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Jobs Act

SEC JOBS Act Rulemaking Creates Opportunities and Potential Burdens for Hedge Funds Contemplating General Solicitation and Advertising

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When the JOBS Act (formally the Jumpstart Our Business Startups Act) was signed by President Obama last year, 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. After more than a year of delay, the agency's implementing rules are now here. But the SEC at the same time proposed a raft of controversial additions to the new rules, ensuring that the politically charged debate around the JOBS Act – in which consumer advocates and certain lobbies (such as that for the mutual fund industry) vigorously oppose the law and its opportunities for private funds while many business groups push for it – will continue. The awkward compromise offered by that two-step has nods to both sides of the debate.

On the one hand, the SEC rules reflect only one of many changes called for by JOBS Act opponents, that being some increase in procedures to confirm investor qualifications (this addition was expected, although the final guidance is more strongly worded than in the SEC's original proposal from a year ago). See "JOBS Act: Proposed SEC Rules Would Dramatically Change Marketing Landscape for Hedge Funds," The Hedge Fund Law Report, Vol. 5, No. 34 (Sep. 6, 2012). On the other hand, the SEC proposal now asks whether the agency should add a number of new requirements that will cheer the opposition. These include "legending" and disclaimer requirements; pre-filing rules for offering materials; expanded Form D requirements (Form D is the primary regulatory filing under Regulation D, the regulation that is being overhauled by the new rules); and the like. Lest there be any mistake that the SEC is flashing a yellow light, the release also says that the agency's examination staff will be charged with monitoring new offering activity in the private funds industry and that firms that expand their marketing profile should carefully consider their compliance infrastructure before doing so.

On the same day that the SEC adopted the JOBS Act rules, it also adopted new rules that foreclose reliance on Regulation D in the case of securities offerings involving felons and other "bad actors." The new bad actor rules, like the JOBS Act rules, were directed by Congress, although in another context (they implement a provision of the 2010 Dodd-Frank Act).

Both the new general solicitation and the bad actor rules go into effect 60 days after their publication in the Federal Register, so in mid-September. Comments to the SEC's accompanying proposal are due on the same timetable. This article describes the above-referenced JOBS Act rulemaking in more detail and highlights important implications for hedge fund managers.

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Background

When the JOBS Act was passed, it prompted news stories predicting splashy publicity campaigns advertising private funds. Industry reaction has been more muted, with many fund managers predicting only incremental changes in sales practices, such as the ability to be less tight-lipped with industry press; to be freer in what is posted about funds to public websites or databases; and to engage in more natural marketing with contacts made at venues like industry conferences.

However the particular changes in practice play out, their genesis will be Title II of the Act, which 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 sentence, the JOBS Act strikes an 80-year old requirement to conduct unregistered securities offerings only through private channels. It instead specifically provides for transactions to "not be deemed public offerings" under the federal 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 contained 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 remain 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, was self-executing and has been in effect since last year.

The SEC Rules

General Solicitation

Rule 506 is the provision of Regulation D under which nearly all U.S. hedge fund offerings are made. The SEC adopted a new paragraph (c) to Rule 506 that establishes an offering framework that is 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 new 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 a notice to the SEC and state regulators of an offering of securities made under Regulation D. The form will 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 will amend the Rule 144A exemption so that it no longer requires that offers be made solely to QIBs and instead requires only that sales be made solely to QIBs. This has 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 under new Rule 506(c).

Bad Actor Disqualification

The new bad actor (sometimes called bad boy) rules, which in many ways are similar to the bad actor rules under Regulation A and Rule 505 of Regulation D, disqualify a fund or other issuer of securities from reliance on Rule 506 in the event that a covered person associated with the issuer has been convicted of a felony, is subject to a federal court injunctive or restraining order for securities-related activity, a cease-and-desist order for violations of antifraud provisions of the securities laws or of Section 5 of the Securities Act, an administrative suspension or bar, or other disqualifying conduct. Covered persons include:

- Officers. "Executive officers" of the issuer and any compensated solicitor in the offering (non-executive officers who participate in the offering also are treated as covered persons).
- 20% Owners. Beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power.
- Fund Managers. When the issuer is a fund, its investment managers and their principals (who is a "principal" is left undefined).

The rules provide that disqualification applies only for covered persons whose conduct is subject to a final order or conviction, so that, for example, an arrest or allegation is not enough. There also is a phase-in provision under which disqualification applies only if the final order or conviction occurs after the September 2013 date of effectiveness of the current rule changes (although the conduct may have taken place before that). The rules do require disclosure of a pre-effectiveness triggering event.

Going forward, funds will need to be aware that criminal convictions, SEC injunctive relief, certain cease-and-desist orders and administrative suspensions or bars, or having executive officers or certain significant investors with these regulatory problems, will prevent reliance on Rule 506 of Regulation D unless the SEC staff grants a waiver. These collateral consequences are in addition to the disqualifications and disclosures that may be required pursuant to other securities law provisions. Avoiding bad actor disqualification for a fund thus will require keeping current lists of covered persons; providing for a mechanism to monitor for triggering events; and planning for how to remedy any issues that may arise.

