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Practice Groups:

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Private Offerings under the JOBS Act

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The President signed into law the Jumpstart Our Business Startups Act (the "JOBS Act" or the "Act") on April 5, 2012. The Act represents a significant deregulation of private securities offerings and contains a number of provisions that will directly impact private funds, their advisers, and broker-dealers that participate in private fund offerings. This alert is directed only to those provisions of the Act. The entire Act has been addressed in an Alert from our Corporate Practice Group that can be accessed from the link at the end of this Alert. Specifically, the JOBS Act:

- requires the SEC to amend Rule 506 of Regulation D within 90 days of enactment to eliminate the prohibition on general solicitation and general advertising contained in Rule 503(c) on private offerings made pursuant to Rule 506, including offerings by hedge funds and private equity funds, as a condition of the safe harbor for exemption from registration under Section 4(2) of the Securities Act of 1933, as amended ("Securities Act"), provided that all purchasers are "accredited investors."[1]
- requires the SEC to further amend Rule 506 to require an issuer relying on that Rule to take reasonable steps to verify that the purchasers are accredited investors using methods to be determined by the SEC.
- provides that the SEC shall, in the same period, revise Rule 144A under the Securities Act to provide that securities sold under the revised rule may be offered to persons other than qualified institutional buyers ("QIBS"), including by means of general solicitation and general advertising, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBS.
- amends Section 4 of the Securities Act to provide that offers and sales that are exempt under Rule 506, as amended pursuant to the JOBS Act, "shall not be deemed public offerings under the Federal securities laws as a result of general solicitation or general advertising."
- amends Section 4 of the Securities Act to provide that, with respect to securities offered and sold in compliance with Rule 506 of Regulation D, certain persons performing certain functions shall not be subject to registration as broker-dealers pursuant to Section 15(a)(1) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), solely because of the performance of those functions, subject to certain conditions.[2]
- increases the Section 12(g) threshold for registration under the Exchange Act to 2,000 record holders or 500 record holder, non-accredited investors, in both cases excluding securities held by persons who acquired the securities pursuant to an employee compensation plan exempt from registration under Section 5 of the Securities Act.

[1] The term "accredited investor" is defined in Rule 501 of Regulation D.

[2] The JOBS Act refers to Section 15(a)(1) of "this title" but apparently meant the Exchange Act title.

Regulation D Offerings of Private Fund Interests under Rule 506

The JOBS Act will eliminate restrictions on the manner of offering for private placements sold to accredited investors pursuant to Rule 506 of Regulation D. Once the SEC has amended Regulation D, private funds will be permitted to conduct Rule 506 private placements in virtually any manner, including the use of general solicitation and general advertising, provided purchasers are exclusively accredited investors. This would include, but not be limited to, the use of their and other web sites, as well as other media. Developing substantive relationships with prospective investors through questionnaires or other means prior to showing them deal specific information presumably no longer will be required.[3] The prohibition on general solicitation and general advertising apparently still will apply to Rule 506 offerings if there are any sales to non-accredited investors unless the SEC eliminates such prohibition, which we think unlikely.

Issuers relying on the Rule 506 of Regulation D safe harbor still will have to take steps to determine whether the purchasers are accredited. As set forth above, the JOBS Act requires the SEC to adopt rules to require the issuer to take reasonable steps to **verify** that purchasers are accredited by methods determined by the SEC. Currently, the requirement under Rule 501 of Regulation D is that, at the time of sale, the investor be accredited or that the issuer reasonably believes the investor to be accredited. As set forth above, the reasonable belief standard still applies to the determination of whether purchasers are QIBS under the amended Rule 144A. Reasonable belief traditionally has been based on questionnaires and subscription agreements. The SEC may require something further under Rule 506 in addition to the traditional questionnaires and subscription agreements in determining methods to **verify** that purchasers are accredited.

