KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

July 17, 2013

SEC Adopts JOBS Act Rules Allowing Public Marketing of Private Fund Securities

PENpoints

As required by the JOBS Act, the SEC recently adopted rule changes permitting a private issuer to engage in solicitation and advertising in selling its unregistered securities.

As discussed in previous *PEN*s, 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 general advertising for investors.

As required by the JOBS Act, the SEC recently adopted 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. The new rules are expected to be effective in mid-September 2013 — 60 days after they are published in the Federal Register — and were adopted in substantially the same form as proposed in August 2012, except that the SEC has introduced four non-exclusive safe harbor methods for verifying the accredited investor status of a natural person.

The SEC concurrently proposed additional investor protection measures that could increase the regulatory burden on an issuer engaging in general solicitation or advertising, as discussed below under *SEC Proposes New Private Placement Marketing and Disclosure Requirements and Form D Amendments*.

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 the issuer did not engage in any general solicitation of or general advertising for investors.

The SEC interpreted this general solicitation and 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 each person being solicited is an accredited investor or is financially sophisticated), including a prohibition against cold-call solicitations, even to institutional investors generally known to be accredited investors. This led many 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.

New Rule 506(c)

Under newly adopted Rule 506(c) of Regulation D, an issuer may engage in general solicitation and 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]

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However, the SEC preserved the prior Rule 506 exemption (which permits an offering not involving general solicitation or advertising) as new Rule 506(b), which is electively available to an issuer who (a) is selling to non-accredited (as well as accredited) investors and/or (b) does not wish to be subject to Rule 506(c)'s new requirements listed above and is not engaging in general solicitation or advertising.[3]

What constitutes "reasonable steps to verify" accredited investor status for Rule 506(c)?

Whether an issuer took "reasonable steps to verify" the accredited investor status of each purchaser (including an LP in a private fund), as required by new Rule 506(c), is judged on the facts and circumstances of each transaction, looking at factors that include, but are not limited to:

- 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 an open-end fund with a high minimum initial investment amount).

The SEC confirmed that self-certification by an investor without any additional steps is not sufficient to verify such investor's accredited investor status, except in certain limited circumstances where a natural person has a pre-existing relationship with the issuer, as discussed below.

Rule 506(c) safe harbors for verification of natural persons

The SEC adopted the following non-exclusive safe harbors through which an issuer can demonstrate that it took "reasonable steps to verify" the accredited investor status of a natural person:

- *Tax documents*. Reviewing copies of any IRS form that reports the income of such person (e.g., copies of Forms W-2, 1099 and 1040 and Schedule K-1) plus obtaining a written representation that such person reasonably expects to continue to meet the necessary income threshold during the current year;
- *Bank and other financial statements.* Reviewing documentation[6] of such person's net worth dated within the prior three months plus obtaining a written representation that all liabilities necessary to make a determination of net worth have been disclosed;
- *Third party verification*. Receiving a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, or a licensed attorney or certified public accountant in good standing that such third party has taken reasonable steps to verify such person's status as an accredited investor; and
- *Pre-existing relationship*. With respect to any person who purchased securities in an issuer's private placement as an accredited investor prior to the effective date of the new rules and remains an investor in the issuer, obtaining a certification to the effect that such person remains an accredited investor at the time of any subsequent investment in the issuer under a Rule 506(c) offering.

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

Reasonable belief standard preserved for Rule 506(c)

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 Rule 506(c) private placement exemption as long as the issuer had a reasonable belief that such purchaser was an accredited investor at the time of sale.

Form D revisions

The SEC also adopted modifications to Form D, which an issuer must file with the SEC, so that an issuer must indicate whether it is relying on (x) the new Rule 506(c) exemption allowing general solicitation or advertising but no non-accredited purchasers or (y) the long-standing private placement exemption now embodied in Rule 506(b) (with no general solicitation or advertising but with up to 35 non-accredited purchasers).

