Federal and state securities laws and regulations have evolved over time to create a complicated set of rules that apply each time a private investment fund, such as a hedge fund, private equity fund, real estate fund or venture fund, offers or sells interests in that fund. This post is the first in a two-part series and gives a general overview of some of the federal securities laws and regulations that may apply to a domestic private placement. In a subsequent post, we will discuss state securities or "Blue Sky" laws and regulations.

This post is an overview only. Fund managers are strongly encouraged to seek advice from securities counsel before offering or selling any fund interests.

The Private Offering Exemption

Federal securities laws generally prohibit any offering of interests in pooled investment vehicles unless either the offering is registered with the Securities and Exchange Commission ("SEC") under section 5 of the Securities Act of 1933, as amended (the "1933 Act") (which is usually time-consuming and expensive), or an exemption from registration applies. Private investment funds typically take advantage of the so-called "private offering" exemption from this registration requirement under section 4(a)(2) of the 1933 Act, which provides that the registration provisions of the 1933 Act do not apply to transactions by an issuer not involving any public offering. The SEC promulgated Regulation D under the 1933 Act to outline certain "safe harbors" in which a transaction will not be deemed to involve any public offering.

1. Regulation D

Regulation D establishes three safe harbor exemptions from the registration requirements of the 1933 Act. Most private investment funds take advantage of the safe harbor exemption in Rule 506(b), which allows sales of securities to an unlimited number of "accredited investors" (as defined in Regulation D) and to no more than 35 non-accredited investors in any offering;[1] provided, that the fund complies with certain information disclosure requirements, does not engage in general solicitation or advertising and does not sell fund interests to investors who intend to resell the fund interests. Rule 506(b) requires the filing of a notice (on Form D) with the SEC no later than 15 days after the first sale of fund interests.

In addition, when relying on Regulation D, a fund needs to exercise reasonable care to comply with Rule 506(d) of Regulation D, also known as the "Bad Actor Rule." The fund must determine if any "covered person" under the Bad Actor Rule, including the fund manager, executive officers of the fund, any fund promoter and any beneficial owner of 20% or more of the voting securities of the fund, has been the subject of a "disqualifying event," such as an order from a regulatory agency barring such person from engaging in the business of securities or a conviction of a felony or misdemeanor related to securities transactions. No private investment fund can rely on Rule 506 of Regulation D if a "covered person" with respect to the fund's offering has experienced a "disqualifying event" after September 21, 2013, and funds must disclose any "disqualifying events" prior to that date.

2. Section 4(a)(2) of the 1933 Act

As indicated above, Regulation D is only a "safe harbor" provision and is not the only means of complying with the 1933 Act. A private investment fund could (and should) rely on section 4(a)(2), as implemented and developed over the years by the courts and the SEC; however, doing so affords less certainty than Regulation D. The standards generally applied by the courts and the SEC to section 4(a)(2) offerings are that --

(a) The securities may be offered to only a few selected offerees without any form of public solicitation (for example, any public advertising, mass mailing, random contacts or other solicitation of persons whom you do not believe, on the basis of their relationships with you, are qualified offerees, would make exemption totally unavailable -- even if only one offeree is not qualified);

(b) On the basis of a prior relationship or documentary evidence, you must reasonably believe that each offeree is so sophisticated and knowledgeable in business and financial matters that such offeree is capable of evaluating the merits and risks of investing in the private investment fund;

(c) Each offeree must have sufficient net worth to be able to bear the economic risk of an investment in the fund interests (that is, able to lose the entire investment without extraordinary suffering); and

(d) All offerees must have access to the same information as registration would provide.

Section 4(a)(2) requires that all offerees meet these standards and, unlike Regulation D, does not confine the inquiry to purchasers. If any one of these requirements is not met with respect to any one offeree, the availability of the exemption may be challenged with respect to all investors. Because of these strict standards, private investment funds relying on a private offering exemption should adequately screen all potential investors and consult with counsel.

Recent Changes in Federal Securities Laws

Traditionally, the private offering exemption that prohibits general solicitation and advertising described above was the main tool private investment funds could rely on to avoid the hassle of registration. The U.S. Jump Start

Business Startups Act of 2012 (also known as the JOBS Act), however, relaxed the prohibition on general solicitation and the SEC adopted Rule 506(c) in response. Pursuant to Rule 506(c), an issuer can broadly solicit and generally advertise an offering of securities, but still be deemed to be undertaking a private offering within section 4(a)(2), if each potential investor is an “accredited investor” and the investor’s status is verified as accredited (such as by reviewing tax returns, bank or brokerage statements or credit reports). Compliance with Rule 506(c) also requires filing a notice on Form D after the first sale of securities and compliance with the Bad Actor Rule described above.

Conclusion

A private fund that fails to abide by these securities laws and regulations may be deemed to be selling unregistered securities, which is a violation of the 1933 Act and the Investment Company Act of 1940, as amended. Such a violation may subject that fund to an enforcement action by the SEC and a private right of action by investors. Although compliance with securities laws and regulations may seem daunting, the potential dire consequences of selling unregistered securities can be avoided with appropriate planning. Fund managers who develop routine procedures prior to launch for monitoring securities law requirements as fund interests are sold tend to streamline the ongoing costs of securities compliance issues and avoid late filings and potential penalties. Fund managers should also take the time to ask securities counsel questions to ensure they understand how to document investor qualifications necessary to maintain the offering exemptions described above.

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[1] Many funds do not offer any fund interests to non-accredited investors for a variety of business and regulatory compliance reasons. For example, non-accredited investors may not have enough net worth to be “qualified clients” as defined under the Investment Advisers Act of 1940, as amended, and cannot be charged a performance fee or allocation.