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SEC Lifts Advertising Ban on Private Offerings: What It Means for Private Equity, Hedge and Venture Capital Funds

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On July 10, the SEC adopted a new rule that will permit many private equity funds, hedge funds and venture capital funds to use general advertising and solicitation when offering and selling interests in a fund (the "New Rule"). This is a significant change from existing law. The New Rule will permit a private fund to advertise in any media. Even if a fund decides not to advertise, a fund may find it useful to make its website more accessible to the public, to use social media, and to speak freely at conferences and seminars as well as to the press. Private funds relying on the New Rule may only admit investors that are "accredited investors" and must take "reasonable steps to verify" that the investors are accredited investors. The New Rule will become effective in mid-September (60 days after publication in the Federal Register, the "Effective Date"). Accordingly, funds must wait until the Effective Date before engaging in any general advertising or solicitation.

Background

The New Rule is contained in Rule 506 of Regulation D under the Securities Act of 1933. Most private funds already rely on Regulation D when offering and selling securities. Upon the New Rule's Effective Date, private funds may engage in general solicitation or advertising going forward. If they do, they must satisfy the following conditions and should consider the "Important Considerations" below.

New Rule Conditions

All investors must be accredited investors. Accredited investors are individuals who meet certain minimum income or net worth levels, or certain institutions such as trusts, corporations or charitable organizations that meet certain minimum asset levels. Funds relying on the New Rule may not admit any investors who are not accredited investors. Funds that already have non-accredited investors can still rely on the New Rule going forward.

Private funds must take "reasonable steps to verify" that investors are accredited investors. Under the New Rule, it is not sufficient to rely solely on an investor's representation that the investor is an accredited investor. Otherwise, however, the New Rule does not mandate any specific requirements as to what constitutes "reasonable steps to verify" that investors are accredited investors. Instead, the New Rule provides that the determination of the reasonableness of the steps taken is an objective assessment by the fund, considering the facts and circumstances of the investor and the transaction. The New Rule contains a non-exclusive list of methods that funds may (but are not required to) use to verify that a natural person investor is an accredited investor.

Form D. A fund must indicate on its "Form D" filed with the SEC in connection with the offering that it is relying on the New Rule.

Important Considerations

- *Some Fund Managers May Be Precluded from Relying on the New Rule*
  - *CFTC Exemptions*. Fund managers relying on the "de minimis" exemption from registering as a "commodity pool operator" with the CFTC would not be able to rely on the New Rule. That exemption requires that the fund not be marketed to the public in the United States. A similar analysis may apply to managers relying on an exemption from registration as "commodity trading" advisers with the CFTC.

- *State Investment Adviser Registration Exemptions*. Some states have an investment adviser registration exemption that prohibits the adviser from holding itself out to the public as an adviser. Fund managers who are relying on the exemption from registration in those states arguably may not be able to rely on the New Rule.
- *Foreign Private Adviser Exemption*. The "foreign private adviser exemption" from registration as an investment adviser with the SEC requires that the adviser not hold itself out to the public in the U.S. as an investment adviser. Although it is not entirely clear, non-U.S. fund managers relying on this exemption may not also be able to rely on the New Rule.

- *General Solicitation Materials*. The SEC has proposed amendments that would impose disclosure-related requirements on private fund general solicitation materials. Even if these amendments are not adopted, fund managers that include their track records in any general advertising or solicitation must comply with existing SEC rules and guidance in no-action letters about the presentation of performance history as well as the use of model or hypothetical returns.
- *Other Compliance Issues.* Advisers that decide to take advantage of the New Rule should keep in mind a number of compliance issues that may arise when engaging in general solicitation and advertising, including the following:
  - *Social Media.* SEC-registered advisers must capture and retain all written communications and marketing materials. Accordingly, they will need to capture and retain any general solicitations, including the use of social media.
  - *Websites.* Funds that make their websites more accessible to the public need to be careful not to violate non-U.S. securities laws if they are seeking non-U.S. investors. They should consider a system that directs non-U.S. web users to a password-protected portion of the website.

- *Qualified Client Requirement Still Applies for Performance Fees.* Even though the New Rule only requires that investors be accredited investors, SEC-registered advisers (as well as advisers exempt under California law) should keep in mind that they can only charge performance fees to investors who meet the higher "qualified client" standard.
- *Consider Whether Advertising Is Worthwhile*. The number of accredited investors is still relatively small. Accordingly, funds should consider whether it is worthwhile to advertise in a medium aimed at the public generally, as opposed to a more targeted medium – for example, a publication aimed at high net worth investors.

If you have questions regarding this publication, please contact the authors or your regular Mintz Levin contact.

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