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# Jobs Act

## JOBS Act: Proposed SEC Rules Would Dramatically Change Marketing Landscape for Hedge Funds

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When the JOBS Act (formally the Jumpstart Our Business Startups Act) was signed by President Obama in April, it directed that one of its most transformational provisions – the relaxation of decades-long limits on public offerings of unregistered securities – not go into effect until the Securities and Exchange Commission (SEC) set rules to implement the changes. Though the SEC was given 90 days, or until July 5, the agency did not act until almost two months after the deadline. As summer wound down, emotions surrounding the law flared, with a spate of increasingly strident public comment letters filed with the SEC. Some letters attacked the entire premise of the JOBS Act and urged all manner of burdensome add-ons, while others demanded that the SEC implement the Act without delay and with a minimum of new obligations.

The proposed rules emerged on August 29, with nods to both sides of the debate.

- On the one hand, the SEC proposal reflects only one of many changes called for by JOBS Act opponents, that being some increase – albeit apparently modest – in procedures to confirm investor qualifications. There is no increase in the accredited investor income or net worth thresholds; no ban on reliance on the rules by private funds or other issuers deemed unduly risky; no new "legending" or disclaimer requirements; no pre-filing rules; no Financial Industry Regulatory Authority (FINRA) review of advertising; and so on – all of which had been forcefully advocated.
- On the other hand, the rules will be subject to a further 30-day comment period, so the limits on public offerings survive for the moment and the debate will continue through another round. This is in contrast to widespread expectation into early August that the rules could have immediate effect.

### *Background*

When the JOBS Act was passed, it prompted news stories predicting splashy publicity campaigns advertising private funds. While industry reaction has been more muted, with many fund managers predicting only incremental changes in sales practices, the genesis of these stories is Title II of the Act. It reads in relevant part:

> Offers and sales [of securities] exempt under [Rule 506 of Regulation D] shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation . . . provided that all purchasers of the securities are accredited investors.

Prior to this revision, Regulation D – an expansive safe harbor exemption from the requirement to register securities offerings with the SEC – has always been predicated on the securities in question "not involving any general solicitation." Thus, in the space of a couple of dozen words, the JOBS Act effectively strikes an almost 80-year old requirement to conduct unregistered securities offerings only through private channels.

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It instead specifically provides for transactions to "not be deemed public offerings" under the securities laws even though the offering might use general advertising and apparently unlimited publicity – so long as (as discussed in detail below) "the issuer [of the securities] take[s] reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."

The JOBS Act contains another significant change for private funds. Title V amends Section 12(g)(1) of the Securities Exchange Act of 1934 (Securities Exchange Act) to lift the limit on the number of holders of a class of a private fund's equity securities from 499 to 1,999, thereby allowing funds to remain unregistered under the Securities Exchange Act while growing in size as they admit hundreds of new equity owners. This change benefits so-called "qualified purchaser" (or Section 3(c)(7)) funds that limit their ownership to a class of highly qualified investors. Funds relying on a separate "100-investor" (or Section 3(c)(1)) exclusion will still be subject to that 100-investor limit. Unlike Title II of the JOBS Act relating to public advertising by private issuers, Title V relating to the investor count is self-executing and already in effect.

### *The SEC Proposal*

Rule 506 is the provision of Regulation D under which nearly all U.S. hedge fund offerings are made. The SEC proposes a new paragraph (c) to Rule 506 that would establish an offering framework that will be the same as under existing Rule 506, except for the following key differences:

- General solicitation activity is permitted.
- All of the purchasers in the offering must be accredited investors. Historically, an issuer has had the option of allowing up to 35 non-accredited investor purchasers in a Rule 506 offering. That continues to be the case for Rule 506 offerings generally, but only persons that the issuer reasonably believes are accredited investors may buy in offerings made under proposed Rule 506(c).
- Reasonable steps must be taken by the issuer to verify that purchasers are accredited investors. This important new requirement is discussed in detail below.
- Check-the-box notice of Rule 506(c) offerings is required on Form D. Form D is used as notice to the SEC and state regulators of an offering of securities made under Regulation D. The form would be modified to require issuers to check a box identifying whether the offering includes general solicitation activity.

The JOBS Act directed the SEC to implement a corresponding change in Rule 144A, which governs the offer and sale of securities to large institutions known as qualified institutional buyers or QIBs. The SEC proposes to amend the Rule 144A exemption so that it would no longer require that *offers* be made solely to QIBs and instead would require only that *sales* be made solely to QIBs. This would have the effect of allowing general solicitation activity under Rule 144A offerings. The change is not conditioned on a new "reasonable steps taken to verify" requirement like that proposed for Rule 506.

