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VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: SEC Conditionally Eliminates Prohibition Against General Solicitation and Advertising in Rule 506 Offerings; Disqualifies "Bad Actors"; and Proposes Amendments to Regulation D, Form D and Rule 156

Summary. On July 10, 2013, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 506 of Regulation D (the "New Exemption")[1] under the Securities Act of 1933 (the "Securities Act"), as required by the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act").[2] The New Exemption will become effective on September 23, 2013 (the "Effective Date"). After the Effective Date, the New Exemption will permit general solicitation and advertising in private securities offerings under new Rule 506(c) of Regulation D, subject to the conditions described below. The New Exemption may be available for offerings by hedge funds, venture capital funds, private equity funds and other privately offered investment funds (collectively, "Funds"). The SEC also (a) proposed for public comment rules to monitor the use, and limit opportunities for abuse, of the New Exemption[3] and (b) adopted rules that will disqualify certain "bad actors" from relying on Rule 506.[4]

Current Rule 506(b) Safe Harbor. When Funds offer interests to investors, the interests must be registered under the Securities Act unless an exemption applies. To avoid registration, most Funds rely on the private offering exemption from registering their

[1] *See* http://www.sec.gov/rules/final/2013/33-9415.pdf.

[2] The SEC also adopted corresponding amendments to Rule 144A under the Securities Act, which provides an exemption from the securities registration requirements for re-sales of restricted securities to qualified institutional buyers ("QIBs"). The amendment to Rule 144A provides that securities may be offered pursuant to Rule 144A to persons other than QIBs, including by means of general solicitation or advertising, if the securities are sold only to persons that the seller reasonably believes are QIBs. We do not address the Rule 144A amendments in this letter.

[3] *See* http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

[4] *See* http://www.sec.gov/rules/final/2013/33-9414.pdf.

interests provided by section 4(a)(2) of the Securities Act and Rule 506 of Regulation D thereunder. Section 4(a)(2) exempts securities issued in a transaction by an issuer that does not involve a public offering. The SEC promulgated Rule 506 of Regulation D under section 4(a)(2) to establish safe harbors for issuers relying on section 4(a)(2).

Currently, Funds often rely on the safe harbor exemption provided by Rule 506(b) of Regulation D. Under Rule 506(b), which is unchanged by the New Exemption, an issuer, such as a Fund, may issue its securities to an unlimited number of accredited investors[5] and up to 35 non-accredited investors who meet certain requirements. Rule 506(b) continues to prohibit offering securities by any general solicitation or general advertising. Among other things, this limitation generally precludes issuers from soliciting investors through advertisements in newspapers or magazines, on television or radio or in other media or websites that are accessible by the public. Funds that choose not to engage in general solicitation or advertising may continue to rely on Rule 506(b).

New Exemption - 506(c) Safe Harbor. The New Exemption (Regulation D Rule 506(c)) permits an issuer to use general solicitation and general advertising to offer and sell its securities if:

- all of the purchasers of the securities are "accredited investors" (as defined in Rule 501 of Regulation D) or the issuer reasonably believes that the investors are accredited investors when they purchase the securities; and
- the issuer takes reasonable steps to verify that the investors are accredited investors.

Only Accredited Investors May Invest. The New Exemption does not limit who an issuer may solicit but requires that the Fund sell its securities to accredited investors only. Some Fund managers allow non-accredited investors (such as employees and family members) to invest in their Funds. In the case of an ongoing offering of any such fund under Rule 506 that began before the Effective Date, the Fund may choose to continue the offering after the Effective Date in accordance with Rule 506(b) or Rule 506(c). If the Fund continues the offering in reliance on the New Exemption, any general solicitation or advertising that occurs after the Effective Date will not affect the exempt status (in reliance on Rule 506(b)) of offers and sales of securities before the Effective Date.

