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Client Memorandum September 2013

SEC Bad Actors and General Solicitation Rules Take Effect Today

Proposals for Additional Form D, Solicitation Materials and Sales Literature Requirements Have Serious Implications for Private Funds and Their Advisers

September 23, 2013 – Today is the effective date of amendments to Regulation D under the US Securities Act of 1933 (the "**Securities Act**"), adopted by the US Securities and Exchange Commission (the "**SEC**") on July 10, 2013, that disqualify offerings involving certain "bad actors" from reliance on exemptions from registration under Rule 506 of Regulation D (the "**Bad Actors Release**"), available **here**, and that eliminate the prohibition against general solicitation and general advertising for certain US private placements (the "**General Solicitation Release**"), available **here**. At the same time that the SEC adopted these amendments, it proposed additional amendments, available **here,** that would increase the regulatory burdens associated with the filing of Form D under Rule 506, while imposing new general solicitation materials and sales literature requirements on private funds and their advisers (the "**Proposing Release**").

Our July 2013 client briefing, available **here** (the "**July Briefing**"), summarizes key features of the Bad Actors Release and the General Solicitation Release and aspects of the Proposing Release. This briefing highlights the ongoing challenges posed for private funds and their advisers by these new and proposed requirements, many of which apply even to fundraisings that do not involve general solicitation.

Key Considerations for Private Funds Under the Bad Actors Release

As explained in the July Briefing, the Regulation D amendments taking effect today do more than just lift the ban on general solicitation and general advertising for certain private offerings. They impose new requirements on issuers that continue to rely on Rule 506(b) (*i.e.*, the "old" Rule 506, as re-designated, which still prohibits general solicitation), as well as issuers that choose to rely on new Rule 506(c) and engage in general solicitation. The new "bad actors" disqualification provisions, for example, have far-ranging and important implications for private funds that may not be immediately apparent.

"Bad Actors" Disqualification Provisions

The "bad actors" rules operate to disqualify an issuer from reliance on ***both*** Rule 506(b) and Rule 506(c) where the issuer or any other "covered person"[1] experiences a "disqualifying event"[2] within five to 10 years of an offering.[3] The penalty for experiencing a disqualifying event is severe – particularly in light of the rules' extended "look back" periods. Absent an exemption, the rules can effectively function as five- to 10-year bans on a person's or entity's participation in a Rule 506 offering.

If a natural person experiences a disqualifying event, the effect of disqualification on a related private fund might be remedied by removing the individual from his or her position as an officer or director of the fund or its investment manager. The disqualification of an ***entity*** within a private fund complex, however, presents thornier issues.

A variety of entities can qualify as "covered persons" under the "bad actors" rules, including those with a beneficial ownership interest of 20% or more in a private fund's outstanding voting equity securities, the fund's investment manager, and "affiliated issuers" of the fund. The designation of any of these entities as disqualified could have a catastrophic impact on an organization by, for example, preventing any other fund in a fund complex from relying on Rule 506. This problem is compounded by uncertainties, including (i) the failure of the Bad Actors Release to clarify an organization's ability to cure disqualification once it occurs (*e.g.*, by winding down operations or otherwise),[4] (ii) the absence of clear definitions for certain terms (*e.g.*, "affiliated issuer") appearing in the new rules; and (iii) the failure of the Bad Actors Release to explain how disqualification works in the case of continuous offerings and/or simultaneous offerings by multiple funds where a fund becomes disqualified.

Due Diligence of Third-Party Solicitors

The new disqualification provisions cover any person directly or indirectly compensated for soliciting prospective investors in a private fund offering. Such persons include underwriters, placement agents, and finders.[5] Entities and natural persons

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1 For private funds, "covered persons" include the fund, all affiliated issuers (*e.g.*, other private funds), the fund's officers and directors, the fund's investment manager and its officers and directors, and any person compensated for soliciting investors. *See* **Annex A** to this briefing for a more detailed summary of the persons who qualify as "covered persons".

2 Disqualifying events include criminal convictions related to securities transactions, final orders of securities, insurance, bank, savings association, or credit union regulators that bar the person from associating with a regulated entity or engaging in regulated business activities, and certain SEC cease-and desist orders arising from the violation of US registration requirements. Convictions in foreign courts do not function as disqualifying events. *See* **Annex A** to this briefing for a more detailed summary of disqualifying events.

