KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

September 10, 2012

JOBS Act Proposed Rules Would Allow Public Marketing of Private Fund Securities

PENpoints

The SEC recently issued proposed rule changes eliminating longstanding restrictions on general solicitation or advertising of a private company's issuance of unregistered securities.

As discussed in a previous PEN, the SEC's rules governing the sale of unregistered securities by a private "issuer" — including a private fund and a "newco" formed to purchase or invest in a target — have for many years prohibited the issuer from engaging in general solicitation of or advertising for investors. As required by the JOBS Act, the SEC recently issued proposed rule changes eliminating these longstanding restrictions, so long as the issuer performs additional diligence to verify that all securities purchasers are "accredited investors" under Rule 501.

Until adoption of final rules (expected later this year), however, a private issuer must continue to operate under the old rules and may not engage in general solicitation or advertising for a private offering.

Background

Historically, the SEC's Rule 506 (which is part of Regulation D) allowed an issuer, including a private fund, to sell securities without any dollar limitation to an unlimited number of accredited investors,[1] but only so long as it did not engage in any general solicitation of or general advertising for investors.

The SEC interpreted this general solicitation or advertising ban in private placements to prohibit any publication, broadcasting or use of other mass media methods to solicit investors, so an issuer was required to restrict public statements on websites, in the general media and in public presentations by its (or the sponsor's) employees.

In addition, the SEC required the issuer (or its sponsor) to have a pre-existing substantive relationship with each potential investor solicited (*i.e.*, a relationship that allows the issuer to reasonably conclude the persons being solicited are accredited investors or financially sophisticated), including a prohibition against cold-call solicitations, even to institutional investors generally known to be accredited investors. This led some private funds to retain placement agents because the SEC allowed an issuer to market to a placement agent's pre-existing substantive relationships even if the issuer had no such direct relationship.

Proposed new rule

On August 29, 2012, the SEC proposed (as required under the JOBS Act) new Rule 506(c) of Regulation D, which would permit an issuer to engage in general solicitation and general advertising in an offering, provided that:

- the issuer takes reasonable steps to verify that each purchaser of its securities is an "accredited investor,"
- either each purchaser of securities is in fact an accredited investor or the issuer reasonably believes, at the time of the sale of the securities, that each purchaser is an accredited investor, and
- the issuer satisfies all of the other requirements of a private placement under Regulation D, such as restrictions on transferability of securities.[2, 3]

What constitutes "reasonable steps to verify" accredited investor status?

Under the proposed rules, whether an issuer took "reasonable steps to verify" the accredited investor status of each purchaser (including an LP in a private fund) will be judged on the facts and circumstances of each transaction, looking at factors that include, but are not limited to:

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- the nature of the purchaser and type of accredited investor the purchaser claims to be (*e.g.*, a registered broker-dealer or large 501(c)(3) organization required to make public filings would require less verification than an individual investor),
- the amount and type of information the sponsor has about the purchaser,[4] and
- the nature of the offering, such as the manner of solicitation[5] and the terms of the offering (*e.g.*, less information might be required for a fund with a high minimum initial investment amount).

Regardless of the verification methods employed by an issuer, it is critical for the issuer to make and preserve adequate records of the steps taken to verify that all purchasers were accredited investors.

Reasonable belief standard preserved

Recognizing that prospective investors could provide false information to an issuer or third party claiming to be an accredited investor, the SEC stated that an issuer that took "reasonable steps to verify" the status of each purchaser would not lose the private placement exemption as long as the issuer had a reasonable belief that such purchaser was an accredited investor. [6]

Form D revisions

The SEC also proposed to modify Form D, which an issuer must file with the SEC, so that an issuer indicates whether it is relying on the new Rule 506(c) exemption or the existing private placement exemption (with no general solicitation or advertising) contained in re-named Rule 506(b).

Practical implications

Despite the availability of this more flexible approach to marketing a fund, sponsors must carefully consider the burdens and costs that the heightened investor verification procedures would impose. Once a sponsor elects to engage in general solicitation or advertising under the proposed rule, it likely will be difficult to change course and instead rely on the old rule (with its less intrusive investor qualification requirements) without a sufficient cooling-off period.

In addition, sponsors (a) must still be mindful of securities law prohibitions against making misleading statements or failing to disclose material information to investors and (b) should consider adopting a marketing policy addressing these and related issues. A private fund manager registered as an investment adviser must also consider advertising restrictions that apply to fund offering materials under the Investment Advisers Act, as well as other potentially applicable regulations.[7]

Comment period

Public comments on the proposed rules are due on or before October 5, 2012.