Practical implications

Despite the availability of the more flexible Rule 506(c) approach to marketing a fund with 100 percent accredited purchasers, a sponsor must carefully consider the burdens and costs imposed by the heightened accredited investor verification procedures and by the proposed additional investor protection measures. In particular, a sponsor must evaluate the risk that the intrusiveness of certain accredited investor verification methods under Rule 506(c) could discourage high net worth individuals from investing in a fund that is required to utilize such verification methods.

Once a sponsor engages in general solicitation or advertising under Rule 506(c) (with respect to either the offering or another offering that is integrated with the offering), it is not possible to change course and instead rely on Rule 506(b) (with its less intrusive investor qualification requirements) or the general private placement exemption under §4(a)(2) without a sufficient cooling-off period. Similarly, a sponsor that initially markets a fund under Rule 506(b) and subsequently transitions to a Rule 506(c) offering involving general solicitation or advertising must employ the heightened accredited investor verification standards for all investors, not just those obtained through the later Rule 506(c) offering.

However, where a fund that has privately offered and sold fund equity interests to investors with no general solicitation or advertising prior to Rule 506(c)'s effective date (in a first closing) but switches to a Rule 506(c) offering with general solicitation or advertising for sales after Rule 506(c)'s effective date, the SEC release states that (1) the pre-effective-date offering is respected as a Rule 506(b) offering and hence (2) the prohibition on non-accredited investors and heightened accredited investor verification standards do not apply to pre-effective-date sales.

In addition, a sponsor (1) must still be mindful of securities law and general anti-fraud prohibitions against making misleading statements or failing to disclose material information to investors and (2) should consider amending its marketing policy to ensure that it remains appropriate in light of any general solicitation or advertising it conducts. 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, 8]

Finally, sponsors should consider the proposed rules described below under *SEC Proposes New Private Placement Marketing and Disclosure Requirements and Form D Amendments*, which could be adopted during an offering using general solicitation or advertising, including possible new SEC filing requirements of offering materials.

Effective date

As noted above, the new rules are not effective until 60 days after publication in the Federal Register. No general solicitation or advertising is permitted before such date expected to be in mid-September 2013.

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1 The Investment Company Act and the Securities Exchange Act, however, make it impractical to have more than 100 owners of a §3(c)(1) fund or more than 1,999 equity holders of any private fund, including a §3(c)(7) fund.

2 As directed by the JOBS Act, the SEC also adopted 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 solicitation or advertising, provided that the securities are sold only to persons whom the seller (or its placement agent) reasonably believes is a QIB.

3 The public offering prohibition, including through general solicitation or advertising, remains in effect for other private placement exemptions, such as Securities Act §4(a)(2), Rule 505, or 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 solicitation or advertising by one of the funds likely would preclude the other funds from relying on new 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 may have to take, and vice versa," and "if an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer will not have to take any steps at all." For a prospective investor who is a natural person that cannot be verified under one of the four safe harbor methods, the SEC has suggested that it might suffice to (a) obtain copies of such person's pay stubs for the two most recent years and the current year, (b) review public filings (e.g., under the Exchange Act) disclosing such person's compensation or (c) review specific publicly available information about the average compensation earned at such person's workplace by persons at the level of such person's seniority.

5 For example, an issuer soliciting investors through a website accessible to the general public, through a widely disseminated e-mail or social media solicitation, or through print media 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 an issuer soliciting investors 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 For example, to verify a person's assets, an issuer may obtain redacted copies of such person's bank, brokerage and other statements of securities holdings, certificates of deposit, tax assessments and third party appraisals. To verify a person's liabilities, an issuer may obtain a credit report from at least one of the nationwide consumer reporting agencies.

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 the CFTC will permit use of general solicitation and advertising under the exemption from commodity pool operator registration on which many sponsors engaging in swaps and other derivatives transactions rely.

8 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. In addition, the SEC confirmed that the effect of the JOBS Act is to permit private funds to engage in general solicitation or advertising under Rule 506(c) without affecting the availability of Investment Company Act §3(c)(1) and §3(c)(7) exemptions. However, for a domestic private fund relying on the §3(c)(1) or §3(c)(7) exemption, a Regulation S offering may call into question whether the issuer has conducted a public offering and, therefore, make such exemption unavailable. On the other hand, for an offshore fund, such Regulation S offering is permissible under the *Touche Remnant* doctrine.