3 The relevant "look back" period varies depending on the nature of the disqualifying event.

4 The Bad Actors Release permits the SEC to issue disqualification waivers for good cause shown, or if the regulatory authority issuing an order resulting in disqualification determines that Rule 506 disqualification is unnecessary under the circumstances. We expect such waivers to be uncommon, although they will certainly become important bargaining chips in any related enforcement actions.

5 The release does not, however, limit the rule's coverage to persons meeting the definition of "broker" under the US Securities Exchange Act of 1934, or to persons deemed to be brokers by virtue of receiving sales commissions or similar transaction-based compensation. Thus, funds and their managers may also need to vet in-house marketers under the new rules, depending on the nature of the marketers' activities and how their compensation is determined.

performing these functions often operate independently of the fund and its manager, which may render their status under the "bad actors" rules unclear.

The Bad Actors Release acknowledges this lack of clarity and that issuers may inadvertently violate the new rule by failing to identify a disqualified placement agent. Thus, the new rules permit issuers to avoid disqualification by establishing that they did not know about a disqualification event despite the exercise of "reasonable care."

Meeting the "reasonable care" standard requires private fund managers to inquire into the relevant facts of their existing and future relationships with placement agents on an ongoing basis. While the SEC has not prescribed specific means of doing so, the Bad Actors Release discusses the use of questionnaires or certifications coupled with contractual representations, covenants, and undertakings. At a minimum, fund managers should scrutinize their placement agent relationships to ensure that they: (i) have sufficient information to reasonably conclude that placement agents currently under engagement are not disqualified; and (ii) have agreements in place requiring placement agents to inform the fund and/or the manager immediately upon a change in status. Ensuring that a private fund's placement agents have a sufficient understanding of which persons and which events trigger disqualification is a key component in satisfying the "reasonable care" standard.

No Retroactive Effect, but Disclosure of Would-Be Disqualifying Events Required

Disqualification will not apply retroactively. Thus, only disqualifying events occurring ***after*** September 23, 2013 will trigger disqualification. That said, the "bad actors" rules require that private funds conducting an offering in reliance on either Rule 506(b) or Rule 506(c) must disclose events that would have triggered disqualification had they not occurred ***before*** September 23, 2013 to prospective investors in writing, within a reasonable time prior to sale, and in a format that highlights the disclosure "with reasonable prominence." Failure to do so will render the Rule 506 offering exemption unavailable unless the private fund can establish that despite the exercise of "reasonable care" it did not know about the undisclosed event. This requirement applies whether the would-be disqualifying event affects persons or entities within a fund complex or independent third parties.

Key Considerations for Private Funds Under the General Solicitation Release

Under new Rule 506(c), private fundraisings that involve general solicitation are subject to significant additional compliance obligations.

Reasonable Steps to Verify Accredited Investor Status

Private funds choosing to engage in general solicitation under new Rule 506(c) must conduct more investor due diligence than previously required. Rule 506(b) (the new designation for the "old" Rule 506) generally requires that a fund offer and sell interests only to persons it "reasonably believes" are accredited investors. Private funds have traditionally relied on investor questionnaires in subscription documents to collect information from prospective investors sufficient to establish this "reasonable belief" and courts have generally accepted this practice.[6]

Rule 506(c) upends accepted practice by requiring ***not only*** (i) that an issuer have a reasonable belief that it is selling securities only to accredited investors, ***but also*** (ii) that an issuer take "reasonable steps to verify" that it is selling securities only to accredited investors. This second requirement means that private funds engaging in general solicitation must take steps beyond those required to comply with Rule 506(b). To assist issuers, Rule 506(c) identifies four safe harbor methods to satisfy the new

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[6] *See, e.g., Wright v. Nat'l Warranty Co.,* 953 F.2d 256 (6th Cir. 1991).

reasonable verification requirement with respect to natural persons. **Annex B** to this briefing (which was also attached to the July Briefing) breaks down each method.

