are accredited in Rule 506(c) offerings, such as the principles-based method of using publicly available information, documentation provided by the purchaser or a third party, or one of the methods in the nonexclusive list of verification methods in Rule 506(c)(2)(ii)

## **Additional Disqualification Provisions Under Rule 507**

The proposed rules would amend Rule 507 to disqualify an issuer for one year from conducting offerings pursuant to either Rule 506(b) or 506(c) if the issuer, its predecessor, or an affiliate did not comply in the preceding five-year period with the Form D filing requirements for a Rule 506 offering. The disqualification period would apply only to future offerings (not to offerings that commenced before the failure to comply occurred). It would begin upon the date a missed filing was due, and the one-year waiting period would begin only after all required filings have been made or, in the case of a terminated offering, after a termination Form D amendment has been filed. The five-year look-back period would not apply retrospectively prior to the effective date of the rule, if adopted. Rule 507 currently disqualifies an issuer from relying on Regulation D only if the issuer, or a predecessor or affiliate, has been enjoined by a court for violating the filing requirements in Rule 503.

With respect to an issuer's first failure to file a timely Form D or Form D amendment for a particular offering, the proposed rules would provide for a 30-day cure period, within which the issuer could file a missed Form D or amend an error in an already filed Form D and, thereby, not lose its ability to conduct future Rule 506 offerings. Additionally, the proposed amendments to Rule 507 would continue to permit an issuer to seek a waiver from the disqualification to rely on an exemption in Regulation D, "upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied."<sup>36</sup> This would enable the SEC to waive a failure to comply with Rule 503 if the issuer can make the good-cause showing.

Additionally, proposed Rule 507(a) would make Rule 506 unavailable if a court has taken injunctive action against the issuer, a predecessor, or affiliate for failure to comply with Rule 509 or Rule 510T, as discussed below.

## **Legend and Other Disclosure Requirements for General Solicitation Materials**

The proposed rules set forth in the Proposing Release would add Rule 509, which would require that certain legends be included in written general solicitation materials for offerings made in reliance on Rule 506(c), including specific legends for offerings by private funds. These legends would require that issuers indicate that only accredited investors can purchase in the offering, that the offering is exempt from registration under the Securities Act and need not comply with disclosure requirements under the Securities Act, that the SEC has not approved the offering or the materials for such offering, that the securities purchased are subject to transfer and resale restrictions, and that purchasing the securities involves risk and "investors should be able to bear the loss of their investment."

For private funds, proposed Rule 509 would also require a legend stating that the securities offered are not subject to the protection of the Investment Company Act of 1940. Additionally, private funds that include performance data in solicitation materials must indicate that performance data represents past performance, that past performance does not guarantee future results, that current performance could be lower or higher than the performance data presented, that the fund is not required to follow any methodology to calculate or represent performance data, and that the fund's performance may not be comparable to the performance of other private or registered funds. This legend would be required to include a telephone number or website where investors can obtain current performance data. Finally, the proposed rules would require that any performance data included in a fund's written solicitation material be as of the most recent practicable date, that the fund indicate the period for which performance data is presented, and that the fund indicate, if applicable, that the deduction of fees and expenses would lower the performance presented.

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<sup>36</sup> Rule 507(b), proposed to be redesignated as Rule 507(c).

## **Mandatory Submission of Written General Solicitation Materials**

The proposed rules would add a temporary rule, Rule 510T, which would require issuers that conduct an offering pursuant to Rule 506(c) to submit their written general solicitation materials directly to the SEC through an intake page on the SEC's website (not through the EDGAR system) no later than the date such materials are first used. The materials submitted would not be deemed to be "filed" or "furnished" for purposes of the Securities Act and the Exchange Act. This proposed rule, which would allow the SEC to assess market practices, would remain in effect for a two-year period. Regardless of whether this proposal is adopted, the SEC plans to establish the intake page so that issuers, investors, and other market participants voluntarily can submit written general solicitation materials used in Rule 506(c) offerings. The submitted materials would be considered by the SEC staff as part of the Rule 506(c) work plan.

