IX. Hedge Fund Advertisement

A. Introduction

On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups Act ("JOBS Act") into law with strong bipartisan support.[1] The JOBS Act is designed to boost the emerging growth industry by, for one, loosening current restrictions on methods through which an emerging growth company may raise capital.[2] Among its provisions, Section 201(a)(1) directs the U.S. Securities and Exchange Commission ("SEC") to lift the decades-old ban on "general solicitation and general advertising" originally imposed under the Securities Act of 1933 (the "Act").[3]

Certain statutory exemptions are available, under which securities offerings would be exempt from registering as public offerings. As of September 23, 2013, a new Rule 506(c) went into effect, allowing qualified private companies—startups, hedge funds, private-equity funds, and other investment funds—to engage in "general solicitation and general advertisement" if the funds meet certain criteria.[4] For a company to qualify for Rule 506(c) general solicitation standards, the company must satisfy terms and conditions of Rules 501, 502(a), and 502(d), all purchasers of securities must be

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[1] Timothy Spangler, *Who's Afraid of Hedge-Fund Advertising?*, NEW YORKER (Aug. 6, 2013), http://www.newyorker.com/online/blogs/newsdesk/2013/08/whos-afraid-of-hedge-fund-advertising-1.html; Susan Crabtree, *Jobs Act Signing a Show of Bipartisan Support*, WASH. TIMES (Apr. 5, 2012), http://www.washingtontimes.com/news/2012/apr/5/obama-signs-bipartisan-small-business-bill/ ("With the economic recovery still slow, the measure attracted plenty of bipartisan support, evidenced by the number of lawmakers from each party on hand for the ceremony, including House Majority Leader Eric Cantor of Virginia, Republican Sen. Scott P. Brown of Massachusetts, and GOP Reps. Spencer Bachus of Alabama, Patrick T. McHenry of North Carolina and Scott Garrett of New Jersey.").

[2] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, Exchange Act Release No. 34-69959, No. 34-69959 Advisers Act Release No. 3624, 78 Fed. Reg. 44,771, 44,803 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 and 242).

[3] *Id.*

[4] *See id.* at 44,776.

"accredited investors," and issuers must take "reasonable steps to verify that such purchasers are accredited investors."[5]

Part B outlines the commentary on Rule 506(c) from both proponents and critics. Next, Part C discusses certain limitations on Rule 506(c), such as limiting offerings to accredited investors and bad actor disqualification, which are meant to address issues of fraud. Part D then explores possible implications and developments that are expected to arise from the new rule, including a change in "blue sky" laws and standardization of securities advertising materials. Part E speculates on the possible limited impact of Rule 506(c) and why large, institutional issuers may hesitate to use the new rule right away. Finally, Part F discusses the increased need for due diligence services arising from implementation of Rule 506(c) and possible industry changes that may result.

B. Commentary on Rule 506(c)

Proponents applaud Rule 506(c) as a successful follow-up to Obama's JOBS Act, stating that the rule will help companies, including early stage businesses, raise capital and decrease administration costs.[6] Some go further in commenting that anti-solicitation rules from the 1990s are burdensome and unnecessary in today's world of technology, where potential investors can mitigate risks of fraud through the world of information available to them through the Internet.[7]

Supporters also anticipate that general advertising and solicitation will lead to increased transparency, as the rule lifts restrictions on open communication between companies and possible

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[5] *Id.*

[6] *Id.* at 44,775 ("Commenters who supported the proposed amendment to Rule 506 stated that Rule 506(c), if adopted, would assist issuers, particularly early stage and smaller issuers, in raising capital allowing them to solicit investments from a larger pool of investors.").

[7] Karina Sigar, Comment, *Fret No More: Inapplicability of Crowdfunding Concerns in the Internet Age and the JOBS Act's Safeguards*, 64 ADMIN. L. REV. 473, 504 (2012) ("[T]hese worries about investor protection are unfounded in light of the characteristics of the public and the tools available in this Internet age. The democratization of access to information—facilitated by the Internet—levels the playing field between issuers and prospective investors.").

investors.[8] Currently, hedge funds face strict restrictions on any type of media communication and have "been advised not to establish websites . . . , make public statements that reference the name of the fund . . . , make presentations about the fund to an unscreened or large audience at a conference or industry event, give interviews to the financial press, etc."[9] As a result, the general public often views hedge funds as "shadowy and secretive."[10]

Critics of the rule argue that lifting the general solicitation ban unnecessarily increases risk to investors while failing to add value to the market.[11] Specifically, opponents point out that Regulation D was already successful in raising capital without Rule 506(c)[12] and that the new rule will increase risk of fraud as "the demi-monde of fraudulent stock promoters . . . abuse the ability to fish in the broader pond of potential victims."[13] SEC Commissioner Luis A. Aguilar, an outspoken opponent of the rule, warned that the rule would cause "a boon to boiler room operators, Ponzi schemers, bucket shops, and garden variety fraudsters, by enabling them to cast

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[8] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, Exchange Act Release No. 34-69959, No. 34-69959 Advisers Act Release No. 3624, 78 Fed. Reg. at 44,784.

