

The logo for K&L GATES, featuring the text "K&L GATES" in white, uppercase letters on an orange rectangular background. This logo is positioned in the upper left corner of the slide, partially overlapping a blue bokeh background that covers the top half of the page.

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Lifting the Ban on General Solicitations: Impact on Private Funds and Other Issuers

Michael S. Caccese
Nicholas S. Hodge
Paul J. Marnoto

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Is this a good development or a bad development?

Putting This Development into Context

- Private investment funds and operating businesses of all sorts make use of the private placement exemption from registration in Section 4(a)(2) of the Securities Act of 1933 in order to avoid having to register their securities offerings under that Act.
- Rule 506 was adopted by the SEC in 1982 to provide a safe harbor: if an issuer of securities complies with the requirements of Rule 506, it is deemed to have made a valid Section 4(a)(2) offering.

Putting This Development into Context

- Rule 506 has always forbidden general solicitation and general advertising. That will change on September 23, 2013, when new Rule 506(c) becomes effective.

Effect of New Rule 506(c)-General Solicitation and General Advertising Permitted

- An extraordinary shift in public policy brought about by the JOBS Act.
- Any issuer relying on Rule 506(c) may solicit the public to purchase the issuer's securities.
- Issuers may publicly advertise their offerings through any form of advertising, such as on their websites, or through newspapers, magazines, Internet, T.V., radio or other media.

Rule 506(c) Required Elements

- Offerings by general solicitation may be made to anyone, but all purchasers must be “accredited investors.”
- The issuer must take reasonable steps to verify that each purchaser is an “accredited investor” before the sale.
- Rule applies a “principles-based” approach to verification.
- Must continue to comply with other Regulation D conditions:
 - Resale restrictions apply
 - Integration risk
 - Form D filing

Verification Procedures Required

- Status as an actual accredited investor is not sufficient in order to rely on Rule 506(c) if the issuer has not taken reasonable steps to verify each purchaser's status as an accredited investor.
- Unless issuer has “actual knowledge” that the purchaser is an accredited investor.
- Critical to preserve records of discussions with, and other related documentation pertaining to, purchasers to establish reasonable verification process.

Verification Process-Principles Based Method

- An issuer must consider all relevant facts and circumstances to assess whether its verification process is reasonable.
- Issuers must consider the particular conditions of the offering, including:
 - Nature of the purchaser and type of accredited investor the purchaser claims to be;
 - Amount and type of information the issuer has about the purchaser;
 - Manner in which the purchaser was solicited; and
 - Terms of the offering, in particular **the minimum investment amount.**

Verification Procedures for Natural Persons

- Rule 506(c) provides 4 non-exclusive methods for verifying accredited investor status of natural persons:
 - (1) **Income Test.** Review prospective purchaser's IRS filings for the two most recent years and obtain purchaser's representation that he/she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.
 - (2) **Net Worth Test.** Review one or more of the following, dated within the prior 3 months, and obtain purchaser's representation that all liabilities have been disclosed:
 - For assets: bank statements, brokerage statements and other evidence of securities holdings, CDs, tax assessments and appraisal reports issued by independent third parties.
 - For liabilities: a credit report from at least one of the nationwide consumer reporting agencies.

Verification Procedures for Natural Persons

(3) **Third Party Confirmation.** Obtain 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 the purchaser is an accredited investor:

- Registered broker-dealer
- SEC-registered investment adviser
- Licensed attorney
- CPA

(4) **Existing Investor.** If purchaser invested in an issuer's previous Rule 506(b) offering as an accredited investor before September 23, 2013, remains an investor of the issuer at the time of the Rule 506(c) offering, and certifies his/her status as an accredited investor at the time of sale.

Considerations – Verification Process

- Reps, warranties and “check-the-box” approaches alone are not sufficient.
- The non-exclusive verification safe harbors do not automatically apply to entities even though many of the sanctioned verification methods for natural persons would seem to be suitable for verifying the accredited investor status of an entity.
- 3-month reliance window for supporting documentation is very short.
- If the issuer seeks to infer that the purchaser is accredited based on a high minimum investment amount, the issuer must “confirm” that the purchaser’s cash investment is not being financed. Is a representation sufficient?
- Most private equity, venture and real estate funds will not be able to rely on the 4th verification procedure.

