



## Legal Risk Management Tip October 2013

### GENERAL SOLICITATION AND ADVERTISING UNDER RULE 506(c): LOOK BEFORE YOU LEAP

With the final JOBS Act rules removing the ban on general solicitation and advertising now in effect as of September 23, 2013, advisers of private funds are seeking the promotion of their funds through public web sites and other forms of social media. But before advisers act and begin such solicitation, it will be necessary to adopt policies and procedures reasonably designed to ensure that (1) each investor in the fund is an “accredited investor,”<sup>1</sup> and (2) each person involved in the operation and distribution of the fund is not a “bad actor” (as defined in the Rule below). Failure to do so could result in disqualification that prohibits them from relying on any of the private placement exemptions.

Rule 506(c) permits a fund to advertise<sup>2</sup> as long as it takes “reasonable steps” to verify that the investors in the fund are accredited investors. In the past, advisers generally relied on investor representations made in the subscription agreement without independently verifying the financial status of the investor. But now if the fund uses Rule 506(c) to promote its interests, the SEC will expect the adviser to exercise greater diligence than before in ascertaining accredited investor status. The adopting release lists several non-exclusive and non-mandatory methods that it considers reasonable steps to verify “accredited investor” status. These include the following:

- (1) When relying upon *income* as the basis for establishing accreditation, review any Internal Revenue Service form that reports the purchaser’s income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtain a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;
- (2) When relying upon *net worth* as the basis for establishing accreditation, review one or more of the following types of documentation dated within the last three (3) months and obtain 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 statements, brokerage statements 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 of the nationwide consumer reporting agencies; or
- (3) Obtain a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited

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<sup>1</sup> Under Rule 501(a), for individual investors, accredited investor shall mean any natural person (i) whose individual net worth, or joint net worth with that person's spouse, exceeds \$1,000,000 excluding primary residence, or (ii) who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, or (iii) any director, officer, general partner of the issuer.

<sup>2</sup> The SEC has confirmed that a fund may advertise and still rely on exemption from registration under either Section 3(c)(1) or Section 3(c)(7) under the Investment Company Act.

investor within the prior three (3) months and based on this review, has determined that such purchaser is an accredited investor:

- (a) A registered broker-dealer;
- (b) An investment adviser registered with the Securities and Exchange Commission;
- (c) A licensed attorney who is in good standing under the laws of the Jurisdictions in which he or she is admitted to practice law; and/or
- (d) A certified public accountant who is duly registered and in good standing

But what the new rule giveth, it also taketh away. Rule 506(d) disqualifies funds from relying on Rule 506 in its entirety as a safe harbor if persons involved with the fund are bad actors. Notwithstanding this, the Rule will not disqualify an offering even if a bad actor is involved provided the adviser can demonstrate that it did not know, and in the exercise of reasonable care, could not have known the person was a bad actor.

Rule 506(d) applies to the following persons:

- (1) the issuer, including its predecessors and affiliated issuers;
- (2) directors, general partners, and managing members of the issuer;
- (3) executive officers of the issuer, and other officers of the issuer that participate in the offering;
- (4) 20 percent beneficial owners of the issuer, calculated on the basis of total voting power
- (5) promoters connected to the issuer;
- (6) for pooled investment fund issuers, the fund's investment manager and its principals; and
- (7) persons compensated for soliciting investors, including their directors, general partners and managing members.

Upon the effective date of the rule, persons are considered a "bad actors" if they engage in the following:

- (1) Certain criminal convictions for a felony or misdemeanor in connection with:
  - (a) The purchase or sale of a security,
  - (b) Making a false filing with the SEC, or
  - (c) Inappropriate business conduct as an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor;
- (2) Certain court injunctions and restraining orders in connection with:
  - (a) The purchase or sale of a security,
  - (b) Making a false filing with the SEC, or
  - (c) Inappropriate business conduct as an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor;
- (3) Final orders of certain state and federal regulators of securities, commodity, insurance, banking, savings associations or credit unions constituting a bar from engaging in certain activities or final orders based upon fraudulent, manipulative, or deceptive conduct;

- (4) Certain SEC disciplinary orders related to brokers, dealers, municipal securities dealers, and investment advisers and their related persons;
- (5) Certain SEC cease-and-desist orders;
- (6) SEC stop orders and orders suspending the Regulation A exemption;
- (7) Suspension or expulsion from membership in a self-regulatory organization (SRO), such as FINRA, or from association with an SRO member; and
- (8) U.S. Postal Service false representation orders.

Notably, even though September 23, 2013 is the trigger date for bad actor disqualifying events, disqualifying events that existed before September 23 are required to be disclosed in writing to investors. Issuers must furnish this written disclosure to purchasers a reasonable time before the Rule 506 sale. Even though disqualification will not arise as a result of disqualifying events that occurred before September 23, 2013, Rule 506 is unavailable to a fund that fails to provide the required disclosure, unless the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event was required to be disclosed.

The new provisions under Rule 506 give advisers of private funds more latitude in how they market and promote their product. Nevertheless, internal controls and specific procedures must be adopted in order to effectively screen out non-accredited investors, identify bad actors, and identify and disclose disqualifying events that occurred before September 23. For those advisers relying on Rule 506(c), failure to demonstrate compliance will result in loss of the Regulation D exemption and, since general solicitation and advertising is involved, most likely the loss of the Securities Act Section 4(2) private placement exemption as well. Given that advisers potentially face strict liability under the Securities Act Section 12(a)(1), which allows purchasers to sue sellers for selling a non-exempt security without registering it, advisers must exercise great care in designing a program that demonstrates they have taken reasonable steps to comply with Rule 506(c) and (d).

For more information on Rule 506 or questions on designing a program to verify accredited investors status and to identify bad actors, please contact us at [info@jackolg.com](mailto:info@jackolg.com), or (619) 298-2880. Also, please visit our website at [www.jackolg.com](http://www.jackolg.com).

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