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In the twilight of liberalization

Restrictions on general solicitation and advertising in private equity have stifled the industry's evolution. But the SEC appears to be setting the stage for change. By Jedd Wider

For many years, restrictions on general solicitation and general advertising in connection with private offerings exempt from registration under the US Securities Act of 1933, as amended, as well as under the "safe harbor" exemptions of Regulation D, have created difficulties for private investment fund sponsors and their broker-dealer agents seeking to raise capital from prospective investors.

The lack of clearly understood bright-line tests in addition to well defined guidelines and criteria relating to numerous issues surrounding the bans on solicitation and advertising have restricted private investment fund sponsors from developing more widespread capital raising techniques and reaching a broader sophisticated investor audience. Such restrictions have prevented the industry from evolving in step with modern technologies and capabilities. For example, the traditional investment fund industry has over the last fifteen years been generally sidelined while unprecedented leaps in technological advancement through the Internet has occurred, curbing the industry's potential for global retail reach.

Many recent questions have been raised by the Securities and Exchange Commission in addition to industry participants over the past several years questioning the efficacy of the existing bans on general solicitation and advertising - from the SEC's hedge fund report in September 2003, the "Implications of the Growth of Hedge Funds," to the Final Report of the Advisory Committee on Smaller Public Companies in April of this year.

The issue of general solicitation and advertising is relevant in Section 4(2) of the Securities Act, the "private placement" exemption which exempts certain transactions from registration by an issuer "not involving any public offering." A private investment fund sponsor engaged in a private placement of fund interests in the United States can either rely on Section 4(2) or in the alternative rely on the "safe harbor" private placement offering rules of Regulation D of the Securities Act. Although the bans are evident within the law and interpretations, the criteria for determining what constitutes solicitation is less evident and often left to subjective analysis.

Fending for themselves

In the opinion by the SEC's general counsel released in 1935, the SEC provided several factors to be used in determining whether an offering was public or private: (i) the manner of the offering, (ii) the size of the offering, (iii) the number of offerees, (iv) the relationship of the offerees to each other and to the issuer, and (v) the number of units offered in the offering. The release effectively set forth that an offering to not more than 25 persons did not involve a public offering. In SEC v. Ralston Purina Co. decided by the Supreme Court in 1953, the Supreme Court addressing the issuance of stock to a broad based group of Ralston Purina's employees focused not on the number of offerees as an objective test but on whether the "particular class of persons affected needs the protection of the Act" and whether they could "fend for themselves," underscoring the importance of the offeree's capabilities and not the characteristics of the offering itself.

The SEC and courts have tended to focus since the Ralston Purina ruling on numerous factors in determining whether an offering is nonpublic including: (i) the number of offerees (although the number of prospective investors alone is not generally dispositive of the existence of general solicitation and advertising), (ii) pre-existing substantive relationships between the issuer and the offeree, (iii) the sophistication of the prospective investors and (iv) other factors relating to the nature, scope, type and manner of the offering. Rules 505 and 506 of Regulation D, which establish safe harbor criteria for the private offering exemption, also prohibit general solicitation under all instances while Rule 502 addresses the specific form of restrictions on the manner of offering interests. Rule 502(c) states "[n]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following: (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar, or meeting whose attendees have been invited by any general solicitation or general advertising."

Blast email communications, blind mail distributions, press releases and interviews and unrestricted websites are all covered by 502(c).

Despite numerous no-action letters, SEC releases and enforcement actions and court rulings over the years, the legal framework surrounding the ban on general solicitation has not provided meaningful objective guidance with regard to the determination of what constitutes solicitation and as a result has left the private fund issuer continuing to tread in a murky pool. What is clear through interpretative evolution is the tenet that all prospective investors who are the subjects of solicitation must have a preexisting substantive relationship with the

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issuer in order to avoid qualifying as general solicitation under Regulation D. Typically, suitability questionnaires distributed to prospective investors prior to an offering that provide a private fund sponsor with sufficient information in order to analyze a prospective investor's financial sophistication and capabilities is sufficient. The determination of the existence or absence of a general solicitation however is based on the factual circumstances of each case. The consequences of failing to navigate the blurry line tests are nothing short of draconian - full rescission by one's existing investors as well as potential fines. With the stakes high, the question raised is, does the regulatory framework supporting the ban on general solicitation require revamping today?