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1 The Investment Company Act and the Securities Exchange Act would, however, make it impractical to have more than 100 equity owners of a §3(c)(1) fund or more than 1,999 holders of any private fund.

2 As directed by the JOBS Act, the SEC also proposed amendments to allow securities sold pursuant to Rule 144A (governing resale by a holder of restricted securities to "qualified institutional buyers," (*e.g.*, an institution that manages at least $100 million in assets, or a broker-dealer owning and investing at least $10 million of securities for non-affiliates, commonly called a QIB)) to be offered by means of general advertising and solicitation, provided that the securities are sold only to persons whom the seller (or its placement agent) reasonably believe is a QIB.

3 The public offering restriction, including through general advertising or solicitation, will, however, remain in effect for other private placement exemptions, such as §4(a)(2) or Rule 505 of the Securities Act. In addition, the SEC intends to preserve the existing Rule 506 exemption for offerings that do not involve general solicitation or general advertising in new Rule 506(b). However, where two or more funds formed at or about the same time (*e.g.*, a main fund and a parallel fund) are integrated for Regulation D purposes, the use of general advertising or solicitation by one of the funds likely would preclude the other funds from relying on Rule 506(b).

4 According to the SEC, "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa," and "if an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer would not have to take any steps at all." For a prospective investor who is a natural person, the SEC has suggested that it might suffice to (a) obtain copies of such person's Form W-2, or (b) review public filings (*e.g.*, under the Exchange Act) or industry or trade publications with compensation information, if information about the person is available.

5 For example, an issuer soliciting investors through a website accessible to the general public or through a widely disseminated e-mail or social media solicitation likely must take more steps (*e.g.*, beyond simply requiring a prospective investor to check a box or sign a form attesting to its status as an accredited investor) than from a pre-screened database of potential investors maintained by a reliable third party. In the latter case, the SEC believes an issuer could rely on the verification of an investor's status as an accredited investor by a third party if the issuer has a reasonable basis to rely on the third party's verification.

6 The SEC also confirmed that it will continue to follow its historical treatment of concurrent Regulation S and Rule 506 offerings. That is, it will not integrate an offshore offering conducted in compliance with Regulation S with a domestic unregistered offering conducted in compliance with Rule 506 or Rule 144A.

7 For example, sponsors must continue to comply with securities laws of non-U.S. jurisdictions in which securities are offered, as well as publicly traded partnership tax rules, as applicable. In addition, it is currently unclear whether use of general solicitation and general advertising will be permitted under the CFTC exemption from commodity pool operator registration that many sponsors engaging in swaps and other derivatives transactions rely upon. There is more clarity, however, with respect to Investment Company Act considerations, with the SEC confirming its view that the effect of the JOBS Act is to permit private funds to engage in general solicitation or general advertising under amended Rule 506 without affecting the availability of the exemptions.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

Breakup Fees — Picking Your Number

During the negotiation of every public company deal, the conversation inevitably turns to the amount of the breakup fee payable by the target company to the buyer if the deal terminates under certain circumstances. Kirkland attorneys David Fox, Daniel Wolf, David Feirstein and Josh Zachariah warn against relying too heavily on statistical data and court precedent when setting the appropriate amount of the target breakup fee, calling for a more nuanced, fact-specific and tailored approach to determining a breakup fee. To learn more, see their recent *M&A Update*.

PENnotes

PLI's Hot Topics in Mergers & Acquisitions 2012
New York, New York
September 20, 2012

The Practising Law Institute will host its "Hot Topics in Mergers & Acquisitions 2012" seminar on September 20 in New York to explore the fascinating state of M&A and the trends you need to be aware of for the year ahead. Kirkland partner William Sorabella will participate as a panelist at the New York conference. Click here for more information or to register for this event.

7th Annual Kirkland Real Estate Private Equity Symposium
New York, New York
October 3, 2012

Please save the date for the upcoming "Kirkland Real Estate Private Equity Symposium." More information to come.

Registered Adviser Seminar & CCO Summit
San Francisco, California
October 25, 2012

Chicago, Illinois
October 30, 2012

New York, New York
November 8, 2012

Please save the date for our 2012 Registered Adviser Seminar & CCO Summit in San Francisco, Chicago and New York. Now that most private fund managers are registered as investment advisers with the SEC, firms must be familiar with the new and evolving regulatory environment. This seminar is designed specifically for private fund manager CCOs, general counsel and other senior executives.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 300 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" for 2012 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm in the United States" at *World Finance*'s 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011*, and has consistently received top rankings among law firms in Private Equity by Chambers & Partners, *The Legal 500*, the Practical Law Company and *IFLR*, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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