Considerations—Verification Procedures are Subject to Challenge

- Beyond the verification methods for individuals, whether an issuer has taken “reasonable steps” to verify an investor’s status is a question of fact.
- Issuer has the burden of proving its verification steps were reasonable.

Considerations – Confidentiality

- Natural persons who are accredited investors may be unwilling to share personal financial information due to confidentiality and other concerns.
 - Rule 506(c) does not specify how the issuer should retain such documentation or for how long.
 - Broker-dealer rule may give some guidance – 5 years
- Issuers will need to adopt policies and procedures that ensure confidential treatment of purchasers' personal financial information.
 - Compliance with state and federal privacy and data security laws.

Considerations—Securities Law Implications

- If general solicitation is used, the issuer cannot later rely on other exemptions for the same offering.
- A sponsor of multiple private funds that relies on Rule 506(b) for some offerings and Rule 506(c) for others would have to take serious precautions to make sure that the general solicitation in the Rule 506(c) offerings do not taint the exemptions for the Rule 506(b) offerings.
 - Potential guidance: simultaneous offerings by registered funds and private funds.
- Offerings that rely on Section 4(a)(2) without the benefit of the Rule 506(b) safe harbor without general solicitation could be integrated with Rule 506(c) offerings.
- From a non-U.S. perspective, if a sponsor is offering securities within and outside the United States, the use of general solicitation in the U.S. could violate the private placement rules applicable to a non-U.S. offering even if the solicitation is targeted at U.S. investors.
- Exemption from registration under the Advisers Act for certain foreign private advisers may not be available if the fund manager is deemed to be “holding itself out to the public in the US”.

Considerations—Commodity Exchange Act

- An investment pool that trades in commodity interests and whose manager relies on the *de minimis* exemption from commodity pool operator (CPO) registration may be unable to engage in general solicitations
 - The *de minimis* exemption applies only to offerings made without marketing to the public.
- An investment pool whose manager relies on the exemptive relief in CFTC Regulation 4.7(b) may likewise be unable to engage in general solicitations due to a similar prohibition against marketing to the public.
- CFTC is reviewing this inconsistency.

Considerations – State “Blue Sky” Laws

- SEC and states are on notice of offering via Form D filing.
 - Massachusetts Securities Division
 - New Enforcement Unit formed to:
 - Collect data on the types and quantity of public advertising in unregistered offerings
 - Track issuers’ use of advertising
 - Track issuers’ methods to verify investor status.

Considerations – Advertising Rules Apply

- Anti-fraud provisions of US securities laws apply.
- Rules 206(4)-1 and 206(4)-8 under the Advisers Act apply to an adviser's advertising materials, not just offering documents.
- Investment advisers to private funds that offer securities in reliance upon Rule 506(c) should adopt policies and procedures to ensure that all forms of general solicitation conform to strict advertising rules and related SEC guidance.
- SEC Staff is considering whether to adopt advertising rules specifically for private funds.

Proposed Amendments to Rule 156 under the Securities Act

- Applies guidance to private funds on the types of information in “sales literature” that could be misleading under the antifraud provisions of the federal securities laws.
- Sales literature is materially misleading if it (1) contains an untrue statement of a material fact, or (2) omits to state a material fact necessary in order to make a statement made, in light of the circumstance of its use, not misleading.
- SEC’s view is that private funds should now be considering the principles underlying Rule 156 to avoid fraudulent statements in their sales literature (even if not engaged in general solicitations).

Impacts of Rule 156 Amendments

- Rule 156 anti-fraud guidelines apply to oral statements made in connection with the offering of a private fund.
- Rule 156 applies to all communications used by any person to offer to sell or induce the sale of securities of a fund, such as PPMs, OMs, pitch materials, RFIs, RFPs and DDQs (if not unique to the investor).
- Discussions of risks must be presented with equal prominence to discussions of possible benefits.