Private placement of fund interests will continue to be subject to the anti-fraud provisions of federal and state securities laws, the advertising restrictions of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and the rules thereunder. Further, when broker-dealers act as placement agents or intermediaries in connection with these offerings, Exchange Act rules and rules of the Financial Industry Regulatory Authority (“FINRA”) applicable to FINRA members also will apply. (See Effect on Investment Advisers and Broker-Dealers below.)

Most private funds rely on the exceptions contained in either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the “1940 Act”), to avoid registration under the 1940 Act. Notably, both Sections 3(c)(1) and 3(c)(7) prohibit “public offerings” of securities. However, the JOBS Act amends Section 4 of the Securities Act to provide that offers and sales of securities exempt from registration under Rule 506 (as amended pursuant to the JOBS Act) “shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation.” Thus, as the amendment applies to all of the Federal securities laws, it appears that private funds relying on the Section 3(c)(1) and 3(c)(7) exceptions will continue to be exempt from registration under the 1940 Act, if they engage in general advertising or general solicitation, as long as all of their investors are “accredited investors.” The effect of the JOBS Act on advisers to private funds relying on certain exemptions from registering with the Commodity Futures Trading Commission (the “CFTC”) appears to be less clear. For example, both CFTC Regulations 4.13(a)(3) and 4.7 generally require the operators of private funds relying on such exemptions to offer and sell the fund interests without marketing to the public in the United States. Therefore, operators of private

[3] Previously, SEC no-action letters delineated procedures and conditions that issuers were required to observe to avoid making a general solicitation or engaging in general advertising in connection with Regulation D private offerings. These restrictions no longer will apply to Rule 506 offerings sold only to accredited investors once the SEC adopts the changes mandated by the JOBS Act.

funds relying on such exemptions still may be subject to restrictions on marketing unless and until the CFTC or its staff clarifies the effect of the JOBS Act on these exemptions.

Increased Registration Threshold

The JOBS Act creates an opportunity for Section 3(c)(7) Funds to admit a far larger number of investors. While Section 3(c)(7) itself imposes no numerical limitation on the number of investors that may be admitted to a fund, those funds have in almost all instances limited the number of their record holders to fewer than 500 to avoid becoming public companies under the Exchange Act. The JOBS Act increases the threshold for registration under the Exchange Act, such that a Section 3(c)(7) fund now can admit up to 1,999 record holders (excluding record holders who received the securities pursuant to an employee compensation plan exempt from registration under Section 5 of the Securities Act) without having to register a class of securities under the Exchange Act (although the fund would be required to register a class of securities under the Exchange Act if it were held by 500 or more record holders that were not accredited under Rule 501 under the Securities Act).

Section 601 of the JOBS Act amends Section 12(g) of the Exchange Act and requires the SEC to issue final regulations implementing these amendments no later than one year after the enactment of the JOBS Act, which means that final regulations must be adopted by April 5, 2013.

Status of Intermediary Platforms

Section 201(c) of the JOBS Act amends Section 4 of the Securities Act to provide that, with respect to securities offered and sold in compliance with Rule 506 of Regulation D, certain persons will not be subject to the broker-dealer registration requirements of Section 15(a)(1) of the Exchange Act solely because of certain activities, subject to certain conditions. Note that this provision appears to apply to all offers and sales in compliance with Rule 506. The persons are: (A) a person that maintains a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements or similar or related activities by issuers of such securities, whether online, in person or through any other means; (B) a person or person associated with that person that co-invests in such securities; or (C) a person or person associated with that person that provides "ancillary services" such as due diligence or standardized documentation.[4] However, this exemption is conditioned upon: (1) the person and each person associated with the person not receiving compensation in connection with the purchase or sale of the security; (2) the person and each person associated with the person not holding investor funds or securities in connection with the purchase or sale of such security; and (3) any person described in (A), (B) or (C) above not being subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act (the "bad person" provisions).

