2013: Another Year of Change for Private Fund Regulation

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2013 brought a number of important regulatory developments for private fund managers and investors, including (1) the removal of the ban on general solicitation and advertising in private fund marketing in the US, (2) the adoption of new "bad actor" rules for private placements in the US and (3) the implementation of the Alternative Investment Fund Managers Directive (AIFMD) impacting marketing of private funds in the EU.

JOBS Act Rules Allow Public Marketing of Private Funds in the US

The SEC's rules governing the sale of unregistered securities have for many years prohibited private funds from engaging in general solicitation or general advertising when marketing to investors under Regulation D of the Securities Act, including any publication, broadcasting, cold-calling or use of other mass media methods to solicit investors.

As required by the JOBS Act, in 2013 the SEC adopted rules eliminating these long-standing restrictions, so long as the fund performs additional diligence to verify that all investors are "accredited investors." Effective in September, the rules now permit a fund to engage in general solicitation and advertising, provided that the fund takes reasonable steps to verify that each investor is an "accredited investor." Whether a fund took "reasonable steps to verify" the accredited investor status of each investor is judged on the facts and circumstances of each transaction. The SEC adopted certain non-exclusive safe harbours through which a fund can demonstrate that it took such steps for a natural person, including (1) a review of tax documents or bank and other financial statements, or (2) verification by a third-party broker-dealer, registered investment adviser, licensed attorney or CPA.

A fund must file a Form D with the SEC indicating whether it is relying on the new exemption (allowing general solicitation and advertising but no non-accredited investors) or the traditional private placement exemption (with no general solicitation or advertising but with up to 35 non-accredited investors), and changing course in either direction will be difficult. Despite the availability of this more flexible approach to marketing a fund, sponsors must carefully consider the burdens and costs imposed by the heightened accredited investor verification procedures, and most private funds marketing in the US have not yet moved to more general public marketing.

"Bad Actor" Disqualifications for Private Fund Offerings

As required by the Dodd-Frank Act, in 2013 the SEC adopted new rules that disqualify a fund's private placement, with or without general solicitation or advertising, if the fund, its GP or other related persons, service providers or solicitors have been subject to certain disciplinary events that occur on or after September 23, 2013. In addition, events occurring up to 10 years prior to that date must be disclosed to investors (e.g., in a PPM supplement) within a reasonable time before closing.

The long list of persons and entities that can have "bad actor" implications for a fund's private placement includes: (1) the fund and its GP/management company and placement agent(s), and any directors, executive officers, other officers "participating in the offering" and other persons compensated based on soliciting fund investors, as well as the respective GPs or managing members of those entities; (2) any affiliated or predecessor issuer (not including portfolio companies or other affiliates unless they are issuing securities in the same offering as the fund); and (3) beneficial owners of 20% or more of the fund's voting securities.

If there is any good news, it is that: (1) the rules pick up only serious events, such as securities-related criminal convictions, court injunctions and restraining orders, certain disciplinary orders issued by regulators and suspension or expulsion from membership in, or association with, a self-regulatory organization; and (2) the new rules' disclosure and disqualification provisions do not apply to events of which the fund was unaware despite exercising "reasonable care," including, at minimum, a factual inquiry into whether any triggering events exist. However, private fund sponsors are expending considerable efforts to ensure appropriate diligence is performed and no "bad actor" events are present.

The AIFMD Takes Effect

The big development in Europe in 2013 has been the AIFMD, which came into force in July. The AIFMD will impact any manager marketing its funds to European investors (note that the AIFMD does not generally impact funds that are already raised). There was some eleventh hour transitional relief for funds in market across the July implementation date in key jurisdictions, including the UK, Netherlands, Germany and Sweden, meaning that those funds may be able to avoid the AIFMD for this fundraise, and that the full impact of the AIFMD is only just beginning to be felt.

The AIFMD is going to result in additional costs and regulatory burdens for funds marketing in Europe - there are requirements for additional investor disclosures, for an annual fund report and for reporting to regulators in those European jurisdictions where the fund has been marketed. For funds investing in Europe, there are various "portfolio company provisions," including some anti-asset stripping rules. In some jurisdictions (e.g., Italy), active marketing will not, for now, be permitted under national rules (reverse solicitation by an investor to the manager, if supportable on the facts, may be a possibility), and in most jurisdictions it will be necessary to register before marketing, a relatively quick and simple process in, for example, the UK, but in some jurisdictions, for example Germany, Denmark and Austria, there is a two-to-four month approval process which should be factored into timing. These jurisdictions also require that a fund depositary be appointed.

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