Impacts of Rule 156 Amendments (continued)

- Projections of future performance will no longer be permitted in any marketing materials for a private fund, including the PPM.
 - Model/hypothetical backward-looking performance is still permitted
- Comparisons to other investment vehicles or indices must be explained completely.
- Enhanced disclosure required for performance over selective time periods.
- Failure to comply with Rule 156 could potentially give investors a private right of action under the Securities Act.

Rule 156 Examples

- Rule 156 amendments were intended to address concerns about:
 - Failing to disclose unusual circumstances that contributed to performance
 - Example: contribution of IPOs to performance
 - Failing to disclose the performance period or that more current information about performance is available and may be lower
 - Example: use of year-end numbers when most recent quarter was lower
 - Failing to provide disclosure that would permit an investor to evaluate the significance of performance based on a selective time period.
 - Example: presenting performance only after J-curve

Are Manner and Content Restrictions Next?

- SEC requested comment on whether these restrictions should apply to private fund general solicitation materials.
- No standardized performance reporting rules.
- SEC requested comment on whether to require disclosure of financial and other information that is required to be provided to a purchaser that is not an accredited investor by Rule 502(b).

Proposed Requirement to Submit General Solicitation Materials to the SEC

- Proposed Rule 510T would require an issuer that is relying on 506(c) to submit any written general solicitation materials to the SEC
 - Must be submitted no later than first day of use
 - Would not apply to oral communications with potential purchasers.
 - Not treated as “filed” or “furnished” for securities law purposes and would not be publicly available.
 - Exemption is not conditioned on compliance with Rule 510T.
 - But an issuer could be disqualified from relying on Rule 506 if the issuer, or any of its predecessors or affiliates, has been subject to an order, judgment or court decree for failure to comply.
 - Temporary rule that would expire in 2 years.

Proposed Rule 509-Mandated Legends for Written General Solicitation Materials

- The securities may be sold only to accredited investors, which for natural persons, are investors who meet certain minimum annual income or net worth thresholds.
- The securities are being offered in reliance on an exemption from the registration requirements of the Securities Act, and the issuer is not required to comply with specific disclosure requirements that apply to offerings registered under the Securities Act.
- The Commission has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials.
- The Securities are subject to legal restrictions on transfer and resale, and investors should not assume they will be able to resell their securities.
- Investing in securities involves risk, and investors should be able to bear the loss of their investment.

Proposed Rule 509-Additional Mandated Legends for Private Funds Only

- Designed to address the risk of confusion with registered funds
 - The securities offered are not subject to the protections of the Investment Company Act.
 - Performance data represent past performance.
 - Past performance does not guarantee future results.
 - Current performance may be lower or higher than performance data presented.
 - The private fund is not required by law to follow any standard methodology when calculating and representing performance data; and
 - The performance of the fund may not be directly comparable to the performance of other private or registered funds.
 - Provide a telephone number or website where an investor may obtain current performance data.

Rule 509 Additional disclosures by Private Funds

- Performance data in written general solicitation material must be “as of the most recent practicable date [when published] considering the type of private fund and the media through which the data will be conveyed.”
 - The SEC noted that “current performance data” means data as of the last date on which the private fund customarily determines the valuation of its portfolio securities.
- Must disclose the period for which performance is presented.
- Performance data that does not reflect the deduction of fees and expenses must include disclosure to that effect and that if such fees and expenses had been deducted, performance may be lower than presented.
- What about other issuers who rely on Rule 506(c)?

Proposed Rule 509 Disqualification

- Exemption is not conditioned on compliance with Rule 509.
- But an issuer could be disqualified from relying on Rule 506 if the issuer, or any of its predecessors or affiliates, has been subject to an order, judgment or court decree for failure to comply with the mandatory legends and disclosures.
 - SEC recognized the chilling effect that automatic disqualification for inadvertent errors or omissions would have on Rule 506(c) offerings, particularly for issuers who may use a large amount of written general solicitations in an offering.
- SEC has requested comment on whether to define “written general solicitation materials” for purposes of Rule 509.
- Comments due by September 23, 2013.