Private funds intending to engage in general solicitation should review and revise both their offering documents and investor on-boarding procedures to satisfy one or more of the safe harbor methods. Doing so will require, among other things, obtaining from each US individual investor: (i) private financial information (*e.g.*, IRS forms for the past two years) and/or (ii) income or net worth certifications from an SEC-registered entity (*i.e.,* a broker-dealer or investment adviser) or a licensed professional (*i.e.*, an attorney or certified public accountant) as to the individual's accredited investor status. In the case of natural person investors, this presumably will require private funds and their representatives to satisfy SEC and US Federal Trade Commission rules intended to protect the privacy of consumer non-public information (*e.g.*, Regulation S-P).

Funds may satisfy the reasonable verification requirements of Rule 506(c) with respect to natural persons through means other than the prescribed safe harbors, but doing so will provide less regulatory certainty.

Potential Conflicts with Other Regulatory Regimes

Rule 506 previously prohibited general solicitation and general advertising in connection with unregistered offerings. Many other securities offering regimes, both domestically and abroad, followed the Rule 506 example. Thus, the SEC's newly permissive stance on general solicitation puts it out of sync with other US and non-US offering exemptions. This problem may be particularly acute where, for example, a fund manager places offering materials on, and solicits prospective investors through, its website.

On the domestic front, engaging in general solicitation may impact the availability of exemptions from registration under rules promulgated by the US Commodity Futures Trading Commission ("**CFTC**"). The CFTC's *de minimis* exemption from registration as a commodity pool operator, found its Rule 4.13(a)(3), still requires that interests in an exempt fund be "offered and sold without marketing to the public in the United States" in addition to being exempt from registration under the Securities Act.

Reliance on Rule 506(c) also means that private fund marketing practices may be inconsistent with securities offering registration exemptions under state law, as most states also prohibit the use of general solicitation and general advertising. Although federal law preempts registration requirements under state law where an offering qualifies for the Rule 506(c) safe harbor, ***loss of the safe harbor*** while engaging in general solicitation could trigger state registration requirements (even if the offering still qualifies for exemption under the Securities Act). Thus, private funds that choose to rely on Rule 506(c) would be well-advised to identify the states in which they intend to solicit investors and to understand the particular offering restrictions and risks of non-compliance in those states. Private funds that intend to use on-line solicitation methods may need to understand the offering restrictions and risks in all 50 states.

Key Considerations for Private Funds in the Proposing Release

As discussed in the introduction to this briefing, the SEC proposed additional amendments at the same time that it adopted the new "bad actors" rules and lifted the ban on general solicitation for certain private placements. The Proposing Release has serious implications for private funds and their advisers, whether or not they plan fundraisings that involve general solicitation.

Form D Filings to Collect More Offering Information; One-Year Disqualification for Failures to File

Form D is the notice of an offering conducted without registration under the Securities Act in reliance on Rule 504, 505, or 506, which is filed by issuers relying on the Regulation D safe harbor. It is organized around 16 numbered items and categories of information and collects basic data about the issuer, the offering and the exemption from registration on which the offering will rely. While Regulation D calls for issuers that rely on the safe harbor to file Form D no later than 15 days after the first sale of

securities in an exempt offering, filing a Form D is not currently a condition to availability of the safe harbor. Failure to file Form D may, however, result in an issuer being disqualified from relying on the Regulation D safe harbor in ***future*** offerings where a court has enjoined the issuer for such failure.

The SEC believes that a lack of stronger penalties has resulted in issuers having insufficient incentives to file Form D. Citing this belief, as well as the SEC's need to gather more information about Regulation D offerings and the market for private placements generally, the Proposing Release would amend the SEC's Form D requirements (i) to expand the range of information called for;[7] (ii) to establish new filing requirements in connection with Rule 506 offerings; and (iii) to condition future reliance on Rule 506(b) and Rule 506(c) on satisfaction of the Form D filing requirements.

The most extensive filing requirements would be imposed on issuers relying on the new Rule 506(c) exemption. Such issuers would be required to make up to ***three*** separate Form D filings and amended filings with the SEC and, potentially, even more. Specifically, Rule 506(c) issuers would be required to file:

- an "advance" Form D, containing basic information, at least 15 days ***before*** commencing any "general solicitation activities,"
- an amended Form D not later than 15 days after the first sale of securities in a Regulation D offering, and
- a closing Form D amendment not later than 30 days after termination of the offering.