### *Special Regulatory Considerations for Investment Funds*

#### *Investment Advisers Act*

Historically, many fund managers were not registered with the SEC as investment advisers and were subject to Investment Advisers Act of 1940 (Investment Advisers Act) rules that limited their ability to "hold themselves out" to the public

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as offering fund management or other advisory services. Following Dodd-Frank Act rule changes, most fund managers marketing funds in the United States today are either registered as investment advisers with the SEC or have filed notices to be treated as "exempt reporting advisers." Neither SEC registered advisers nor exempt reporting advisers are subject to Investment Advisers Act limitations on marketing their services, so need not be concerned that the Investment Advisers Act will be a source of restrictions on their ability to rely on new Rule 506(c). The Investment Advisers Act can, however, restrict the actual content of public statements. For example, registered advisers are subject to SEC staff positions on how to present track record information, and all advisers are subject to the Investment Advisers Act's general antifraud provisions.

### *Investment Company Act*

Hedge and other investment funds not registered with the SEC as investment companies typically rely on either of the Section 3(c)(1) or Section 3(c)(7) exclusions from having to register as an investment company pursuant to the Investment Company Act of 1940 (Investment Company Act) referred to above. In doing so, they are subject to a "no public offering" requirement under the Investment Company Act, which is in addition to limits on general solicitation under Regulation D. The SEC confirms in its rulemaking that funds that rely on new Rule 506(c) and engage in general solicitation activity can still rely on their Investment Company Act exemptions.

### *CFTC Rules*

A large number of investment funds implicate the jurisdiction of the Commodity Futures Trading Commission (CFTC) because they trade in futures or other markets overseen by that regulator. Managers of these funds rely on CFTC exemptions that may have their own "no public offering" requirements. Absent action by the CFTC to clarify its requirements, it appears that funds operated under at least some CFTC exemptions may not be able to take advantage of new Rule 506(c) and instead will have to forego general solicitation activity. Accordingly, many firms will need to review their approach on a fund-by-fund basis. Some may find themselves free to engage in general solicitation as to some funds while being constrained by CFTC no public offering rules as to others.

### *Regulation S*

Many funds carry on parallel U.S. and non-U.S. offerings, with the U.S. offering typically made pursuant to Regulation D and the non-U.S. offering typically made pursuant to Regulation S. Regulation S prohibits "directed selling efforts" in the United States, and there had been concern that this prohibition might conflict with the proposed ability to carry on U.S. general solicitation activities under revised Regulation D and Rule 144A. The proposal, however, confirms that unregistered U.S. offerings that satisfy the new Rule 506 or Rule 144A exemptions will not be "integrated" with non-U.S. offerings under Regulation S, so that activity under one regulation will not taint the ability to rely on the other. Assuming the proposed rules are adopted without changes and that the conditions to the proposed rules are otherwise satisfied, funds therefore should be able to conduct Rule 506 or Rule 144A offerings and generally solicit investors in the United States without concern that U.S. activity will limit their ability to also sell securities pursuant to Regulation S.

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### *Reasonable Steps to Verify Accredited Investor Status*

Faced with a direction from Congress to "determine" reasonable verification methods, and the reality that there can be no one-size-fits-all approach, the SEC was intentionally fuzzy in its guidance. The proposal simply states that the reasonableness of the steps an issuer takes to identify a purchaser's accredited investor status would be subject to "an objective determination, based on the particular facts and circumstances of the transaction."

The proposal also suggests a number of factors that may be relevant to whether an issuer's verification is "reasonable," including:

- Nature of the purchaser (e.g., fewer or different steps might be required to verify the status of a broker-dealer, investment company or similar institutional investor as opposed to a natural person).
- Information about the purchaser (e.g., if it is a matter of public record that the purchaser is a company executive or the purchaser works in a field where high compensation levels can be presumed, less verification might be necessary).
- Nature and terms of the offering, in particular the type of general solicitation used (e.g., a small, invitation-only event would allow for less verification of purchasers than those solicited through a social media campaign).
- Size of investment (e.g., a high minimum purchase requirement would allow for less verification than a lower requirement).
- Pre-screening (e.g., no additional verification may be required when a purchaser has been pre-screened for accredited investor qualification by a third party, so long as there is a reasonable basis to trust the third party's process).

The hedge fund industry relies for its core verification process on so-called "self-certification" by investors (who complete detailed investor questionnaires), and hence, this aspect of the rulemaking has been closely followed. The closest the SEC came to speaking to investor questionnaires was its statement that an issuer will not have taken reasonable steps to verify accredited investor status (absent other information) if the issuer only requires prospective purchasers to "check a box" or sign a form as to their status, at least after conducting solicitations through a website open to the general public or through a widely disseminated e-mail or social media solicitation. This can be read to question the ability of a fund to rely solely on self-certification by an investor about whom the fund or its manager or other agents has no other information – an infrequent circumstance for most firms.

Given typical fund terms, it is helpful that the SEC acknowledged that a high minimum investment is, in and of itself, an element to be considered in the verification process. To this point, the proposing release says:

> [Absent any red flags], if an issuer knows little about [a potential natural person purchaser], but the terms of the offering require a high minimum investment amount, then it may be reasonable for the issuer to take *no* (emphasis added) steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by the issuer or by a third party. . . .