[9] Timothy F. Silva, Matthew A. Chambers & Justin L. Browder, *SEC Proposes Rules to Eliminate the Prohibition Against General Solicitation and Advertising for Hedge Funds and Other Private Funds*, WILMERHALE PUBLICATIONS & NEWS (Sept. 5, 2012), http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=110251.

[10] *See* Spangler, *supra* note 1.

[11] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, Exchange Act Release No. 34-69959, No. 34-69959 Advisers Act Release No. 3624, 78 Fed. Reg. at 44,776.

[12] VLADIMIR IVANOV & SCOTT BAUGUESS, SEC, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012 5 (2013), *available at* http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d ("Underscoring the importance of the Regulation D market as a source of capital to smaller firms, a significant number of issuers have relied on this market over the last four years. There were 49,740 unique issuers of new Regulation D offerings over the four years under consideration.").

[13] Bruce Dravis, *Public Advertising of Private Investments Offerings: The Operation and Issues in Post-JOBS Act Regulation D*, 13 U.C. DAVIS BUS. L. J. 295, 306 (2013).

a wider net, and making securities law enforcement much more difficult."[14]

C. Limitations That Address Risk of Fraud

The SEC addressed concerns of increased risk of fraud by imposing certain limitations on Rule 506(c) offerings, including limiting offerings to accredited investors, placing the burden of verification on the issuer, and instating a bad actor disqualification.[15]

By limiting offerings to accredited investors, the SEC hopes to limit potential investors to those "knowledgeable about financial matters and otherwise able to fend for themselves."[16] Some, including Commissioner Aguilar, remain unconvinced, arguing that the definition of an "accredited investor" pursuant to Rule 506(c) does not necessarily require that the investor is "experienced or sophisticated" and that general solicitation "provides fraudsters with key advantages over legitimate capital raisers [because] the scam artist does not feel compelled to tell the truth—but can make the sales pitch as compelling as imagination permits."[17]

The accredited investors limitation in Rule 506(c) will place the burden of verification on the issuer of the security.[18] The SEC has stated that "the purpose of the verification mandate is to address concerns, and reduce the risk that the use of general solicitation in Rule 506 offerings could result in sales of securities to investors who are not, in fact, accredited investors."[19] The mandate will require issuers to "take reasonable steps to verify" the status of potential investors.[20] Reasonableness will be objectively determined based on

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[14] Luis A. Aguilar, Comm'r, SEC, Facilitating General Solicitation at the Expense of Investors (July 10, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539684712#.Ui1CrDakqu8.

[15] *New Rule 506(c): General Solicitation in Regulation D Offerings*, CROWDCHECK (CrowdCheck, Alexandria, Va.), 2013, http://www.crowdcheck.com/sites/default/files/CrowdCheck%20Memo%20on%20New%20Regulation%20D.pdf.

[16] *See* Aguilar, *supra* note 14.

[17] *Id.*

[18] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, Exchange Act Release No. 34-69959, No. 34-69959 Advisers Act Release No. 3624, 78 Fed. Reg. at 44,800.

[19] *Id.* at 44,776.

[20] *Id.* at 44,778.

a number of predetermined factors: "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 issuer has about the purchaser; and the nature of the offering."[21]

Additionally, the bad actor disqualification will "disqualify . . . issuer[s] or other relevant persons who have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws."[22] Disqualifying events listed include: "[f]elony and misdemeanor convictions in connection with transfer of a security . . . ; injunctions and court orders against . . . purchase or sale of securities; [and] U.S. Postal Service false representation orders within the last five years."[23] Commissioner Aguilar remains unconvinced that the bad actor disqualification will be effective, arguing that the rule cannot protect investors from first-time offenders.[24]

In addition to SEC-imposed limitations, some have identified external limitations on Rule 506(c) offerings as natural restraints against fraud.[25] For example, though the lift on general solicitation is broad, antifraud provisions of the Investment Advisers Act of 1940 ("Advisers Act"), as well as certain applicable laws of foreign jurisdictions, will still apply to securities issuers regardless of whether they choose to rely on Rule 506(c).[26] In fact, in enacting Rule 506(c), the SEC specifically warned that the Advisers Act prohibition against misleading disclosures and deceptive conduct will still apply.[27] The Advisers Act also prohibits "use of

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[21] *Id.* at 44,776.