The filing of additional Form D amendments would be required on an annual basis while the offering is ongoing and on an as-needed basis to correct information in a prior filing that becomes materially inaccurate. Issuers relying on Rule 506(b) would not have to file the "advance" Form D; issuers relying on Rule 504 or Rule 505 would not be subject to new filing requirements.

An issuer that misses a filing or otherwise fails to comply with the Form D filing requirements within the preceding five years would be ***automatically disqualified from using Rule 506(b) and Rule 506(c)*** in any future offering for one year after it makes the required filing. More importantly, the failure of an issuer's predecessor or affiliate to comply with the Form D filing requirements within the preceding five years would also disqualify the issuer from relying on Rule 506.[8] Therefore, under certain circumstances, the failure of one private fund in a fund complex to file a Form D could render the Rule 506 safe harbor unavailable to ***all*** funds affiliated with (*e.g.*, having the same or a commonly controlled manager as) the non-complying fund. Private funds engaging in continuous offerings must also be mindful of the annual Form D updating requirement.

The SEC proposal would make a 30-day "cure period" available to issuers, but only to the extent that they fail to file a Form D or Form D amendment on a timely basis, and only once with respect to any particular offering.

Finally, private fund advisers registered with the SEC under the Investment Advisers Act of 1940 (the "**Advisers Act**") and whose advised funds rely on Rule 506 would need to ensure that information disclosed on their Form ADV and Form PF filings reasonably aligns with that disclosed in Form D.

Sales Literature Anti-Fraud Guidance Extended to Private Funds

The Proposing Release would also amend Rule 156 under the Securities Act to cover all "private funds," regardless of whether they engage in general solicitation.[9] The SEC originally adopted Rule 156 to provide interpretive guidance to registered

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7 For example, new Form D would require information concerning (i) all direct/indirect owners of an issuer relying on the new Rule 506(c) exemption; (ii) the number of accredited investors/non-accredited investors that have purchased in the offering, whether they are natural persons or legal entities, and the amount raised from each category of investors; (iii) the types of general solicitation used or to be used when relying on Rule 506(c) (*e.g.*, mass mailings, e-mails, and public websites); and (iv) whether issuers relying on Rule 506(c) intend to rely on one of the investor verification method safe harbors and/or to verify investor information through other means including publicly available information and documentation provided by third parties.

8 This five-year "look back" period will apply on a prospective basis, meaning that failures to file Form D occurring before the proposed rules become effective would be disregarded.

9 A "private fund" for these purposes is any investment company that relies on either Section 3(c)(1) or Section 3(c)(7) of the Investment

investment companies (*e.g.*, mutual funds) concerning whether sales literature containing a particular description, representation, illustration, or other statement is materially misleading under various anti-fraud provisions of the US securities laws. Rule 156 is not a safe harbor for compliance with these anti-fraud provisions. Instead, the rule identifies various factors that should be considered in determining whether sales literature containing representations about past or future investment performance and certain other statements is likely to violate the statutory anti-fraud prohibitions. Under the Proposing Release, this guidance would also be applicable to private funds.

Legend and Content Requirements for General Solicitation Materials

The Proposing Release would also add Rule 509 to Regulation D, which would require a private fund that engages in general solicitation to include the following six specific disclosures and legends in ***all written general solicitation*** materials:

- Interests in the fund may be sold only to accredited investors, which for natural persons are investors who meet certain minimum annual income or net worth thresholds.
- Interests in the fund are being offered in reliance on an exemption from the registration requirements of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act.
- The SEC has not passed upon the merits of or given its approval to the fund interests, the terms of the offering, or the accuracy or completeness of any offering materials.
- Interests in the fund are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their interests.
- Investing in fund interests and other securities involves risk, and investors should be able to bear the loss of their investment.
- Interests in the fund are not subject to the protections of the Investment Company Act.

Private fund solicitation materials including performance data would also be required to disclose: (i) that the performance data represents past performance; (ii) that past performance does not guarantee future results; (iii) that current performance may be lower or higher than the performance data presented; (iv) that the private fund is not required by law to follow any standard methodology when calculating and representing performance data; (v) that the performance of the fund may not be directly comparable to the performance of other private or registered funds; and (vi) a phone number or website where the investor can obtain current fund performance data. In addition, the performance data must be up to date and the period for which the performance is presented must be clearly indicated. While these disclosures would only expressly apply to funds engaging in general solicitation, they are fairly indicative of the SEC's views concerning fund advertising materials generally.

