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Investment Funds Update March 20, 2025

SEC Provides Bright-Line Test for Investor Verification Under Rule 506(c)

On March 12, 2025, the Securities and Exchange Commission (SEC) issued a no-action letter that establishes a clear path to compliance with the "accredited investor" verification steps required to engage in general advertising and solicitation in reliance on the private placement safe harbor set forth in Rule 506(c) of Regulation D under the Securities Act of 1933.

I. Overview

The letter makes Rule 506(c) a more attractive option for private fund sponsors by eliminating the need to obtain intrusive documentation from investors who meet minimum investment thresholds and give certain representations, although broadly marketing a private fund continues to present certain challenges that the letter does not address.

II. Rule 506(c)

Generally speaking, offerings of securities must be registered with the SEC and/or relevant states unless an exemption is available. Rule 506(c), adopted in 2013, provides one such exemption from registration that, unlike the more commonly used Rule 506(b) safe harbor, permits sponsors to offer fund interests using general advertising and solicitation so long as they "take reasonable steps to verify that purchasers of securities sold in any offering…are accredited investors." Compliance with this requirement has been daunting, because the accredited investor verification methods prescribed to date have required sponsors to obtain and review extensive

personal financial information from many investors prior to sale, or a written confirmation from certain third-party professionals that the investor is accredited.

III. The Letter

The no-action letter seeks to address this problem by confirming that, so long as the following conditions are met, a sponsor will be deemed to have taken reasonable steps to verify that a prospective investor is an accredited investor for purposes of Rule 506(c):

1. The sponsor must obtain written representations that the prospective investor (a) is an accredited investor and (b) is not specifically financing, in whole or in part, the minimum investment amount;

2. The prospective investor's minimum investment amount, which may be in the form of a binding capital commitment, must be:

    a. at least $200,000 for natural persons; or

    b. at least $1,000,000 for legal entities.[1]

3. The sponsor must not have actual knowledge of any facts indicating that a prospective investor is not an accredited investor or that a prospective investor has used third-party financing specifically to make their investment.

IV. Analysis & Key Takeaways

While the no-action letter provides much-needed clarity with respect to complying with the Rule 506(c) accredited investor verification requirement, there are a number of considerations that sponsors should keep in mind when deciding whether to utilize general advertising and solicitation for a fundraise:

- The letter has no bearing on the limitations imposed by the exemptions from registration under the Investment Company Act of 1940, including the requirement that private funds (other than certain real estate funds relying on the Section 3(c)(5)(C) exemption) cap investors who are not "qualified purchasers" at 100. The letter could, however, prompt sponsors to explore permanent capital vehicles that are registered under the Investment Company Act, and accordingly not subject to this limitation, but rely on Rule 506(c) to avoid the significant cost and burden of Securities Act registration.

- For sponsors who are SEC-registered investment advisers, the provisions of the Investment Advisers Act of 1940 continue to apply, including the requirement that investors in Section 3(c)(1) funds (not more than 100 beneficial owners) must be "qualified clients" in order to charge them performance-based compensation, and the marketing rule, which, among other things, would impose heightened scrutiny on public-facing advertisements that contain "hypothetical performance" (e.g., targeted or projected returns).

- Sponsors who plan to seek investments from outside the U.S. must be careful not to run afoul of any applicable "world sky" private placement regimes, including the Alternative Investment Fund Managers Directive in the European Economic Area, by broadly

marketing a fund through, for example, a globally accessible website or social media account.

- While the various exemptions available under Regulation D are non-exclusive, once the general advertising and solicitation bell has been "rung", *per se*, it generally cannot be "unrung". The use of Rule 506(c) could, for instance, preclude a fund from subsequently relying on the "statutory exemption" under Section 4(a)(2) of the Securities Act, which prohibits broad marketing activity. This could be particularly problematic in a situation where a sponsor is disqualified from relying on the Rule 506 safe harbors for certain "bad acts" as Section 4(a)(2) likely would be the only avenue available to maintain the private placement status of a given fund offering absent a waiver from the SEC.

[1] For an entity that is an accredited investor solely on the basis that its beneficial owners are accredited investors, the minimum investment amount is at least $1,000,000, or $200,000 for each beneficial owner if owned by fewer than five natural persons (and written representations described above should be obtained for each natural person beneficial owner).

The following Gibson Dunn lawyers prepared this update: Kevin Bettsteller and Zane Clark.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding the issues and considerations discussed above. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Investment Funds practice group, or the authors:

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