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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 as offering fund management or other investment 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 and other laws 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. See "Advertising Rules for Private Funds: A Post-JOBS Act Primer," The Investment Lawyer, Vol. 19, No. 11 (Nov. 2012) and Vol. 19, No. 12 (Dec. 2012).

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 the definition of an investment company referred to above. In doing so, the funds are subject to a "no public offering" requirement under the Investment Company Act of 1940 (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 may rely on CFTC exemptions that have their own "no public offering" requirements. One such exemption – the so-called "de minimis" commodity pool operator registration exemption in CFTC Rule 4.13(a)(3) – raises particularly significant questions about a fund manager's ability to rely on that exemption while taking advantage of new Rule 506(c). Accordingly, absent action by the CFTC to clarify its requirements, 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 the CFTC's 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 ability to carry on U.S. general solicitation activities under revised Regulation D and Rule 144A. The SEC, 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 conditions to the rules are otherwise satisfied, funds therefore can 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.

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 open-ended in its proposed verification guidance from last year. The proposal simply stated 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 suggested 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 final rules adopted last week affirm that guidance, but also go further and, in setting a kind of safe harbor, list methods an issuer may use to verify accredited investor status that are deemed to be "reasonable." The list, which is non exhaustive, includes:

- Receipt of certain documentation of levels of income or net worth of a purchaser who is a natural person (such as tax returns, bank statements, and credit reports);
- Verification of accredited investor status from certain third parties, such as a registered broker dealer, a registered investment adviser, a licensed attorney, or a certified public accountant; or
- In a form of grandfathering, for existing investors in a Rule 506 offering by the issuer, simply the receipt of a certification from a purchaser who is a natural person that such investor is an accredited investor.

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The hedge fund industry presently 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 if the issuer only requires prospective purchasers to "check a box" or sign a form as to their status, at least "absent other information . . . indicating accredited investor status." This questions 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 helpful 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 said:

> [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 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. . . .

Close readers will see that the final rule release walks back a bit from that, though it still says:

> [T]he ability of a purchaser to satisfy a minimum investment amount that is sufficiently high such that only accredited investors could reasonably be expected to meet it, with a direct cash investment that is not financed by the issuer or any third party, could be taken into consideration in verifying accredited investor status.

The SEC does not offer a view on what a "sufficiently high investment amount" would be, but does note that it received suggestions to set that level for individual investors as low as $25,000 and as high as $1 million. Falling in the middle of the range, a prominent fund industry trade association had recommended to the SEC that the number be $500,000 for individuals and $2.5 million for entity investors (so, in each case, 50% of the requisite net worth requirement).

No specific recordkeeping requirements were adopted. But the SEC said that "it will be important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor."

Two final items of note:

- First, the concept of a "reasonable belief" continues to apply, so that the seller of securities under new Rule 506(c) need only have a reasonable belief that the purchaser is an accredited investor. While the text of the rule might be read to state an absolute requirement that all purchasers be accredited investors (with risk that even one inadvertent mistake in accreditation could spoil the offering), the SEC confirms that is not its intent.
- Second, the SEC also confirms that reliance on new Rule 506(c) will 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 Proposals

The SEC at the same time announced proposed amendments to Regulation D, Form D and Rule 156 (relating to investment company sales literature). The proposed rules would impose additional filing and disclosure requirements on issuers using general solicitation and advertising in Rule 506 offerings.

Specifically, the proposed rules would, in addition to the current requirements applicable to Rule 506 offerings generally, impose the following new requirements for issuers using general solicitation and advertising in a Rule 506 offering:

- Pre-filing of written offering materials with the SEC.
- Filing a so-called "Advance Form D" at least 15 calendar days prior to the first use of general solicitation (that will be in addition to the regularly required Form D filing, which is due after the first sale of the securities).
- Filing a closing Form D amendment within 30 calendar days after the termination of the offering.
- Expanding the content of Form D to include new information concerning the offering, including the types of general solicitation used; the methods used to verify the accredited investor status of purchasers; categories of investors; and other information about the fund and its investment advisers, promoters and other related persons.
- Providing for a one-year disqualification (or time-out) from reliance on Rule 506 in the case of Form D filing failures.
- Including certain legends in any written general solicitation materials (the types of legends suggested are already in wide use); and
- If a private fund's general solicitation materials include performance data, requiring additional disclosures for private funds, including a telephone number or a website where an investor may obtain current performance data (notably, while the SEC acknowledges that mutual fund-style standardized performance reporting is likely to be impracticable for private funds, the proposal still requests feedback on this option).