The background of the slide is a dark blue field filled with numerous out-of-focus light spots, creating a bokeh effect. These spots vary in size and brightness, with some appearing as soft, glowing circles and others as sharper, more defined points of light. The overall color palette is dominated by shades of blue, from deep navy to lighter, almost white highlights.

Proposed Rules:
Amendments to Regulation D and Form D

Proposed Changes to Form D Requirements

Current Form D Filing Rules

Proposed Amendments to Rules 503 and 507

Initial filing required within 15 days <u>after</u> first sale.	File no later than 15 days <u>before</u> the issuer engages in general solicitation
Annual and other updates required for any changes in previous filing.	Amend within 15 days after the first sale and also for any updates.
No requirement to file a closing amendment.	Closing amendment required within 30 days after offering is terminated (even if no securities sold)
Generally, no disqualification for failure to comply with filing requirement (so long as the issuer, its predecessor or affiliate, has not been enjoined by a court for failure to file).	<p><u>Automatic</u> disqualification for one year <u>for future offerings</u> if the issuer, <u>or any predecessor or affiliate</u>, does not comply with filing requirements in any offering within the last five years. (Limited 30-day cure period.)</p> <p>One-year disqualification starts from when the overdue filings are made.</p> <p>Transition: Five-year look back only to effective date of the amended rule.</p>
Relatively minimal information required.	More detailed information pertaining to the nature of the offering and parties involved.

Proposed Additional Form D Disclosure

- Issuer must declare reliance on Rule 506(b) or Rule 506(c)
- Type of general solicitation used, if any
- Methods used to verify investor status--506(c) (which could vary from investor to investor)
- Website address
- Disclosure of “control persons” (including greater than 10% owners)--506(c)
- Industry group information
- Issuer size--“Decline to Disclose” no longer available. If issuer provides financial information in its general solicitation or otherwise “makes it publicly available” or does not use “reasonable efforts to maintain confidentiality,” then it must disclose size info on Form D
- Trading Symbol and other security identifiers, if any, to help the SEC analyze the nature of securities offered
- Number and types of accredited and non-accredited investors
- Use of proceeds (not required for private funds)
- If the issuer’s securities are traded on an exchange, must disclose name of exchange
- If the issuer is registered with FINRA, whether the general solicitation materials were filed with FINRA
- Name of registered investment adviser to the private fund
- Disclosure of “bad actor” events.

Implications of Proposed Reg D Amendments

- Form D filing compliance critical for any Rule 506 offering—risk of *automatic* disqualification for failure to file.
 - 15-day advance filing requirement for general solicitations
 - Difficult to know when to file the closing amendment
 - Disqualification applies even if the issuer is not engaged in general solicitation
- Additional disclosures: nature of investors, general solicitation types, verification methods used, industry and financial information.
- Operating companies may be reluctant to disclose revenue, other financial information and use of proceeds on Form D even if included in general solicitation materials.
- SEC and state regulators are on notice of the offering.
- Requirement to submit general solicitation materials to SEC before use. May be difficult to keep track of all materials and timely submissions. SEC does not intend to make the materials publicly available, but could be shared with other agencies.
- An issuer may be disqualified as a result of actions beyond issuer's control such as past conduct by "bad actors" or conduct by affiliated entities in connection with their own offerings.
- Mandatory use of "prominent" legends in general solicitations may discourage the use of print and other advertisements. (Failure to do so could result in disqualification.)

**Now you decide whether to take
advantage of new Rule 506(c).**

Questions?

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Contact Information:



Michael S. Caccese
617.261.3133
michael.caccese@klgates.com



Nicholas S. Hodge
617.261.3210
nicholas.hodge@klgates.com



Paul J. Marnoto
617.261.3245
paul.marnoto@klgates.com

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