## **Guidance Applicable to Sales Literature of Private Funds**

In its current form, Rule 156 under the Securities Act prohibits the use of sales literature that is materially misleading in connection with the offer and sale of securities issued by a registered investment company. The rule provides guidance regarding circumstances in which a statement could be misleading. The amendments proposed in the Proposing Release would also apply Rule 156 to all sales literature used by private funds, including sales literature used in connection with general solicitation activity under Rule 506(c).

## **Request for Comments**

In addition to requesting comments on the proposed rules, the SEC has requested comments on manner and content restrictions for the solicitation materials used by private funds and the definition of "accredited investor." The Dodd-Frank Act requires the SEC to review the accredited investor definition, as it relates to natural persons, four years after the enactment of the Dodd-Frank Act, or July 20, 2014. The Dodd-Frank Act also requires the net worth standard of \$1 million, excluding the value of a person's primary residence, until July 2014. Comments may be submitted to the SEC on the proposed rules until September 23, 2013.

## **Impact on Private Funds**

Private funds<sup>37</sup> rely heavily on section 4(a)(2) and Rules 506 and 144A in offering shares in the United States. Prior to the effective date of the amendments set forth in the General Solicitation Release, all of these regulations prohibit a private fund or its adviser from advertising the offerings of fund interests to the general public or soliciting the general public to invest in the fund. The amendments to Rules 506 and 144A could substantially broaden the range of securities for which there is publicly available information. Hedge funds and other private funds will be able to market private fund interests on websites, in print ads, and on television, so long as the interests are only sold to U.S. persons reasonably believed to be accredited investors.<sup>38</sup> However, as set forth below, some regulatory ambiguity remains—particularly with respect to the Proposing Release—and, with this new freedom, comes several potential compliance and liability pitfalls. In determining whether to rely on the new Rule 506(c) exemption to offer private fund interests, private fund advisers should carefully consider the issues discussed below.

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37. The term "private funds" is used here to refer to funds that would be "investment companies" under section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, as defined in section 202(a)(29) of the Investment Advisers Act of 1940 (Advisers Act).

38. The SEC clarified in the General Solicitation Release that, although the JOBS Act did not specifically address private funds, "the effect of Section 201(b) [of the JOBS Act] is to permit offers and sales of securities under Rule 506(c) by private funds relying on the exclusions from the definition of 'investment company' under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act." General Solicitation Release, *supra* note 1, at 49.