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SEC Adopts New Rules for "Bad Boy" Disqualifications for Regulation D Offerings

PENpoints

The SEC has adopted new rules preventing bad actors from relying on safe harbor rules governing private placements of securities.

As required by the Dodd-Frank Act, the SEC has adopted new rules (which will be effective 60 days after publication in the Federal Register (the "Effective Date")) disqualifying "issuers" — including a private fund and a "newco" formed to purchase or invest in a target — from relying on Regulation D's commonly used Rule 506 safe harbor from securities registration if any of the following persons or entities ("Covered Persons") is subject to certain disqualifying events within the prior five-to-10 year time period:

- an issuer (including any predecessor or affiliate[1] of the issuer);
- if the issuer is a fund, the fund's general partner or investment manager, or other entity fulfilling a similar investment advisory role (and any of their respective general partners or managing members);
- if the issuer is a partnership or LLC operating company, the issuer's general partner or managing member;
- an issuer's placement agents or other compensated solicitors (and any of their respective general partners or managing members);
- for the foregoing categories of Covered Persons, any (i) director or executive officer or (ii) other officer who participates[2] in the offering;
- an issuer's "promoters;"[3] or
- an owner of 20 percent or more of the issuer's outstanding voting securities.[4]

Among other things, such disqualifying events include:

- securities-related criminal convictions, court injunctions and restraining orders;
- certain disciplinary orders issued by the SEC, the CFTC, state securities regulators and certain other regulatory bodies; and
- suspension or expulsion from membership in, or association with, a self-regulatory organization.

The new rules provide disqualification only for events (e.g., a securities-related criminal conviction, court injunction or restraining order, certain SEC disciplinary orders, etc.) that occur on or after the Effective Date (expected to be in mid-September 2013), even if the underlying conduct occurred prior to such date. However, anything that would have been a disqualifying event if it had occurred on or after the Effective Date must be disclosed a reasonable period of time prior to any sale on or after the Effective Date. For ongoing Regulation D offerings, the new disqualification and disclosure rules do not impact the exemption for offers or sales made prior to the Effective Date, but apply only to an offer or sale on or after that date.[5]

The new rules also require certification on Form D that no Covered Person is subject to any disqualifying event.

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1 "Affiliate" is broadly defined in Regulation D as any person who directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the issuer.

2 Whether an officer participates in an offering is a question of fact. Participation would have to be more than transitory or incidental involvement and could include activities such as participation in due diligence activities, involvement in the preparation of disclosure documents, and communication with the issuer, prospective investors or other offering participants.

3 In most cases, a "promoter" of a private fund is likely to be a Covered Person because he, she or it is an officer, director, general partner or investment manager. However, a "newco" may have "promoters" outside those categories. Rule 405 under the Securities Act defines "promoter" to mean any person who: (i) acting alone or together with others, directly or indirectly takes initiative in founding or organizing the business or enterprise of an issuer; or (ii) in connection with the founding or organization of the business or enterprise of an issuer, directly or indirectly receives 10 percent or more of any class of issuer securities or 10 percent or more of the proceeds from the sale of any class of issuer securities (not including securities received solely as underwriting commissions or solely in exchange for property if the recipient does not otherwise take part in founding and organizing the enterprise).

4 Whether or not an issuer's equity interests qualify as "voting securities," and therefore whether any of its beneficial owners could potentially be a Covered Person, is a facts-and-circumstances determination depending on the terms of the issuer's governing document (e.g., where the issuer is a fund, the fund's limited partnership agreement). The SEC release states that (1) "voting security" means a security having "the ability, either currently or on a contingent basis, to control or significantly influence the management and policies of the issuer through the exercise of a voting right," including the right to elect or remove the issuer's directors or other controlling persons (presumably including the issuer's general partner, in the case of an issuer that is a limited partnership) and (2) an equity interest is not a "voting security" simply because it entitles the holder to approve changes to the holder's rights and preferences.