This provision appears to allow third parties to provide various services in Rule 506 offerings through web sites and other means and not be required to register as broker-dealers, provided that they do not receive purchase or sales compensation, do not hold customer funds or securities and do not render investment advice or recommendations for separate compensation. The provision, except for the

[4] The term "ancillary services" is defined in Section 201 of the JOBS Act as "(A) the provision of due diligence services in connection with the offer, sale, purchase or negotiation of such security so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors; and (B) the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service."

second prong of the definition of ancillary services (see note 4), does not specifically address a person's participation in negotiation of a purchase or sale transaction. Under Section 201(c), a platform or mechanism may permit negotiation and, under the first prong of the definition of ancillary services, a person may provide due diligence services in connection with negotiation. These activities do not appear to include broader participation in transaction negotiation. Participation in transaction negotiation, therefore, does not appear to be within the excepted activities and may continue to subject a person to broker-dealer registration requirements.

Also, the no-action letters requiring substantive relationships prior to an issuer or broker providing deal specific information to avoid general solicitation or advertising presumably will apply for purposes of Section 5 of the Securities Act if there are sales to non-accredited investors, in spite of this provision. So the issuers using a third party platform or mechanism for a Rule 506 offering still could have Section 5 compliance issues if they sell to non-accredited investors.

Effect on Investment Advisers and Broker-Dealers

Although general advertising and general solicitation will be permitted in Rule 506 offerings if sales are made only to accredited investors, investment advisers must comply with the Advisers Act rules regulating advertising in connection with such advertising or solicitation to the extent applicable. Broker-dealers that are FINRA members and that are acting as placement agents or intermediaries that engage in general solicitation or advertising on behalf of private funds or private fund managers may be required to comply with FINRA/NASD rules concerning communications with the public and the new FINRA rules recently approved by the SEC that will replace the current rules.[5]

These new FINRA rules reduce the number of categories of communications to three: (1) "institutional communications"; (2) "retail communications"; and (3) "correspondence." The requirements for principal approval, filing and content standards apply differently to each category. Communications with "accredited investors," "qualified clients" and "qualified purchasers" do not necessarily fit within "institutional communications" because there is a $50 million asset test for institutions other than certain institutions specified in the new rules. Although these rules will not affect the JOBS Act's elimination of the prohibition on general solicitation and advertising for Rule 506 offerings purchased only by accredited investors, the new rules may affect the responsibilities of broker-dealers with respect to these communications. FINRA has not yet determined the effective date of its new rules.

Private fund advisers seeking to market their funds through general solicitation and broker-dealers participating in such offerings likely will need to amend their offering memoranda, subscription documents, placement agent agreements and policies and procedures to reflect these new requirements and practices.

Expected SEC Action

In view of the relaxation of the Securities Act requirements with respect to Rule 506 of Regulation D, as well as other deregulation in the JOBS Act, the SEC may put more emphasis on anti-fraud enforcement and broker-dealer regulation and enforcement, particularly on the requirements for broker-dealer registration. The SEC may put more emphasis on review of disclosure materials used by private funds, their advisers and by broker-dealers in marketing private fund securities, as well as

[5] New FINRA Rules 2210, which revises and consolidates Rules 2210 and 2211, and 2212-2215 and interpretive materials; Release No. 34-66681, March 29, 2012, SR – FINRA – 2011 – 035.

methods and manner of offerings. In addition, it is possible that the SEC will rely on FINRA to conduct examinations on offerings through broker-dealers. It is also possible that the SEC will conduct its own examinations with respect to private funds with registered advisers and exempt reporting advisers. It is worth noting that these advisers must now disclose in Form ADV Part 1 and in their Form Ds whether their placement agents are registered as broker-dealers, and the SEC may focus on investment advisers that use unregistered placement agents. In addition, the SEC and FINRA may scrutinize advertising by private fund advisers in order to determine whether the adviser and its placement agents are complying with broker-dealer registration requirements.

To view our previous Corporate Practice Group alert that addresses the entire JOBS Act, please click here.

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