[22] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 33-9414, 78 Fed. Reg. 44,730, 44,731 (July 24, 2013).

[23] *Id.* at 44,731–32.

[24] Aguilar, *supra* note 14.

[25] Yin Wilczek, *Fund Sponsors, Issuers Must Be Alert To Potential Pitfalls in New Reg D Regime*, 16 MERGERS & ACQUISITIONS L. REP. (BNA) 1287 (Sept. 2, 2013).

[26] *Id.*

[27] Michael L. Zuppone, *Under JOBS Act, SEC Eliminates Prohibition Against General Solicitation and Advertising*, 6 Alternative Investment L. Rep. (BNA) No. 37, at 1144 (Sept. 25, 2013) ("Private fund advisers should keep in mind, however, that any such advertisements of solicitations will still be subject to the antifraud provisions of the Investment Advisers Act of 1940 . . . and the rules promulgated thereunder, which include prohibitions against the use of testimonials, past specific recommendations and

testimonials, past-specific recommendations and restrictions on the presentation of performance data in connection with the offer and sale of private fund securities and the investment activities of private funds."[28]

D. Implications and Expected New Developments

Implementation of Rule 506(c) will lead to new industry developments, but industry players are still unsure of the impact of the new rule.[29] Goodwin Procter partner Brynn D. Peltz commented that, though new proposed rules may not completely eliminate unwise investments, increased regulation on this new class of securities may help to prevent widespread use of general solicitation of investors by investment funds.[30]

One expected change will be a shift in SEC regulations and various state laws that govern securities.[31] States have traditionally employed what are known as "blue sky laws," securities statutes that govern registration of securities offerings within the state.[32] Because Rule 506(c) preempts general anti-solicitation blue sky laws but still authorizes each state to continue regulating securities offerings,

restrictions on the presentation of performance data in connection with the offer and sale of private fund securities and the investment activities of private funds. The SEC specifically reminded investment advisers that they are subject to Rule 206(4)-8 under the Advisers Act which prohibits any investment adviser to a pooled investment vehicle from disseminating misleading disclosure or engaging in deceptive conduct.").

[28] *Id.*

[29] Telephone Interview with Brynn D. Peltz, Partner, Goodwin Procter LLP (Sept. 9, 2013).

[30] *Id.*

[31] *Id.*

[32] Michael W. Shumate, Student Article, *Crowdfunding and State Level Securities Fraud Enforcement Under the JOBS Act*, 90 DENV. U. L. REV. ONLINE 109, 109–10 (2013) ("While the SEC prosecutes most large-scale securities actions at the federal level, states also have their securities statutes, colloquially known as 'blue sky laws,' and bring their own enforcement actions. Blue sky laws vary from state to state, but have traditionally focused on the registration of both broker-dealers and securities offerings. . . . States also typically have in place anti-fraud provision that make actionable false statements in connection with securities offerings.").

states will likely implement new state laws that regulate general advertisement under Rule 506(c) in the coming months.[33]

Similarly, the SEC may also look to pass new rules governing general advertising.[34] Generally, the SEC was opposed to lifting the general solicitation ban, but the JOBS Act required them to do so.[35] As a result, the SEC "will probably be slow to do so, but they may pass additional rules that affect Rule 506(c) filings."[36]

For example, issuers currently have no uniform way to advertise, but the SEC has already begun attempting to standardize advertising materials.[37] A new proposed rule requires Rule 506(c) advertisements to have legends that "would include notifications about the risk inherent in the offering, as well as what investors are eligible to participate."[38] Another proposed rule would require issuers relying on Rule 506(c) to "provide their written general solicitation materials to the SEC" for approval.[39] In addition to current proposed rules, industry experts also expect that the SEC and the states will regulate the way private funds present their financial numbers in advertisements.[40]

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[33] Jonathan Axelrad, Matthew L. Giles & Brynn D. Peltz, Goodwin Procter LLP, *Considerations for Private Funds After Lift of Ad Ban*, LAW360 (July 11, 2013, 4:15 PM), http://www.goodwinprocter.com/~/media/Files/Publications/Attorney%20Articles/2013/Axelrad_Considerations%20For%20Private%20Funds%20After%20Lift%20Of%20Ad%20Ban.pdf.