5 Thus, where an issuer has had its final closing before the Effective Date and is not proposing a new offering under Rule 506 after the Effective Date, the new rules would not require that such events be disclosed.

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SEC Proposes New Private Placement Marketing and Disclosure Requirements and Form D Amendments

PENpoints

The SEC proposed several amendments to the rules governing marketing and disclosure by an issuer effecting a private placement of securities.

In connection with removing the ban on general solicitation of or general advertising for investors in certain Regulation D offerings as described in *SEC Adopts JOBS Act Rules Allowing Public Marketing of Private Fund Securities* above, the SEC proposed several amendments to the rules governing marketing and disclosure by an issuer—including a private fund and a "newco" formed to purchase or invest in a target—effecting a private placement of its securities, particularly for a fund selling securities through general solicitation or advertising, as well as significant changes to Form D.

Stricter Requirements for Marketing Materials

Rule 156 Standards for All Private Funds. Securities Act Rule 156 currently applies anti-fraud standards to the marketing materials of a registered investment company. The Rule requires that adequate context be given to statements regarding the offer or sale of securities, and sets forth specific guidance on what statements may be misleading, particularly in the context of past or future investment performance. The SEC's proposal would impose these stricter standards on all private fund marketing materials (whether offered under Rule 506(b) or 506(c)), and given its broad scope would require a private fund adviser to review all investor communications for appropriate explanations, qualifications or limitations, and to eliminate exaggerated or unwarranted claims.

Heightened Standards and New Filing Obligations for General Solicitation or Advertising. The proposal would also require written marketing materials under Rule 506(c) for a private fund or other issuer to include legends disclosing that the relevant securities:

- may be sold only to accredited investors, with certain minimum income or net worth thresholds for natural persons;
- are being offered pursuant to an exemption from Securities Act registration and are not subject to Securities Act requirements;
- have not been approved by the SEC, nor have the offering terms or the offering materials;
- are subject to restrictions on transfer and resale;
- involve investment risk, and investors should be able to bear investment losses; and
- in the case of a private fund, are not subject to the protections of the Investment Company Act.

Additional requirements would apply to any such materials used by a private fund containing performance data, such as statements that past performance is not a guarantee of future results and the mandatory inclusion of a telephone number or website where investors may obtain current performance data.

For a period of two years following the adoption of final rules relating to the proposal, an issuer must file any written general solicitation or advertising marketing materials with the SEC through an intake page on the SEC website[1] contemporaneous with first use. Although these materials would not be publicly available under the proposal, an interested party may be able to seek access to such materials through FOIA requests, unless an exemption applies.

Failure to incorporate the specified legends in marketing materials used under Rule 506(c) would not void the exemption, but such a failure could lead the SEC to seek an injunction preventing the issuer from relying on Rule 506 in future offerings. The proposal recommends that a private fund adviser review its compliance policies and procedures to make appropriate marketing-related updates if its funds intend to engage in general solicitation or advertising activity.

Additional Form D Requirements

The SEC also proposed to amend the timing for and content of Form D and to impose a new penalty – a one-year suspension from using the exemptions for an issuer's failure to file Form D.

New General Solicitation and Advertising Filing Obligations. Currently, Form D must be filed no later than 15 days after the first sale and thereafter amended annually if the offering is ongoing or to reflect material changes to prescribed information. Under the SEC's proposal, an issuer would be required to file a short-form "Advance Form D" 15 days before beginning any general solicitation or advertising, with a full Form D to be filed under the current schedule. The SEC's proposal would also require an additional Form D filing within 30 days after the conclusion of a 506(b) or 506(c) offering. These changes are summarized below:

Item	Current Form D	Proposed Form D
Pre-Sale Filing	Not required, but commonly made	For Rule 506(c) offerings, "Advance Form D" 15 days prior to any offering by general solicitation or advertising
Initial Sale Filing	No later than 15 days after first sale[2]	No later than 15 days after first sale, unless information already provided in Advance Form D
Ongoing Amendment	Annually for so long as offering continues or material information changes in manner identified by Form D	Annually for so long as offering continues or material information changes in manner indentified by Form D
Closing Amendment	Not required	Generally within 30 days after conclusion of offering

New Disclosures. Form D would be expanded to include, among other items, disclosures of:

- issuer's web address;
- for filings made after any sale of securities, issuer's 10 percent or greater beneficial owners;
- for filings made after any sale of securities, number and type of investors, including individual or entity and accredited investor status; and
- for an issuer marketing securities through general solicitation and advertising, types of general solicitation and advertising used and methods used to verify accredited investor status.