## General Solicitation Release

- *Revisions to investor verification procedures.* Currently, many private funds rely on investor questionnaires, purchaser representations, and limited personal identification information to ensure that fund investors are “accredited investors.” Advisers to private funds that rely on Rule 506(c) will bear the burden of proving that their offerings are entitled to rely on Rule 506(c).<sup>39</sup> As a result, advisers relying on 506(c) will likely have to strengthen their accredited investor verification processes to include a more robust review of documentation that demonstrates a prospective investor’s income or net worth in addition to obtaining representations from the prospective investor. Even though Rule 506(c)(2)(ii)(C) deems obtaining a written confirmation from one of the third parties set forth in the rule to be a “reasonable step[] to verify” an investor’s accredited investor status, private fund advisers that rely on this verification process may want to consider inquiring with the third party about its verification processes to strengthen the adviser’s “reasonable steps.” Also, the fact that a fund’s minimum investment is above the net worth threshold for accredited investor status without additional verification steps taken by the adviser. Failure to implement reasonable verification procedures could disqualify a private fund from relying on Rule 506(c), and, if the fund had already conducted general solicitation or general advertising activity, the fund would no longer be able to rely on section 4(a)(2) or Rule 506(b) to privately offer its shares. Private fund advisers that frequently make offerings in foreign jurisdictions may already have policies and procedures in place that could be readily adapted to their U.S. offerings. For example, the United Kingdom requires private fund advisers to have reasonable grounds for believing that a prospective fund investor qualifies as an eligible investor prior to sending such prospective investor any promotional materials about the fund.
- *Independence of U.S. and non-U.S. concurrent private fund offerings.* The application of the SEC’s guidance regarding the use of general solicitation or general advertising in a Rule 506 or Rule 144A private fund offering conducted concurrently with a Regulation S private fund offering is not entirely clear. We believe that, absent further guidance from the SEC, general solicitation in a Regulation S private fund offering must be segregated from general solicitation in a U.S. private fund offering such that the Regulation S solicitation will satisfy the “no directed selling efforts” requirement. With regard to Internet postings, private fund advisers should consider providing separate URLs containing information directed separately to U.S. and non-U.S. prospective private fund investors.
- *Review of policies and procedures for marketing practices.* The SEC expressly reminded private fund advisers that they are subject to Rule 206(4)-8 under the Advisers Act,<sup>40</sup> which prohibits an adviser to a pooled investment vehicle from making material misstatements or omissions to investors or prospective investors in the pool and from otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to such investors or prospective investors. Citing six enforcement actions brought by the SEC within the last 16 months against private fund advisers and other market participants concerning material misrepresentations with respect to performance, strategy, and investments, the SEC directed firms to “carefully review” their policies and procedures regarding the nature and content of private fund sales literature to determine whether such policies and procedures are “reasonably designed to prevent the use of fraudulent or materially misleading private fund advertising.”<sup>41</sup> The SEC indicated that private fund advisers—particularly those that will rely on Rule 506(c)—should make appropriate amendments to their marketing policies and procedures. Given the SEC’s statements, marketing policies and procedures are likely areas of focus for SEC examiners.
- *Inconsistencies with CFTC requirements.* CFTC rule changes that became effective in December 2012 deleted CFTC Rule 4.13(a)(4), which exempted private fund advisers from having to register as commodity pool operators as long as fund shares were offered only to qualified eligible persons. As a result, many advisers to private funds that held only a *de minimis* amount of commodity interests began to rely on CFTC Rule 4.13(a)(3). One of the conditions to CFTC Rule 4.13(a)(3), however, is that interests in the private fund must be “offered and sold without marketing to the public in the United States.”<sup>42</sup> Absent

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39. *Id.* at 28.

40. *Id.* at 52.

41. *Id.* at 53.

42. CFTC Rule 4.13(a)(3)(i).

guidance from the CFTC, no private fund adviser that is currently relying on CFTC Rule 4.13(a)(3) would be able to offer interests in a private fund in reliance upon Rule 506(c). As a result, private fund advisers may want to consider instead relying on CFTC Rule 4.7, which subjects the adviser to registration with the CFTC as a commodity pool operator but provides an exemption from disclosure document delivery and certain recordkeeping and reporting requirements as long as interests in the private fund are sold only to qualified eligible persons.

- *Inconsistencies with foreign and state laws.* Although private funds relying on Rule 506(c) will be able to engage in general solicitation and general advertising with respect to U.S. private offerings, comparable exemptions from registration in certain foreign jurisdictions may still require that a private fund not make use of any general solicitation or general advertising or similar activities to the applicable non-U.S. prospective investors. Certain state law exemptions that private funds may rely on to avoid state notice filing requirements may impose similar requirements. As a result, private funds should conduct an inventory of the foreign and state exemptive laws that they rely on and determine whether engaging in general solicitation and general advertising poses any problems in those jurisdictions.
- *Increased oversight from the SEC via Form D filings.* Private funds relying on Form D will now have to indicate whether they are relying on Rule 506(b) or Rule 506(c). This requirement will provide the SEC with information about the private fund offering market, which could be used by the SEC to conduct sweep exams or seek additional information on industry practices.