[34] *See generally* Amendments to Regulation D, Form D and Rule 156; Reopening of Comment Period, Securities Act Release No. 33-9458, Exchange Act Release No 34-70538, Investment Company Release No. IC-30737, 78 Fed. Reg. 61,222 (July 24, 2013).

[35] *See* Aguilar *supra* note 14 (opposing generally the idea of passing Rule 506(c)).

[36] Telephone Interview with Brynn D. Peltz, *supra* note 29.

[37] *Id.*

[38] Letter from Shelly Mui-Lipnik, Senior Dir., Tax and Fin. Servs. Policy, Biotechnology Indus. Org., to Elizabeth M. Murphy, Sec'y, SEC (Sept. 18, 2009), http://www.sec.gov/comments/s7-06-13/s70613-357.pdf.

[39] *Id.*

[40] *See* Lillian Brown et al., *SEC Adopts JOBS Act and Dodd-Frank Act Private Placement Provisions; Proposes Additional Requirements for Private Placement Market*, WILMERHALE PUBLICATIONS & NEWS (July 11, 2013), http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=10737421791.

Recently, the SEC proposed a new rule that would require pre-filing at least fifteen days prior to general advertising.[41] During the comment period, the proposal received widespread opposition from interest groups, startups, and some members of Congress.[42] More than 150 comment letters from newly created entities and other interested parties complained that "startups do not have the resources to comply with the proposed [pre-filing] requirements."[43] Republican Congressmen Scott Garrett and Patrick McHenry have also criticized the proposed rule as "contrary to the JOBS Act" and its purpose to promote economic growth in the emerging growth industry.[44]

E. Possible Limited Impact of Rule 506(c)

Some speculate that, because of economic constraints, the impact of Rule 506(c) may not be as widespread as the media is projecting.[45] Instead, fund managers may use the new rule as a "safety net" to speak freely to the press instead of directly seeking to advertise through traditional media.[46] In such a case, Rule 506(c) would "limit the potential consequences of inadvertently breaching the prohibition against general solicitation in connection with an offering otherwise intended to comply with Rule 506(b),"[47] which is still subject to prior anti-solicitation laws. In essence, the new rule may provide some protection to fund managers who open up to the public regarding certain funds.[48]

Predominantly, issuers exercise caution against relying on Rule 506(c) for economic reasons. David S. Guin, Chairman of the

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[41] Yin Wilczek, *Startups Protest SEC Proposal to Add Requirements to Generally Solicited Offerings*, 45 Sec. Reg. & L. Rep. (BNA) No. 34, at 1562 (Aug. 26, 2013) ("Commenters also faulted three of the proposed amendments as especially onerous for startups [including] requiring the filing of Form D within 15 days in advance of the first use of general solicitation.").
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] Telephone Interview with Brynn D. Peltz, *supra* note 29.
[46] *Id.*; *see* Axelrad, Giles & Peltz, *supra* note 33; Marine Cole, *Hedge Funds Won't Rush to Advertise Even After Ban Lifted*, ADVERTISINGAGE (July 12, 2013), http://adage.com/article/news/hedge-funds-rush-advertise-ban-lifted/243047/.
[47] Axelrad, Giles & Peltz, *supra* note 33.
[48] Telephone Interview with Brynn D. Peltz, *supra* note 29.

Corporate and Securities Department at Withers Bergman, described the new rule as a "double edged sword that increases flexibility for issuers to solicit purchasers through general solicitation, while imposing a more significant due diligence burden on issuers to verify that purchasers are accredited investors."[49] In other words, firms may conclude that the costs of due diligence are so "burdensome, expensive, and time consuming"[50] that the costs outweigh the benefits of potential new investors and ultimately decide to opt out of Rule 506(c) securities offerings in general.[51]

Furthermore, because anti-solicitation rules still apply to non-Rule 506(c) securities, issuers who engage in general solicitation under Rule 506(c) run the risk of eliminating Regulation D exemptions that may otherwise be available to them.[52] Moreover, issuers who choose to rely on Rule 506(c) may foreclose the option of issuing to financially sophisticated, but non-accredited, investors.[53] Such issuers also take on the additional cost of due diligence in ensuring that potential investors are accredited within the meaning of Rule 506(c).[54] As a result, industry analysts warn that issuers should exercise caution before pursuing general solicitation under the new rule "to ensure that, if the offering does not meet their business objective, they will be able to utilize another exemption under Regulation D in order to secure the required funding, which may require advance planning and/or waiting a substantial period of time after the initial offering."[55]

Furthermore, because proposed rules and restrictions on Rule 506(c) offerings are still developing, larger firms may be slow to use

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[49] Russ Alan Prince, *How Hedge Funds Can Effectively Advertise*, FORBES (Aug. 8. 2013, 4:13 AM), http://www.forbes.com/sites/russalanprince/2013/08/08/how-hedge-funds-can-effectively-advertise/.

