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General Solicitation by Private Funds on the Horizon

By Joshua Deringer

Among the six separate provisions that make up the Jumpstart Our Business Startups Act (JOBS Act), the most important for private funds is that which will modify current securities laws to remove the prohibition on general solicitation and advertisement for certain offerings. The change will alter fundamentally the way private funds are offered and sold.

Currently, almost all private funds rely on Rule 506 of Regulation D under the Securities Act of 1933 (Securities Act) to sell their interests. In general, Rule 506 allows sales to up to 35 non-accredited investors, and an unlimited number of accredited investors,[1] subject to certain conditions. One of the most significant of these conditions is Rule 502(c) of Regulation D, which provides that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising."

Signed into law by President Obama on April 5, 2012, the JOBS Act requires the Securities and Exchange Commission (SEC), within 90 days of its enactment, to revise Rule 506 of Regulation D under the Securities Act to provide that the prohibition against general solicitation or general advertising contained in Rule 502(c) of Regulation D does not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors. This is a very significant development for sponsors of hedge funds, private equity funds and venture capital funds as it will allow them to raise capital in a much broader manner and eliminate the "one on one" method that is in place today.

The 90-day period that the SEC had to enact the Rule expired without any action by the SEC. However, the SEC has announced that it will consider this matter at its open meeting on August 22, 2012 (it is unclear whether the SEC intends to consider a rule proposal or whether

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they will enact interim final rules while they consider industry comments). While removal of the general solicitation condition should be an easily crafted rule, the JOBS Act does raise a number of difficult interpretative issues for the SEC's rulemaking division.

Perhaps the most difficult issue for the SEC to tackle is enacting a methodology for private funds to determine whether investors are accredited. Under Rule 506 as currently in effect, an issuer must have a reasonable basis to believe that an investor meets the accredited investor definition.[2] To meet this requirement, private funds typically require prospective investors to complete detailed subscription documents representing to their qualifications. Absent a reason to believe that those representations are not true, issuers typically rely on them in meeting the reasonableness standard.

However, the JOBS Act provides that in order to rely on the ability to generally solicit or advertise, an issuer must take reasonable steps to verify that purchasers of the securities are accredited investors. In other words, the responsibility of the issuer under the JOBS Act is arguably more stringent – it must reasonably verify that an investor is qualified rather than just reasonably believing it to be the case. Furthermore, the JOBS Act provides that such verification must be done pursuant to a methodology created by SEC rulemaking. Therefore, in enacting its requisite rule, the SEC must construct a methodology. A substantial number of the comments that the SEC has received to date on Title II of the JOBS Act concern the appropriate methodology. Based upon these comment letters, the industry is concerned with a few particular points:

- The verification methodology for direct sales as well as sales through intermediaries;
- Creation of a safe harbor provision in the event that an investor turns out not to be accredited; and
- Confirmation that the standards applicable to Rule 506 offerings that do not rely upon general solicitation are not changing.

Throughout the comment period the industry has urged the SEC to enact rules that provide issuers with clarity. Some have suggested that the existing practice of relying on investor questionnaires should suffice.[3] Others have suggested the development of accredited investor verification providers – essentially independent third parties that can provide investors with certifications to the effect that they meet the accredited investor definition.[4]

Such third-party verifications raise several issues, however. For one, a private fund must generally make the accredited investor determination at the time of sale. Therefore, unless prospective private fund investors are going to get re-certified each time they invest in a private fund, the SEC would need to provide in its rulemaking that issuers may rely on a certification for some length of time. One commenter has suggested 12 months.[5] Another issue is cost – if providing issuers with greater access to private capital is a purpose of the JOBS Act, then requiring investors to bear the costs of obtaining third-party verifications could be burdensome and cost prohibitive, thus thwarting the statutory intent. Nonetheless, several commenters have argued that the costs of such verification would be insignificant.

A related issue is whether a private fund may rely upon an intermediary's verification. Private funds are often sold through third-party intermediaries, such as broker-dealers. Under current law, private funds often rely upon such third parties to establish a pre-existing relationship (and avoid a general solicitation). However, issuers do not typically rely upon a third party's reasonable belief that a subscriber is accredited. Depending upon how onerous the SEC's prescribed verification process is, it may become important for issuers to be entitled to rely on intermediaries rather than perform all of the verifications themselves.