## Bad Actors Release

- *Need for due diligence.* The potential for a bad actor disqualification in Rule 506 offerings will require private funds, private fund advisers, placement agents, and their counsel to include in their due diligence activities verification that none of the covered persons is subject to a disqualification. Private funds should implement a diligence process that enables them to rely on the exemption from disqualification, available when the issuer can show that it did not know and in the exercise of reasonable care could not have known that a covered person with a disqualifying event participated in the offering. Likewise, selling agreements and placement agent agreements can be expected to include mutual representations regarding the absence of a bad actor disqualification.
- *Bad actor screening.* Similar to a prohibited political contribution by a covered person under the pay-to-play rule,<sup>43</sup> a disqualifying event sticks with a bad actor and may limit advisory firms to which the bad actor can relocate. As a result, private fund advisers should implement in their employment process (to the extent they do not already) representations as to the absence of disqualifying events. In the context of corporate mergers, which are not infrequent in the investment management industry, Rules 506(d) and 506(e) will need to be heightened areas of diligence.

## Proposing Release

- *Importance of Form D filings.* If the proposed changes to Form D and Rule 507 are adopted, private funds will have to implement robust compliance policies and procedures to ensure that Form D filings are timely made both before an offering that will rely on Rule 506(c) and after the conclusion of any offering made under Rule 506(b) or 506(c). If a private fund, its predecessor, or an affiliate failed to meet the Form D filing requirements at any time in the prior five years (but not preceding the effective date of the rule, if adopted), then the private fund may be prohibited from relying on Rule 506 for one year from the date all required filings have been made. The five-year look-back proposal could effectively prohibit new private fund offerings from coming to market, absent a waiver from the SEC.
- *New disclosure requirements on Form D.* Form D would also be amended to include many new disclosure requirements for private funds relying on Rule 506(b) or 506(c). These disclosure requirements would represent additional compliance burdens for private funds and their advisers, but they could also subject the funds to SEC inquiry or disclosure liability with respect to investors. If the amendments are adopted,

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43. Advisers Act Rule 206(4)-5.

private fund advisers would have to implement policies and procedures to ensure that the information provided on Form D is not only accurate but that it also does not conflict with any information in the private fund's offering documents, which could be a challenge because often these tasks are divided between different groups. These additional disclosures would be yet another example of the heightened reporting and compliance requirements that recently have been imposed on private funds and their advisers (e.g., private fund amendments to Form ADV, Form PF, and Form 13H).

- *New disclosure requirements on offering documents.* Proposed Rule 509 would require private funds to include disclosure legends in the solicitation and advertising materials used under Rule 506(c). Private funds would also have to include disclosure about performance data and provide a telephone number or website at which investors could obtain current data. If private fund advisers do not already provide such a service to fund investors, they could be faced with significant costs and compliance issues, which, in some instances, may discourage such advisers from providing performance information in marketing materials altogether. Although the Proposing Release did not attempt to adopt a uniform method of performance calculation, the SEC did request comments on whether manner and content restrictions for private fund marketing materials should be adopted. We anticipate that commenters from the mutual fund industry will likely support this idea.
- *Submission of solicitation materials to the SEC.* For an initial two-year period, proposed Rule 510T would require private funds and other issuers relying on Rule 506(c) to submit their written general solicitation materials to the SEC no later than the date of first use. Although the submitted materials would not be available to the public, the SEC's access to the materials could easily lead to regulatory inquiry.
- *Application of the "materially misleading" standard.* As proposed, Rule 156 would be amended to expressly apply to private fund marketing materials. Similar to the SEC's warning in the General Solicitation Release about Rule 206(4)-8 under the Advisers Act to private fund advisers, this amendment would heighten the need for private fund advisers to have thorough compliance policies and procedures for reviewing the content and use of private fund marketing materials. The application of Rule 156 to private funds would open the door for additional regulatory enforcement actions.

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If you have any questions about the effect of the SEC's adopted and proposed rules on the securities market and the potential impact on start-up issuers, or if you would like more information on the issues discussed in this White Paper, please contact any of the following Morgan Lewis attorneys:

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