No specific recordkeeping requirements were proposed. But the SEC said that "regardless of the particular steps taken, it would be important for issuers to retain adequate records that document" the verification process.

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Two final items of note:

- First, the concept of a "reasonable belief" continues to apply, so that the seller of securities under proposed Rule 506(c) need only have a reasonable belief that the purchaser is accredited. While the text of the proposed rule might be read to state an absolute requirement that all purchasers be accredited (with risk that even one inadvertent mistake in accreditation could spoil the offering), the SEC confirms that is not its intent.
- Second, the proposal also confirms that reliance on proposed Rule 506(c) would be optional. Rule 506 as it stands today, i.e., without any of the new changes, continues to be available, which could be a prompt for some issuers to opt out of the flexibility to publicly offer their securities. It is, however, reasonable to expect that the new Rule 506(c) requirements may inform verification practices more broadly, even under traditional (or "quiet") offerings.

### *The Political Debate*

The hedge fund community can breathe a sigh of relief that the SEC proposal sticks so closely to the relatively narrow script suggested by Congress. Given the vigor of the opposition, that outcome was not foregone. Yet JOBS Act opponents – who were especially exercised about extending the benefits of general solicitation to hedge funds – had an interesting task before them, that being to argue against a rule whose core thrust is directed by law and essentially non-negotiable. The opposition was thus left primarily with two tools: (1) calling for delay and (2) advocating various kinds of "friction" that would make the rules less attractive for many issuers.

With regard to delay, much of the heat in the debate was directed at the prospect of the SEC adopting an "interim final rule" with immediate effect, which would have allowed general solicitation activity to commence right away. This is in contrast to the default approach to rulemaking that requires a reasonable public notice period before a rule can take effect. JOBS Act opponents called for an extended notice period; studies before certain kinds of advertising would be permitted; and other types of "go slow" approaches.

With regard to friction, JOBS Act opponents called for a far-ranging approach to reconsider the regulation of private offerings in light of what some baldly characterized as a mistake by Congress in adopting the JOBS Act in the first place. Letters from consumer and labor organizations (including the Consumer Federation of America, AFSCME, the AFL-CIO and the Teamsters) from the Investment Company Institute, which is the main trade group for the mutual fund industry, and from various state regulators, offered every imaginable variation on limits to the general solicitation rule, notably including repeated suggestions that hedge funds and private equity funds not be allowed to rely on the rule at all. Their arguments apparently did not sway the SEC, though the agency did ask for comment as to whether certain issuers should be carved out of the final rule. Another outpouring of suggestions to block funds from engaging in general solicitation should be expected.

Meanwhile, several letters from members of Congress in support of the JOBS Act were also filed with the SEC. The tone of one of these – an open letter from the Chairman of one of the subcommittees of the House Committee on Oversight and Government Reform – spoke to the question of timing and was positively inflammatory, accusing SEC Chairman Mary Schapiro of "delaying tactics" motivated by her "ideological opposition" to the JOBS Act.

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### *What Next?*

Perhaps in response to the highly politicized environment, an SEC press release pointedly hints that the agency will move quickly through the remainder of the rulemaking process, saying that:

> The Commission will seek public comment on the proposed rules for 30 days. *Shortly thereafter*, the Commission will review the comments and determine whether to adopt the proposed rules. (Emphasis added.)

For now though, the proposal on the table remains just that, a proposal. No change in offering activity is permitted at this time. But the proposal is also fundamentally positive for the hedge fund community and represents a defeat for those who tried to block the rules or restrict the ability of hedge funds to take advantage of them.

That said, even if the rules are adopted as proposed, the tenor of the debate that preceded the proposal should not be forgotten. This rulemaking will only be the beginning of the regulatory equation as hedge funds expand their marketing activities, and there are other means for regulators – who will be subject to shifting pressures from multiple constituencies – to affect what comes next. SEC or FINRA staffers could use their day-to-day authority when examining registered advisers or broker-dealers to question individual marketing or compliance judgments. Even more worrying, both federal and state regulators have the ability to bring enforcement cases alleging improper marketing practices – potentially applying *de facto* different standards of review, one for public activity and one for traditional "quiet" offerings – that could stifle interest in the new flexibility.

Finally, aside from encouraging recordkeeping, the SEC is uncharacteristically silent in its proposal as to suggestions for compliance officers. But as a firm expands its website, opens up to the media and engages marketing and public relations firms, the SEC undoubtedly will expect firms to critically evaluate risks the organization is taking and respond with appropriate systems and internal checks and balances. With no pre-screening of persons viewing marketing materials, the SEC may expect a firm to judge the sophistication of its potential audience and calibrate accordingly. As more fund personnel speak to the press or in open seminars and conferences, the SEC may expect robust "gatekeeping" procedures that determine who at the firm gets what level of oversight when addressing the public. These as yet unarticulated regulatory expectations may even reach such ostensibly commercial questions as whether broader marketing activities require investment in a deeper or more experienced bench in the front-line departments (i.e., marketing, media relations and investor servicing) affected by the changes.

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