

## Investment Funds Alert

### SEC Proposes Rule Changes Permitting General Solicitation in Rule 506 and Rule 144A Offerings

September 4, 2012

On August 29, 2012, the Securities and Exchange Commission (SEC) proposed rule amendments that would eliminate the prohibition on general solicitation and general advertising in private placements made by issuers in reliance on Rule 506 under the Securities Act of 1933 (the “Securities Act”), and in resales of securities to qualified institutional buyers pursuant to Rule 144A under the Securities Act. The rule changes were mandated by the Jumpstart Our Business Startups Act. The proposed amendments to Rule 506 would permit an issuer, including a private fund,<sup>1</sup> to decide whether to (i) generally solicit investors but be subject to new requirements to verify that all investors in the offering are accredited investors or (ii) continue offering interests pursuant to the current rule which includes a ban on general solicitation but does allow sales to up to 35 non-accredited investors. The SEC’s proposed rules would provide for flexibility in how advisers verify whether the potential investor is an accredited investor.

#### Changes to Rule 506

The proposed amendments would add a new paragraph (c) to Rule 506 that would permit issuers to conduct a general solicitation so long as:

- All purchasers are accredited investors.
- The issuer takes reasonable steps to verify the accredited investor status of all purchasers.
- The conditions of Regulation D other than the general solicitation restriction are satisfied.

Neither new Rule 506(c) nor the accompanying release specifies what reasonable steps would be required to verify the status of the investors—only that the steps taken be objectively reasonable. The SEC recognizes that the verification requirement should be sufficiently flexible to accommodate the different types of issuers that would conduct offerings under Rule 506(c), and that what is a reasonable verification would depend on the facts and circumstances of the offering, including:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be
- the amount and type of information that the issuer has about the purchaser, 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.

<sup>1</sup> The SEC stated in the proposing release that it believes that the JOBS Act permits a privately offered fund to make a general solicitation under the proposed amendments to Rule 506 without losing its exemption under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.



Each of the factors is interconnected, with the satisfaction of one factor reducing the required verification efforts imposed by other factors. For example, if an issuer requires a large minimum investment that only large net worth investors would be reasonably expected to satisfy, it may be reasonable for an issuer to take no steps to verify a prospective purchaser's accredited investor status other than to confirm that the prospective purchaser's cash investment was not financed, unless other facts indicate that the prospective purchaser is not an accredited investor.

While Rule 506(c) does not require methods of verification or provide suggested verification methodology, the proposing release does provide examples of verification methods. Examples of verification include:

- review of information in publicly available sources, such as
  - filings with the SEC under the Securities Exchange Act of 1934 (including executive compensation information in a reporting company's proxy statement)
  - the broker check system maintained by the Financial Industry Regulatory Authority, Inc. (FINRA)
  - Form 990s required to be filed by 501(c)(3) exempt organizations
- review of tax returns
- retention of a third party to conduct the required verification, so long as the issuer has a reasonable basis to rely on that verification.

These examples are not, however, intended to reduce the flexibility that the rule is intended to provide. The SEC also clarified that the verification requirement in Rule 506(c) would not mean that all investors must, in fact, be accredited in order to use the exemption if the issuer is conducting a general solicitation. The issuer must only have a reasonable basis that the investor is accredited, but the basis should be documented and objectively reasonable.

## Form D

The SEC also proposed to amend Form D to include a checkbox stating that the issuer is relying on the exemption in Rule 506(c).

## Rule 144A

In addition to amendments to Rule 506, the SEC proposed amendments to Rule 144A, which currently exempts an offer or sale of securities from the registration requirements of the Securities Act so long as, among other conditions, all persons who are offered securities are "qualified institutional buyers." The requirement that all offerees be qualified institutional buyers thereby effectively prohibits general solicitation. The amendments would change the conditions of Rule 144A to permit offers to persons other than qualified institutional buyers (including by general solicitation) so long as the issuer reasonably believes that all ultimate purchasers in the offering are qualified institutional buyers.

## Policies and Procedures Impact

If the proposed amendments are adopted, advisers to private funds that use new Rule 506(c) will need to amend their policies and procedures to address how the adviser will verify the status of investors in their private funds. Because the issuer will have the burden to show that it has complied with the new requirements, there will be an implicit obligation to retain adequate records that document the steps taken to verify that a purchaser was an accredited investor.

## Conclusion

If the proposed rule amendments are adopted, we expect that many advisers to private funds will opt to have the private funds they advise conduct their offerings under new Rule 506(c).<sup>2</sup> Among other things, the new rule will give advisers:

- more flexibility in the content of their websites
- an increased ability to openly discuss their funds with the media and others
- protection from inadvertent statements calling into question whether the private placement exemption is available.

Other private funds may, due to their investor base, be forced to conduct offerings under the current version of Rule 506. The proposed rule leaves open a number of questions, including whether an issuer that currently has non-accredited investors would be able to rely on Rule 506(c) going forward immediately after the effectiveness of the proposed amendments. In addition, the Commodity Futures Trading Commission (CFTC) has not yet provided guidance on whether commodity pool operators would be able to generally solicit investors in a commodity pool and rely on the “*de minimis*” exemption under CFTC Regulation 4.13(a)(3).

The SEC’s rule proposal is available on its website [here](#). The proposed rules are subject to a shortened comment period of 30 days after publication in the Federal Register.

For a summary of how these proposed amendments would affect issuers other than private funds, see the alert published by our corporate group available [here](#).

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<sup>2</sup> Advisers to funds will still be subject to anti-fraud liability and, to the extent registered as an investment adviser with the SEC or a state, applicable advertising rules.