Wider: Reg D may change

The SEC's Advisory Committee on Smaller Public Companies in April of this year called for liberalizing the "manner of offering" restrictions related to general solicitation and advertising based on the principal rationale that attention to avoiding general solicitation and advertising has the effect of "focusing a disproportionate amount of time and effort on persons who may never purchase securities - rather than on the actual investors and their need for protection..."

Aside from the difficulties of being able to determine whether an offering violated the bans on general solicitation and advertising, the Advisory Committee believed that the bans prohibited issuers from taking advantage of the Internet to reach potential investors who did not need the protection of the Securities Act - a significant impediment to capital raising. The Advisory Committee called for the adoption of a new private offering exemption that would in effect allow sales to eligible investors who don't require the full protections afforded the Securities Act because of several factors including: (i) the investor's financial wherewithal, (ii) investment sophistication, (iii) relationship to the issuer, or (iv) institutional status, regardless of how the prospective investors were contacted.

The Advisory Committee recommended determining the financial wherewithal of a natural person through an income or net worth test similar to the existing accredited investor accreditation thresholds set forth in Regulation D but with increases to both, e.g. $2 million in joint net worth (increased from $1 million), or $300,000 in annual income or $400,000 of joint annual income (increased from $200,000 or $300,000 jointly). Additionally, the Advisory Committee, among other things, recommended that in order to avoid abuses, all solicitations made by mass media such as newspapers, mass mailings, magazines or the Internet would be restricted to the basic information regarding the issuer as proscribed in Rule 135(c) of the Securities Act (e.g. name of the issuer, the title, amount, basic terms, time of offering, statement of the manner and purpose of the offering, etc.).

The SEC in its "Implications of the Growth of Hedge Funds" also questioned whether the restrictions on general solicitation for private offerings of interests in funds relying on Section 3(c)(7) of the Investment Company Act of 1940 should be retained where all investors were required to be "qualified purchasers." Although acknowledging that they would not eliminate the prohibition with respect to Section 3(c)(1) funds relying on the minimum accredited investor accreditation threshold because it could "increase the level of risk of investment interest by less wealthy investors," the SEC confirmed that easing the prohibition on general solicitation with respect to "qualified purchaser" funds could promote capital formation without raising "significant investor protection concerns."

SEC Chairman Christopher Cox recently announced that the SEC, in the wake of its decision not to appeal the US Court of Appeals for the District of Columbia Circuit's decision in the Goldstein case vacating the SEC's recent investment adviser rules on June 23rd, would focus on potentially increasing the accreditation threshold for "accredited investors" from the existing $1 million net worth test for individuals. It's not clear whether such announcement is the laying of necessary groundwork for modification to the general solicitation restrictions under the Securities Act or simply an accelerated response to the Goldstein Court's decision to protect further retailization.

One thing is clear however - regulatory agency reaction in addition to industry support for such modifications to the general solicitation and advertising bans continue to be heard on this point. Additionally, increased attention on the need to modify the bans by focusing on the nature of the investor and not the nature of the offering is setting the stage for future change. The proposed modifications by the SEC's Advisory Committee will enable private fund sponsors and agents to reach a broader retail market and provide for greater potential opportunities for capital raising by protecting the needs of investors who require protection - those who don't qualify as qualified purchasers or accredited investors under the proposed accreditation changes. Why focus on those prospective investors being solicited as opposed to the actual investors investing? After all, as the Advisory Committee captured it well in its April report, "no offeree has ever lost any money unless he or she became a purchaser." ■

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