Verification Requirement. To rely on the New Exemption, a Fund must take reasonable steps to verify that each of its investors is an accredited investor. This requirement is separate from and independent of the requirement that sales be limited to accredited investors. Even if all purchasers are in fact accredited investors, the Fund must be able to demonstrate that it took reasonable steps to verify their status. Issuers conducting Rule 506(b) offerings (that is, without the use of general solicitation or general advertising)

[5] Under Rule 501 of Regulation D, a natural person qualifies as an accredited investor if he or she has either: (a) an individual net worth or joint net worth with his or her spouse that exceeds $1,000,000 at the time of the purchase, excluding the value (and certain related indebtedness) of a primary residence; or (b) an individual annual income that exceeded $200,000 in each of the two most recent years or a joint annual income with his or her spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year.

are not subject to this new verification requirement but must nevertheless reasonably believe that investors claiming to be accredited are in fact accredited.

The determination of the reasonableness of the verification steps is an objective assessment by the issuer. Mere self-verification by a prospective investor (such as checking a box on an investor questionnaire to represent that the investor is accredited) generally will not be deemed sufficient. The issuer must consider the facts and circumstances of each purchaser and the transaction. Records of the issuer's verification steps should be maintained and available for examination. The New Exemption provides a non-exclusive list of methods that an issuer may use to satisfy the verification requirement for individual investors, including any of the following:

- If the purchaser bases accredited investor status on income, reviewing any IRS forms that report the purchaser's income for the relevant years and obtaining a written representation that the purchaser reasonably expects to reach the necessary income level for the current year (and for the purchaser to qualify based on joint income with the purchaser's spouse, the forms and representation must be provided by both spouses);
- If the purchaser bases accredited investor status on net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed: (a) with respect to assets, bank, brokerage and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and (b) with respect to liabilities, a consumer report from at least one nationwide consumer reporting agency (and for the purchaser to qualify based on joint net worth with the purchaser's spouse, the documentation and representation must be provided by both spouses); and
- Obtaining a written confirmation from an SEC-registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant that such person has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that the purchaser is an accredited investor.

Indication on Item 6 of Form D. The New Exemption amends Form D, which is the notice that issuers must file with the SEC when selling securities under Regulation D. An issuer relying on the New Exemption must indicate that it is relying on the Rule 506(c) exemption (the New Exemption) by checking a new box on Form D. The issuer should not check boxes for both Rules 506(b) and 506(c) at the same time for the same offering, because any general solicitation or advertising renders the Rule 506(b) exemption unavailable.

Noncompliance. If a Fund engaging in general solicitation or advertising inadvertently fails to comply with the New Exemption, it may not remedy such failure by relying on section 4(a)(2), because such general solicitation or public advertising will continue to be incompatible with a claim of exemption under section 4(a)(2). In contrast, a

Fund that does not engage in general solicitation or advertising but inadvertently fails to comply with the Rule 506(b) exemption might nevertheless rely on Section 4(a)(2).

Coordination with Other Laws.

Investment Company Act Exclusions. Funds generally rely on the exclusions from the definition of "investment company" provided by sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 to avoid registering as investment companies. Those exclusions require, among other things, that the Fund not make or propose to make a public offering of securities. A Fund that complies with Rule 506 generally is deemed not to be making a public offering of securities for purposes of these exclusions. A Fund may make a general solicitation in compliance with the New Exemption without losing these exclusions.

Performance Advertising Restrictions. The anti-fraud requirements under the Advisers Act, including the rules governing private fund advertising (Rule 206(4)-1) and communications with investors and prospective investors (Rule 206(4)-8), apply to the offer and sale of securities issued by Funds. These rules will continue to apply to any marketing materials used for general solicitation or advertising. We expect examinations by SEC staff to focus, in particular, on compliance by Fund managers relying on the New Exemption. Public advertising that includes performance-related information will raise the profile of that information and may be subject to special scrutiny.

As discussed below, the SEC has proposed to amend Regulation D to add a new Rule 509 requiring general solicitation and advertising conducted in reliance on the New Exemption to contain specific cautionary language. If the new Rule 509 is adopted, any Fund relying on the New Exemption will be required to include a legend disclosing that the securities offered are not subject to the protections of the Investment Company Act of 1940. Proposed Rule 509 would also provide that, if any Fund includes performance information in any written general solicitation or advertising in reliance on the New Exemption:

- The Fund must include a legend disclosing that the performance information represents past performance, that past performance does not guarantee future results, that current performance may be lower or higher than the performance information presented, that the Fund is not required by law to follow any standard methodology when calculating and representing performance and that the performance of the Fund may not be directly comparable to the performance of other funds;
- The legend should state a telephone number or website where an investor may obtain current performance information;
- All performance information must be as of the most recent practicable date, and the Fund must disclose the period for which performance is presented; and
- If applicable, the Fund must disclose that the presentation does not reflect the deduction of fees and expenses, and that if such fees and expenses had been deducted, performance may be lower than presented.