Solicitation materials containing performance data that do not reflect the deduction of fees and expenses *(i.e.,* "gross" performance data) would also have to disclose that such fees and expenses have not been deducted, and that if such fees and expenses had been deducted, performance may be lower than presented. Interestingly, this requirement does not parallel that for investment adviser advertising materials reflecting gross performance, which must present "net performance" information alongside gross performance.

A failure to observe the above requirements by a private fund ***or any of its predecessors or affiliates***, if it leads to a court order, judgment or decree enjoining the issuer for non-compliance with Rule 509, would render Rule 506 unavailable to the private fund.

Company Act of 1940 (the "**Investment Company Act**") to avoid registration as an investment company. The General Solicitation Release clarifies that private funds will not lose their exempt status under the Investment Company Act by engaging in general solicitation as permitted under Rule 506(c).

Submission of General Solicitation Materials to the SEC

The Proposing Release includes a temporary rule that would require issuers conducting offerings with general solicitation to submit to the SEC ***any written general solicitation materials*** prepared by or on behalf of the issuer and used in connection with an offering for two years after the proposal is adopted. Submissions would be made through a new "intake page" on the SEC's website and would have to be made no later than the date of first use of the solicitation materials. The materials would not, however, be considered "filed" or "furnished" for purposes of the liability provisions of US securities laws, and the SEC "does not contemplate" subjecting the materials to staff reviews similar to those for registration statements.

Annex A

Bad Actor Disqualification Criteria

The issuer and any affiliated issuers are disqualified from relying on Rule 506 for any sale of securities if a covered person has experienced or is subject to an applicable disqualifying event after September 23, 2013, as described in the below table. Disclosure is required for any disqualifying event occurring prior to September 23, 2013, during the relevant look-back period.

Event	Look-Back Period	Covered Persons
Criminal convictions related to securities transactions, false SEC filings or involving the misconduct of certain financial intermediaries	5 years	■ Issuer ■ Predecessor of the issuer ■ Affiliated issuer
	10 years	■ With respect to the ***issuer***: – any director – any executive officer – any other officer participating in the offering – any general partner – any managing member ■ Beneficial owner of 20% or more of the issuer's outstanding voting securities ■ Promoter connected with the issuer at the time of sale ■ Investment manager of the issuer, if the issuer is a pooled investment fund ■ Paid solicitor in connection with the offering ■ With respect to any such ***investment manager*** or ***solicitor***: – any director – any executive officer – any other officer participating in the offering – any general partner – any managing member ■ With respect to any such ***general partner*** or ***managing member*** of such investment manager or solicitor: – any director – any executive officer – any other officer participating in the offering

Event	Look-Back Period	Covered Persons
Final orders of US federal or state regulators of securities, insurance products, banks, savings associations or credit unions based on a violation of any law or regulation prohibiting fraudulent, manipulative or deceptive conduct	10 years	■ Issuer ■ Predecessor of the issuer ■ Affiliated issuer ■ With respect to the ***issuer***: – any director – any executive officer – any other officer participating in the offering – any general partner – any managing member ■ Beneficial owner of 20% or more of the issuer's outstanding voting securities ■ Promoter connected with the issuer at the time of sale ■ Investment manager of the issuer, if the issuer is a pooled investment fund ■ Paid solicitor in connection with the offering ■ With respect to any such ***investment manager*** or ***solicitor***: – any director – any executive officer – any other officer participating in the offering – any general partner – any managing member ■ With respect to any such ***general partner*** or ***managing member*** of such investment manager or solicitor: – any director – any executive officer – any other officer participating in the offering
Court orders, judgments or decrees that restrain or enjoin the covered person from engaging in conduct or practices related to securities transactions, false SEC filings or involving the misconduct of certain financial intermediaries	5 years	
SEC cease-and-desist orders arising from a violation of US registration requirements or scienter-based antifraud provisions		
US Postal Service false representation order		