New Penalties. Under the proposal, a failure to comply with the Form D filing requirements by an issuer, its predecessors or affiliates[3] within the previous five years would disqualify the issuer from relying on Rule 506 for new offerings until a one-year period after all required Form Ds have been filed, although limited cure periods are available in the case of inadvertent technical errors.[4] The SEC anticipates that these new penalties will significantly reduce non-compliance with Form D filing requirements.

Accredited Investor Definition

Finally, although the proposal would not itself amend the definition of "accredited investor," it seeks public comment regarding the advisability of such amendment, particularly in the case of natural person investors.

1 A newly developed SEC web-based intake page and and not the SEC's public EDGAR website.

2 An initial sale filing is not required if issuer made a pre-sale filing containing required information.

3 "Affiliate" is broadly defined in Regulation D as any person who directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the issuer.

4 Under the SEC's current regime, an issuer does not need to file a Form D to qualify for the Rule 506 exemption.

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PENbriefs

New York District Attorney Creates New Financial Intelligence Unit

The New York District Attorney recently announced the creation of a new financial intelligence unit, which is charged with investigating and prosecuting a variety of financial crimes, including money laundering, illegal financial transactions and similar white collar matters. This move signals the New York District Attorney's commitment to policing matters normally considered within the purview of federal prosecutors or regulatory agencies. To learn more, see our recent *Alert*.

PENnotes

5th Annual TMA Western Regional Conference
Laguna Beach, California
July 17 - 19, 2013

Partner Samantha Good will be a featured panelist at the 5th Annual Turnaround Management Association (TMA) Western Regional Conference on July 17-19 in Laguna Beach, California. Samantha's panel will discuss "Contrasting Restructurings of Large vs. Middle Market Companies." The panel will provide a contrast between various cases, from small cap restructurings to mega-size restructurings, from the perspectives of the various constituents involved in such cases, as well as thoughts on the current restructuring market and near-term outlook. To register, click here.

Structuring and Negotiating LBOs
Chicago, September 12, 2013
New York, September 19, 2013
San Francisco, September 27, 2013

This biennial event, chaired by partner Jack S. Levin, focuses on the legal, tax, structuring and practical negotiating aspects of buyouts and other complex private equity deal-doing. Registration details to come.

Hot Topics in Mergers & Acquisitions 2013
Chicago, September 19, 2013
New York, October 15, 2013

With the equity markets climbing into record territory in early 2013 and the debt markets continuing to experience favorable pricing, the environment seems ripe for a strong M&A rebound. Join our expert faculty of lawyers, general counsels, regulators and investment bankers as we explore the fascinating state of M&A and the trends you need to be aware of for the year ahead. Kirkland partners R. Scott Falk and Sarkis Jebejian are co-chairs of the event. Also, Kirkland partner Jon A. Ballis will be speaking at the Chicago seminar and partner Taurie M. Zeitzer will be speaking at the New York seminar. Click here for more information.

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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 400 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" in 2012 and 2013 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 2012 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 2012*, 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.

In each of 2013 and 2012, Chambers & Partners ranked Kirkland's Private Funds Group, which includes Kirkland's Investment Management practice, as a Tier 1 law firm for Investment Funds in the U.S., UK, Asia-Pacific and globally, the only law firm in the world with such a Tier 1 ranking two years in a row. Since 1995, Kirkland has represented over 350 private equity firms in forming more than 660 funds, raising more than $425 billion. Kirkland's Investment Management attorneys counsel clients on regulatory issues affecting public and private investment funds and their management companies, advise broker-dealers, commodity firms and other financial service entities, and are active in mergers, acquisitions and joint ventures involving investment fund managers and others in the financial services industry.

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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