Commodity Exchange Act Exemptions. An investment adviser to a Fund that trades commodities, futures, swaps and similar instruments may be required to register as a commodity pool operator or commodity trading adviser under the Commodity Exchange Act

(the "CEA"). Pursuant to CEA Rules 4.13(a)(3) and 4.14(a)(5), a Fund manager may be exempt from these registrations with respect to a Fund that offers and sells interests without marketing to the public in the U.S. and complies with other requirements. An offering that qualifies under Rule 506(b) generally is not considered a public offering for purposes of this requirement. The Commodity Futures Trading Commission has not provided guidance whether a Fund that engages in general solicitation or advertising in compliance with the New Exemption will be deemed to be marketing its interests to the public. Unless and until the CFTC adopts rules or publishes definitive interpretations coordinating with the New Exemption, Fund managers that rely on either CEA Rule 4.13(a)(3) or 4.14(a)(5) should not rely on the New Exemption.

In addition, Fund managers that register as commodity pool operators often rely on an exemption from CEA reporting and disclosure requirements provided by CEA Rule 4.7. CEA Rule 4.7 is available with respect to Funds that offer and sell interests only to qualified eligible persons in an offering that is exempt from the registration requirements of the Securities Act pursuant to section 4(a)(2) of that Act. The requirement that a Fund offer interests only to qualified eligible persons may preclude general solicitation by a Fund, because a general solicitation may include offers to persons who are not qualified eligible persons. As with Rules 4.13(a)(3) and 4.14(a)(5), the Commodity Futures Trading Commission has not issued guidance whether a Fund may rely on Rule 4.7 if it engages in general solicitation or advertising in compliance with the New Exemption, and Fund managers relying on CEA Rule 4.7 should not rely on the New Exemption.

Regulation S for Offshore Offerings. Offshore Funds typically offer their securities to non-U.S. investors without registering them under the Securities Act, in reliance on Regulation S. Regulation S provides a safe harbor for offers and sales of securities outside the U.S. and, among other things, prohibits directed selling efforts in the U.S. A Fund's offshore offering that complies with Regulation S will not be integrated with that Fund's concurrent U.S. offering that complies with the New Exemption.

Foreign Investment Advisers Act. A foreign investment adviser to a Fund that has fewer than fifteen U.S. investors and less than $25,000,000 in U.S. investor assets is not required to register with the SEC as an investment adviser so long as it does not hold itself out generally to the public in the U.S. as an investment adviser. The SEC has not indicated whether a foreign investment adviser to a Fund that engages in general solicitation or advertising pursuant to the New Exemption will be deemed to be holding itself out to the public.

State Advisers. A Fund manager that is exempt from registering as an investment adviser with the SEC may be required to register in one or more states. Some state laws exempt from registration investment advisers that do not hold themselves out to the public and have fewer than specified number of clients. As far as we are aware, no state securities administrator has, as yet, published rules or interpretations indicating how it will apply those requirements to Fund managers that engage in general solicitation or advertising in reliance on the New Exemption.

Non-U.S. Regulation. A Fund relying on the New Exemption should consider whether its general solicitation and advertising efforts reach non-U.S. investors, because

applicable non-U.S. laws may restrict such activities. For example, general solicitation and advertising in reliance on the New Exemption may affect a Fund's ability to rely on reverse solicitation under the European Union's Alternative Investment Fund Managers Directive, discussed in our letters of April 11 and July 17, 2013.

Other Laws. The foregoing is only a summary of certain laws that may interact with or be affected by the New Exemption. Fund managers should consider whether their use of general solicitation or advertising in reliance on the New Exemption affects their compliance with other applicable laws and rules.