[50] David A. Bell, Matthew Thomas Deffebach & Debra Gatison Hatter, *The JOBS Act*, *in* Social Media Law, Corporate Practice Series Portfolio: Intellectual Property (BNA) No. 91 § V(B).

[51] *See* Telephone Interview with Brynn D. Peltz, *supra* note 29.

[52] Robert A. Friedel & Paul C. Dunn, Pepper Hamilton LLP, *Private Placements Under New Rule 506(c)—Interplay with Other Exemptions and State Law Implications*, MONDAQ (Aug. 12, 2013), http://www.mondaq.com/unitedstates/x/257352/Securities/Private+Placements+under+New+Rule+506c+Interplay+with+Other+Exemptions+and+State+Law+Implications.

[53] *Id.*

[54] *Id.*

[55] *Id.*

advertising simply because "the industry really doesn't know what the true impact of the rule will be yet."[56] Firms have been advised to "continue to follow their customary procedures with respect to Rule 506."[57] "[L]awyers and regulators said they expect smaller funds with fewer resources to test the new rule first"[58] as some of the smaller hedge funds try to seek out wealthy investors.[59]

F. Increase of Due Diligence Services

One development that may occur is the rise of a new due diligence industry in establishing "accredited investors."[60] The new rule requires issuers who engage in general solicitation to verify through "reasonable" means that potential investors are accredited investors.[61] The list of actions that meet this standard is illustrative, though not exhaustive.[62] The test is an objective one that considers factors including but not limited to "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 issuer has about the purchaser, and the nature and terms of the offering."[63] Some speculate that third party service providers such as "internet portals that match private issuers with potential investors" may rise to provide this service.[64] The JOBS Act specifically allows for "funding

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[56] Telephone Interview with Brynn D. Peltz, *supra* note 29.
[57] Nathan Greene & Robert Treuhold, *JOBS Act: SEC Proposal Would Dramatically Expand Marketing Options in Regulation D and Rule 144A Private Placements*, 5 Alternative Investment L. Rep. (BNA) No. 36, at 1141 (Sept. 19, 2012).
[58] Sarah N. Lynch, *SEC Lifts Longtime Advertising Ban for Hedge Funds, Other*, REUTERS (July 10, 2013, 6:04 PM), http://www.reuters.com/article/2013/07/10/us-sec-advertising-idUSBRE9690I520130710.
[59] *See* Telephone Interview with Brynn D. Peltz, *supra* note 29.
[60] *Id.*
[61] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415, Exchange Act Release No. 34-69959, No. 34-69959 Advisers Act Release No. 3624, 78 Fed. Reg. 44,771, 44,776 (July 24, 2013).
[62] *See* Zuppone, *supra* note 27 ("The SEC maintained its flexible, objective principles-based approach to verification and added a non-exclusive list of acceptable verification methods for determining the accredited investor status of natural persons in response to public comments.").
[63] *See* Telephone Interview with Brynn D. Peltz, *supra* note 29.
[64] *See* Axelrad, Giles & Peltz, *supra* note 33.

portals" that act as intermediaries between issuers and investors as long as these portals do not offer investment advice, solicit purchase or sale, compensate employees on solicitation, hold or manage investor funds, or engage in other activities.[65]

G. Conclusion

The lift of the decades-long anti solicitation ban will impact the way securities issuers, including hedge funds and startups, advertise and raise capital.[66] Comments on the new rule have been split between support for easier, more transparent fundraising and criticism that the new rule may unnecessarily increase risk of fraud.[67] While larger players are not expected to make immediate changes in capital-raising activities, smaller securities issuers may take advantage of the new Rule 506(c) to try to reach new wealthy investors.[68] The SEC and various states are expected to adopt new laws and regulations that seek to regulate general solicitation and fraud.[69] Legal practitioners are also keeping an eye on possible opportunities to provide due diligence services to and explain new crowdfunding possibilities for clients.

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[65] JOBS Act § 304(b), 15 U.S.C. § 78c(a)(80).
[66] *See supra* notes 2, 30–31 and accompanying text.
[67] *See supra* notes 6–14 and accompanying text.
[68] *See supra* notes 45–51 and accompanying text.
[69] *See supra* notes 33, 36 and accompanying text.
[70] Student, Boston University School of Law (J.D. 2015).