Another issue about which commenters have expressed concern is a safe harbor provision. Under current law, private funds need only a reasonable belief that an investor is accredited at the time of investment. That means issuers are generally not concerned that they will lose their ability to rely on the exemption if an investor's representations later turn out to be inaccurate. But since the JOBS Act allows general solicitation only with respect to offers where all of the investors *are* accredited investors (as opposed to where the issuer has a reasonable belief that they are accredited), a situation where an investor turns out to not be accredited could jeopardize the availability of Regulation D for that issuer. Because of this risk, and the concern that it will prevent some issuers from utilizing the newly provided ability to generally solicit investors, commenters have expressed the need for the SEC to enact a safe harbor provision providing that issuers following the SEC's prescribed verification methodology will be protected in the event an investor turns out not to be accredited.[6]

One issue of concern for the industry is that the SEC could use its rulemaking authority to alter the requirements of a Rule 506 offering that does not make use of general solicitation. In particular, the SEC could apply the verification methodology it adopts to the accredited investor determination for all 506 offerings. Commenters have asked the SEC to confirm that if an issuer does not utilize general solicitation, it may still rely on the current reasonable belief standard.[7]

Despite the uncertainties discussed above, many in the private fund industry have expressed appreciation for the new avenues of sales that are likely to open as a result of Title II (of course how open those avenues will be is dependent upon the SEC's ultimate rulemaking). Not all of the comment letters have been positive about the potential effects of 506 offerings involving general solicitation, though.

In particular, the Investment Company Institute (ICI) has expressed concern about the potential negative effects of the new law.[8] The ICI's comment letter expresses concern about the potential for misleading advertising by private funds which, it notes, are not subject to the same advertising restrictions as are mutual funds. Therefore, in its comment letter, the ICI urges the SEC to:

- Impose content restrictions on private fund advertising at least as extensive as those currently applicable to mutual funds;

- Prohibit performance advertising by private funds until the SEC enacts rules related to such advertising that are similar to those applicable to the mutual fund industry;

- Take steps to ensure that investors that see private fund advertisements do not confuse private funds with mutual funds;

- Direct the Financial Industry Regulatory Authority (FINRA) to require private fund advertisements to be filed with FINRA; and

- Raise the net worth thresholds in the accredited investor definition.

It is not clear at this time whether the SEC is considering adding any of the substantive rules urged by the ICI. At least one industry participant (that manages both mutual funds and private funds) has suggested that the types of regulations desired by the ICI are not necessary.[9]

The removal of the general solicitation prohibitions for certain private offerings will fundamentally change the manner in which private funds are sold in the United States. At this point, however, there remains uncertainty about how the SEC will regulate this new opportunity, and what types of advertising private funds will actually do. However, given the increasingly complex distribution channels for private fund sales, and the competition for assets in this economy, there will likely be significant use of whatever leeway is allowed by the SEC.

Notes

1. Rule 501 under the Securities Act generally defines accredited investors as, among other things, natural persons with individual or joint net worth with a spouse of more than $1,000,000 excluding the value of their primary residence; natural persons with incomes of more than $200,000 (or joint incomes of $300,000 for married couples) per year for the past two years, with a reasonable expectation that such income levels will be attained in the current year; or certain entities with total assets in excess of $5,000,000.

2. Rule 501(c) under the Securities Act.

3. *See* comments of Sean Davy, Managing Director, Securities Industry and Financial Markets Association (SIFMA).

4. *See* comments of Paul S. Sigelman and Paul P. Kestenbaum, Sigelman Law, Beverly Hills, California.

5. *See* comments of Annemarie Tierney, General Counsel, SecondMarket Holdings, Inc., New York, New York.

6. *See* comments of Daniel Oschin, President, Real Estate Investment Securities Association.

7. *See id*.

8. *See* comments of Paul Schott Stevens, President and CEO, Investment Company Institute.

9. *See* comments of Barbara G. Novick, Vice Chairman, BlackRock, Inc., New York, New York.

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