Proposed Amendments to Regulation D, Form D and Rule 156. On July 10, 2013, the SEC also published for comment proposed amendments to Regulation D, Form D and Rule 156 under the Securities Act to enhance the SEC's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise from permitting issuers to engage in general solicitation and advertising under the New Exemption. Specifically, the SEC proposed to:

- Amend Rule 503 of Regulation D (which requires the filing of Form D) to require an issuer relying on the New Exemption to file Form D no later than fifteen days before such an offering begins, instead of within fifteen days of the first sale of securities as currently required;
- Amend Rule 503 to require an issuer to file a final Form D amendment within thirty days after such an offering ends;
- Revise Form D to (a) expand disclosure regarding the issuer, the offering and the use of proceeds and (b) require issuers relying on the New Exemption to identify the methods of general solicitation used and the methods used to verify accredited investor status;
- Amend Rule 507 to disqualify issuers from reliance on Rule 506 for one year for future new offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the prior five years, with all of the Form D filing requirements in a Rule 506 offering (this proposed disqualification rule would apply to Form D filings for all Rule 506 offerings);
- Add new Rule 509 (discussed above) to require that general solicitation materials used in Rule 506(c) offerings contain specific cautionary language;
- Amend Rule 156 (an interpretive rule regarding the types of information in investment company sales literature that could be misleading under federal securities laws) to provide that Rule 156 also applies to sales literature used by Funds;
- Amend Rule 506(c) to require, for two years from the Effective Date, that an issuer relying on the New Exemption electronically submit any written general solicitation materials to the SEC no later than when such materials are first used, so that the SEC can monitor disclosure practices (such materials would not be available for public inspection); and
- Request comments on the definition of "accredited investor."

"Bad Actor" Disqualification from Rule 506 Safe Harbor. On July 10, 2013, the SEC also adopted amendments to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires the SEC to adopt rules prohibiting the use of Rule 506 exemptions (both the existing Rule 506(b) exemption and the New Exemption) for any securities offering in which certain persons covered by the rule had a "disqualifying event" (the "Bad Actor Rule").

Covered Persons. Persons covered by the Bad Actor Rule include the issuer, its predecessors and affiliated issuers, as well as:

- directors and certain officers, general partners and managing members of the issuer;
- beneficial owners of twenty percent or more of the issuer's voting power;
- promoters;
- investment managers and principals of pooled investment funds; and
- persons compensated for soliciting investors, as well as the general partners, directors, officers and managing members of any compensated solicitor.

Disqualifying Event. The Bad Actor Rule defines a "disqualifying event" to include, among other things, certain:

- Criminal convictions, court injunctions and restraining orders in connection with the purchase or sale of a security, making a false filing with the SEC, or certain other conduct;
- Final orders of the Commodity Futures Trading Commission, a federal banking agency, the National Credit Union Administration, or a certain other state regulatory authority that bar the issuer or are based on fraudulent, manipulative or deceptive conduct;
- SEC cease-and-desist, disciplinary or stop orders;
- Suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member; and
- U.S. Postal Service false representation orders.

Disqualification applies only for disqualifying events that occur after the Effective Date and in some cases within specified periods (five or ten years) before the offering. Previous matters that would otherwise be disqualifying events must be expressly disclosed to investors a reasonable time before the sale of securities. This disclosure requirement will apply to all offerings under Rule 506, whether or not purchasers are accredited investors.

The Bad Actor Rule provides a "reasonable care" exception from disqualification when the issuer can show that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. A Fund relying on any provision of Rule 506 should now require each of its Covered Persons to provide written representations that he or she has not been subject to any disqualifying events and conduct other appropriate due diligence. Funds may manage this through questionnaires, certifications, negative consent letters, periodic checking of public

databases, contractual covenants seeking bring-downs of representations from Covered Persons and other procedures, depending on the circumstances.

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This letter generally summarizes certain of the final and the proposed rules released by the SEC on July 10, 2013. This letter is not intended as specific or complete advice. If you need assistance in determining the effects of these developments on your business, or preparing to comply with them, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Jim Frolik, Christina Hamilton, Joan Grant, Ellyn Roberts, Anthony Caldwell or David Suozzi.

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