Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Private Offering Dos and Don'ts: Dealing with the Press and Avoiding a General Solicitation

The ability of a fund manager to raise money in the United States by selling interests (i.e., securities) in limited partnership or other fund vehicles is contingent in large part on ensuring that it is done in a "private offering" and not in a "public offering," which would require registration of the securities and registration of the fund as an investment company with the Securities and Exchange Commission (SEC)—both of which are undesirable results for a private fund manager. The determination of what constitutes a public offering has traditionally focused on whether the issuer engaged in a "general solicitation" or made a "general advertisement" in the United States. While this analysis is still relevant for some private placements in the United States, the SEC has proposed a new Rule 506(c) under the JOBS Act (formally the Jumpstart Our Business Startups Act) that will eliminate the prohibition against general solicitation and general advertising in offerings using Rule 506(c).

To fall within the relaxed solicitation and advertising standards of proposed Rule 506(c), the securities offered thereunder may only be sold to persons in the United States or to U.S. persons who are "accredited investors" (or persons who the fund has reason to believe are accredited investors). (See the definition of "accredited investor" set forth in the Appendix hereto.) Further, funds would be required to "take reasonable steps to verify" that the purchasers are accredited investors. The proposed rule would implement a flexible standard for these "reasonable steps" that depends on the particular facts and circumstances of each offering. In the proposing release, the SEC indicated that some factors to consider in determining reasonable steps are the nature of the purchaser and the type of accredited investor that the purchaser claims to be, the amount and type of information that the fund has about the purchaser, and the nature of the offering (e.g., solicitation, terms, and minimum investment). Note that the SEC has stated that exclusive reliance on subscriber responses in a fund application form would not be adequate verification.

In the proposing release for Rule 506(c), the SEC made it clear that the removal of the general solicitation and general advertising prohibition would apply to private funds that rely on the Section 3(c)(1) or 3(c)(7) exemptions under the Investment Company Act of 1940 for sales to U.S. persons. In addition, with respect to concurrent U.S. offerings (relying on Section 4(a)(2) and/or Regulation D) and non-U.S. offerings (relying on Regulation S, which exempts offshore transactions where no directed selling efforts take place in the United States), the SEC stated that Regulation S offerings will continue not to be integrated with domestic offerings. Thus, the use of general solicitation or general advertisement in the United States under Rule 506(c) will not count as "directed selling efforts" that could otherwise disqualify the concurrent sale of securities outside of the United States in reliance on Regulation S.

If implemented as proposed, Rule 506(c) could substantially broaden the range of securities for which there is publicly available information. Hedge funds and other private funds would be able to market fund interests in the United States on websites, in print ads, and on television, so long as the interests were only sold to U.S. persons reasonably believed to be accredited investors.

We anticipate that some funds will not want to rely on Rule 506(c) due to the burden of verifying that U.S. persons are accredited investors or that some funds may want to be able to sell interests to non-accredited investors. As a result, those funds will still need to avoid any "general solicitation" in the United States or to identified groups of U.S. persons outside of the United States. The following is a summary of the basic "Dos and Don'ts" to observe in avoiding a determination that a fund made a "general solicitation" or "general advertisement" under Rule 502(c) of the Securities Act of 1933.

Legal Background

The existing SEC private placement rule provides no clarification of the phrases "general solicitation" or "general advertising." A number of SEC No-Action Letters, however, do provide some guidelines for determining what actions the SEC will deem general solicitations. Three basic principles provide the framework for the guidelines: (1) a substantive preexisting duty between the investor and the party offering the fund securities (i.e., the general partner, manager, etc.) must exist; (2) the offeror must generally personally direct the offer to the offeree; and (3) the offeror must have some basis to believe the investor meets sophisticated or accredited investor status (note that there is no "verification" requirement as under proposed Rule 506(c)). Using these principles, the following "Dos and Don'ts" summary represents an analysis of the SEC's positions for offerings not using proposed Rule 506(c).

General Solicitation "Dos"

Do limit offers and solicitations to persons with whom the Fund (or its agent) has a "preexisting substantive relationship." A substantive relationship exists where the Fund has information regarding a potential offeree such that the Fund can evaluate the prospective offeree's sophistication and financial circumstances. Such a relationship qualifies as preexisting when it occurs *before* the offering of the specific investment opportunity.

A preexisting substantive relationship can also exist where a general partner or manager of a fund has preexisting substantive relationships with persons who invested previously in other funds sponsored by the general partner or manager. The SEC has allowed mailing of written offers to 330 persons who invested in limited partnerships sponsored by the general partner within the previous three years.

Do monitor the activities of any agents or representatives to ensure that they are not performing general solicitations. The Fund may use an outside agent to serve as an intermediary between the investor and the Fund, but the outside agent must have a substantive preexisting relationship with the investor. Assuming the use of outside agents, the Fund should ensure that the agents' procedures and methods do not violate the general rules described in this document.

Do prepare a list of likely investor targets as early in the process as possible and stick to it. One way to assure regulators that you are not out to attract investors is to limit your investors to those identified prior to any press attention and to turn away any late arrivals no matter how qualified. Exceptions can be made after careful consideration but should be allowed only in limited circumstances and in consultation with your counsel.

Do develop scripted responses for staff to unsolicited inquiries. The standard response to all cold-call inquiries should be to assume that it is from a securities regulator and to reply with the following: "This is a private placement only for qualified purchasers who are personally known to us or to our placement agent. We do not send our private placement memorandum in response to unsolicited

inquiries. Thank you for your interest in us." Inquiries from known industry professionals, private equity competitors, entrepreneurs, etc. will generally be more for "information" and not with a view to invest. Anyone who sends a private placement memorandum under these circumstances should have it stamped "For information only" or something to that effect.