Under the proposed rules, an issuer would be subject to a one-year time-out from using Rule 506 for future offerings if it, or its predecessors or affiliates, has failed to comply within the past five years with the Form D filing requirements in connection with a securities offering under Rule 506. The proposed time-out would end one year after the issuer brings its Form D filing record into compliance. Helpfully, the proposed disqualification would not affect reliance on rule 506 for ongoing offerings at the time of the filing non-compliance. Disqualification would apply to future offerings only, and the proposals do provide for a cure period and a waiver process. (Certain permanent bars from reliance on Rule 506 also are proposed.)

It appears that this new penalty for non-compliance with Regulation D filing rules could, unlike most of the other provisions covered in the proposed rules, be applied to any Rule 506 offering, not just one that is made under new

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Rule 506(c). If so, it would be an example of the kind of regulatory creep that can occur as heightened requirements for new Rule 506(c) gradually extend, whether by fiat or market practice, to other private offerings.
The proposed rules also would amend Rule 156, which provides guidance on the types of information in sales literature of investment companies that could be misleading to investors. The proposal would explicitly extend the application of the guidance in Rule 156 to the sales literature of private funds, though the SEC also said that it believes private funds should be taking Rule 156 into account today. It is important to note that, while Rule 156 is quite detailed, it is a principles-based rule that – as it stands now – does not prohibit any particular statements or presentations.

No specific changes to the definition of an accredited investor are proposed, but the SEC does ask whether the net worth or income elements of the definition should be increased and/or whether other eligibility criteria (such as more subjective indicia of sophistication) should be considered. The SEC notes that Congress has specified that the current $1 million net worth level for individuals should remain in place at least until July 2014 and also that a study by the Government Accountability Office that will address the appropriateness of the current accredited investor definition is due out shortly.

Finally, the element of the proposed rules that has drawn the most immediate cries of concern is a broad new information collection initiative under which funds or other issuers relying on new Rule 506(c) would file with the SEC their offering memoranda or other written communications that constitute a general solicitation or advertising. This would be under a new temporary rule, Rule 510T, which is proposed to have a two-year term. The filings would not be accessible by the public but, until the rule's expiration after two years, would allow the SEC to scrutinize the terms and disclosures of private offerings and compile data. The SEC also invites voluntary filings of these materials even in advance of adopting the new rule and says that it intends to set up a mechanism for receipt of those voluntary submissions shortly. While the SEC signals strongly that it is seeking only to require filing of written materials, the agency requests feedback on whether it also should collect other material (e.g., telephonic, broadcast or oral solicitations). The SEC also omitted to discuss whether filers should use any particular process to maintain confidentiality of their filings from Freedom of information Act or similar requests; confidentiality is certain to be a point of concern as comments on this aspect of the SEC proposal begin to come in.

What Next?

The new general solicitation rules are important and far-reaching. But the SEC's companion proposal to last week's rule release does much to cloud the waters for firms that are considering changing their practices to take advantage of the new flexibility. JOBS Act critics have been vocal in their opposition and, for more than a year, loudly urged the SEC to add exactly the types of limits that now will be explored under the SEC proposal. It thus will be prudent to assume that at least some of the proposed requirements ultimately will be implemented, so that firms considering their options should expect that electing to participate in a general solicitation will mean, for example, filing offering materials with the SEC and being subject to new Form D rules in due course.

The SEC release also includes a cautionary message to compliance officers, saying that:

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> [I]nvestment advisers to private funds should carefully review [their marketing] policies and procedures . . . to determine whether they are reasonably designed to prevent the use of fraudulent or materially misleading private fund advertising and make appropriate amendments to those policies and procedures, particularly if the private funds intend to engage in general solicitation activity.

In this regard, 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 less pre-screening of persons receiving the firm's marketing materials, the SEC may expect a firm to reconsider 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. See "Benefits and Burdens to Hedge Fund Managers of Speaking to the Media (Part Two of Two)," The Hedge Fund Law Report, Vol. 5, No. 46 (Dec. 6, 2012).

Regulatory expectations even may 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. See "Sixth Annual Hedge Fund General Counsel Summit Highlights SEC Enforcement Priorities, Side Letters, Investment Allocations, Expense Allocations, Trade Errors, Record Retention, Fund Marketing, Secondaries, JOBS Act and STOCK Act (Part One of Two)," The Hedge Fund Law Report, Vol. 5, No. 39 (Oct. 11, 2012).

This rulemaking will be only the beginning of the regulatory road as hedge funds expand their marketing activities, and there are other, more subtle means for regulators to affect what comes next. SEC or Financial Industry Regulatory Authority (FINRA) staffers could use their day-to-day authority when examining registered advisers or broker-dealers to question individual marketing or compliance judgments. In this regard, FINRA has been relatively quiet in the course of the JOBS Act debates, but it is a rising overseer in Regulation D offerings (having recently added a requirement that certain Regulation D materials be filed with FINRA) and is likely to closely review the role that its members take in future Rule 506(c) offerings. 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. This too should be in the minds of a fund firm's leaders as they consider their much expanded options going forward.

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