Event	Look-Back Period	Covered Persons
Final orders of US federal or state regulators of securities, insurance products, banks, savings associations or credit unions that bar the person from associating with a regulated entity or engaging in regulated business activities	Applies if in effect at the time of sale	■ Issuer ■ Predecessor of the issuer ■ Affiliated issuer ■ With respect to the ***issuer***: – any director – any executive officer – any other officer participating in the offering – any general partner – any managing member ■ Beneficial owner of 20% or more of the issuer's outstanding voting securities ■ Promoter connected with the issuer at the time of sale ■ Investment manager of the issuer, if the issuer is a pooled investment fund ■ Paid solicitor in connection with the offering ■ With respect to any such ***investment manager*** or ***solicitor***: – any director – any executive officer – any other officer participating in the offering – any general partner – any managing member ■ With respect to any such ***general partner*** or ***managing member*** of such investment manager or solicitor: – any director – any executive officer – any other officer participating in the offering
Suspension or expulsion from membership, or suspension or bar from association with a national securities exchange or association for improper conduct		
Certain SEC orders including suspension or revocation of registration or limitations on activities as a broker-dealer or investment adviser		
US Postal Service temporary restraining order or preliminary injunction for conduct alleged to constitute a scheme or device for obtaining money or property through the mail by means of false representations		

Event	Look-Back Period	Covered Persons
Has filed as a registrant or issuer, or was an underwriter (or was named as such) in, a registration statement as to which the SEC has issued a stop order or suspension order	5 years	■ Issuer ■ Predecessor of the issuer ■ Affiliated issuer ■ Beneficial owner of 20% or more of the issuer's outstanding voting securities ■ Promoter connected with the issuer at the time of sale ■ Investment manager of the issuer, if the issuer is a pooled investment fund ■ Paid solicitor in connection with the offering ■ With respect to any such ***investment manager*** or ***solicitor***: – any general partner – any managing member
Has filed as a registrant or issuer, or was an underwriter (or was named as such) in, a registration statement that is subject of an SEC investigation or proceeding to determine whether a stop order or suspension order should be issued	Applies if in effect at the time of sale	

Annex B

Verification Safe Harbors Under Rule 506(c): Reasonable Steps to Verify Accredited Investor Status of Natural Persons

Basis for Accredited Investor Status	Verification Steps
Income	(1) Review IRS forms that report the investor's income for the two most recent years (such as Forms W-2, 1099 or 1040) AND (2) Obtain a written representation from the investor that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year
Net Worth	(1) Obtain a written representation from the investor that all liabilities necessary to make a determination of net worth have been disclosed and AND (2) With respect to assets, depending on asset type, review one or more of the following types of documentation dated within the prior three months: ■ Bank statements, brokerage statements and other statements of securities holdings ■ Certificate(s) of deposit ■ Tax assessments ■ Independent appraisal reports AND (3) With respect to liabilities, review a consumer report from a nationwide consumer reporting agency dated within the prior three months
Income or Net Worth	Rely on a written confirmation of a registered broker-dealer, SEC-registered investment advisor, or an attorney or certified public accountant duly licensed or registered and in good standing in his or her relevant jurisdiction that: ■ The confirming person or entity has taken reasonable steps to verify that the investor is an accredited investor; and ■ The steps were taken within the prior three months; and ■ The confirming person or entity has determined that the investor is an accredited investor
Income or Net Worth	For an investor who purchased securities in an issuer's Rule 506 offering prior to the effective date of new paragraph (c) of Rule 506 and continues to hold such securities, that issuer may rely on a written certification from that investor at the time of sale that he or she qualifies as an accredited investor.

Contacts

Jeff Berman
Partner
T: +1 212 878 3460
E: jeff.berman
@cliffordchance.com

Cliff Cone
Partner
T: +1 212 878 3180
E: clifford.cone
@cliffordchance.com

Steven Gatti
Partner
T: +1 202 912 5095
E: steven.gatti
@cliffordchance.com

Gerard Saviola
Partner
T: +44 20 7006 4958
E: gerard.saviola
@cliffordchance.com

Roger Singer
Partner
T: +1 212 878 3288
E: roger.singer
@cliffordchance.com

David Adams
Associate
T: +1 202 912 5067
E: davidg.adams
@cliffordchance.com

Ilomai Kurrik
Associate
T: +1 212 878 3356
E: ilomai.kurrik
@cliffordchance.com