Do be very circumspect in any interactions with the press. It is very important that every conversation with any reporter begins and ends with a clear statement that, while you would like to be cooperative, the securities laws prohibit any discussion that might lead to publicity. It is likely that good reporters, such as those from *The Wall Street Journal*, will have independently sourced information. You do not have to go into denial or permit false information to be published. But whatever is reported should reflect that you stated that you could not comment due to the requirements of the securities laws. Also, when you are not dealing with reliable reporters whom you personally know, you cannot count on anything being reported accurately, and it is probably better not to talk.

Do keep strict control over the dissemination of offering materials. You and any placement agent should number your private placement memoranda and keep a list of who receives them. This will also be applicable for offerings under proposed Rule 506(c).

Do use password protection and online questionnaires to prevent nonaccredited investors from accessing investment information on a website. The SEC has approved of arrangements where a website provides information regarding exempt offerings but only where the issuer established a preexisting substantive relationship through the use of an online questionnaire; before completion of the questionnaire, the issuer prevented investor access to the information through the use of passwords. *See* IPONET, SEC No-Action Letter, 1996 WL 431821 (SEC), at *6 (July 26, 1996).

Do review your website content. Ensure that your website does not contain any reference to fundraising or investor returns or other material that could be construed as priming the market. Again, such broader-based websites will be permitted for proposed Rule 506(c) offerings.

General Solicitation "Don'ts"

Don't use mass-communication methods to publicize investments that the Fund offers. Prohibited methods include newspapers, magazines, and broadcasts over television or radio. Similarly, billboard advertisements, trade magazine advertisements, mass mailings, and "cold calling" all constitute general solicitations. Again, such advertising will be permitted for proposed Rule 506(c) offerings.

Don't announce business changes and business events to the media. Although the general solicitation rule applies only to "offers and [sales]," the SEC might construe certain general announcements to the media regarding the Fund's business as implied offers or sales.

Don't speak at industry seminars and events about your fundraising or new business plans. Such appearances, which can lead to statements about your fundraising, may also be construed as implied offers or as efforts to prime the market much like the announcement of business changes cited above.

Don't field calls from an interested investor with whom no preexisting relationship exists. In these cases, the issuer has made no independent solicitation to the individual. Despite this, the issuer would still need to gather information regarding the individual's suitability as an investor. Although the SEC has provided guidance stating that an issuer can use questionnaires to establish a substantive relationship where none existed before, the costs of compliance and risk of exposure jeopardize the entire offering and outweigh any benefit the Fund might receive in soliciting those few investors. Thus, the Fund should inform such unsolicited investors that they must be introduced by someone with a

business relationship—for example, referrals from entrepreneurs, lawyers, etc.—to pursue investment with the Fund.

Don't provide prepared materials to unaffiliated investment newsletters. The SEC found a general solicitation where companies provided materials to an investment newsletter that described companies as intending to have exempt offerings in the future. Providing such information to newsletters will presumably be permitted for proposed Rule 506(c) offerings.

Don't make generalized, nonpersonal offers to investors. Examples of such communications might include letters to CEOs of Fortune 500 companies, Rolls-Royce owners, or attorneys or physicians in a particular area. Even in situations where an issuer could reasonably expect targeted recipients of certain communications to be qualified investors, the SEC staff has tended to find that such communications are general solicitations. It would likely make sense to follow this standard even for offerings under proposed Rule 506(c).

Don't engage unregistered "finders" to locate investors in the United States. Anyone who receives compensation for introducing you to an investor in the United States (or otherwise to U.S. persons) when such compensation or "finder's fee" is based upon the amount of the investor's commitment is acting as a broker-dealer and should be registered as one. Use of unregistered brokers in the United States or with respect to U.S. persons is a violation of the U.S. securities laws and can result in rescission rights or other sanctions imposed by U.S. securities regulators. These broker-dealer registration principles will not change as a result of the adoption of proposed Rule 506(c).

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

About Morgan Lewis's Private Investment Funds Practice
Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally, based on the number of funds worked on for limited partners, by *Dow Jones Private Equity Analyst*.

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APPENDIX

Pursuant to Regulation D of the Securities Act of 1933, each of the following persons, among others, is an Accredited Investor:

(i) A natural person whose net worth* (including the net worth of his or her spouse, if making a joint investment) at the time of purchase exceeds US$1.0 million.

*As used above, the term "net worth" means the excess of total assets over total liabilities. The value of the subscriber's primary residence may not be included in the net worth calculation. The amount of indebtedness secured by a primary residence (e.g., a mortgage) up to the fair market value of the residence does not have to be included as a liability in making the net worth determination unless indebtedness secured by the primary residence was incurred within 60 days prior to the acquisition of the Shares and was not incurred as a result of the acquisition of such residence. In addition, if there is any amount of indebtedness that is secured by the primary residence (e.g., a mortgage) in excess of the fair market value of the residence, such excess of the value of the residence should be considered a liability and deducted from the subscriber's net worth.

(ii) A natural person who has had individual income in excess of US$200,000 in each of the two most recent years or joint income with that person's spouse in excess of US$300,000 in each of those years and who reasonably expects to reach the same minimum income level in the current year.

(iii) A corporation, business trust, or company or an organization described in Section 501(c)(3) of the Internal Revenue Code, not formed for the specific purpose of acquiring Shares, with total assets in excess of US$5.0 million.

(iv) A trust with total assets in excess of US$5.0 million that was not formed for the specific purpose of acquiring Shares and whose purchase is directed by a person who, either alone or with his or her purchaser representative, has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the investment.

(v) The General Partner or Investment Manager or a knowledgeable employee of the General Partner or Investment Manager.

(vi) An entity in which all of the equity owners are Accredited Investors under categories (i)–(v) above.