The Jumpstart Our Business Startups (JOBS) Act: Implications on Hedge Fund Marketing

FOLEY HOAG LLP

© 2012 Foley Hoag LLP. All Rights Reserved.

Rule 506 Under the Securities Act of 1933 (Regulation D)

- Private placement exemption relied on by most private funds in connection with offering of shares/interests of the private fund.
- The exemption applies to sales, not involving a public offering, to purchasers that are "accredited investors." The Rule 506 exemption also permits up to 35 unaccredited investors, but such inclusion is subject to additional information reporting requirements that are impracticable for any private fund to comply with, which in practice eliminates any non-accredited investors from participating in private funds.
- The exemption also requires that neither the issuer (the private fund) nor anyone acting on its behalf, shall offer or sell the securities by means of any "general solicitation or general advertising."

© 2012 Foley Hoag LLP. All Rights Reserved.

Section 201 of the JOBS Act

(a) MODIFICATION OF RULES.—(1) Not later than 90 days after the date of the enactment of this Act, the Securities and Exchange Commission shall revise its rules issued in section 230.506 of title 17, Code of Federal Regulations, to provide that the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors. Such rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission. Section 230.506 of title 17, Code of Federal Regulations, as revised pursuant to this section, shall continue to be treated as a regulation issued under section 4(2) of the Securities Act of 1933 (15 U.S.C. 77d(2)).

(b) CONSISTENCY IN INTERPRETATION.—Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended:

- (1) by striking ‘‘The provisions of section 5’’ and inserting ‘‘(a) The provisions of section 5’’; and
- (2) by adding at the end the following: ‘‘(b) Offers and sales exempt under section 230.506 of title 17, Code of Federal Regulations (as revised pursuant to section 201 of the Jumpstart Our Business Startups Act) shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation.’’.

© 2012 Foley Hoag LLP. All Rights Reserved.

Investment Advisers Act Considerations

- Rule 206(4)-1 (applicable to registered advisers) specifies the manner in which an adviser may advertise its services (prohibition on testimonials, limits on use of past specific recommendations, need for adequate risk disclosures).
- Rule 204-2 (applicable to registered advisers), the recordkeeping rule, will require advisers to maintain adequate records of any solicitation and advertising materials.
- Rule 206(4)-8 (applicable to registered and unregistered advisers), provides the SEC a right to enforcement action in connection with any intentional or negligent deceptive statements or conduct by an adviser and will apply to statements made in advertisements for a private fund managed by the adviser.

© 2012 Foley Hoag LLP. All Rights Reserved.

Other Regulatory Considerations

- Investment Company Act of 1940:
  - Most private funds operate under either Section 3(c)(1) (accredited investor fund) or Section 3(c)(7) (qualified purchaser fund) of the Investment Company Act of 1940, which exclude such funds from the definition of "investment company." Both provisions require that a fund not make, or propose to make, a "public offering" of its securities. Based on the directive in the JOBS Act for the SEC to harmonize the changes to Rule 506 with other federal securities laws, it would appear that engaging in broader solicitation to the extent permitted by Rule 506, as amended by the SEC, should not be an issue with respect to these exemptions.
- Commodity Exchange Act:
  - Any manager of a fund that trades in futures, in options on commodity and futures and/or in swaps must either register, or have a valid exemption from registration, as a commodity trading advisor (CTA) and as commodity pool operator (CPO). The most commonly used exemption set forth in CFTC Rule 4.13(a)(3) (the so-called de minimus exemption) requires that interests in the fund are offered and sold "without marketing to the public." Although the harmonization mandate was placed on the SEC as noted above, no such mandate was provided by the JOBS Act with respect to the CFTC. As such it is unclear whether the CFTC will take action to permit a manager of a private fund that is engaging in general solicitation or advertising to continue to rely on the exemption.

© 2012 Foley Hoag LLP. All Rights Reserved.

Effect on Private Placements

- Enhanced ability to market: private fund managers may be able to access a much wider group of investors through general solicitation and advertising. This is particularly true as the current Advisers Act exemptions do not contain a prohibition on the exempt adviser holding itself out to the public as an investment adviser, as was the case under the prior private adviser exemption under 203(b)(3) of the Adviser Act. However, content of any general solicitation must be carefully considered to ensure compliance with Advisers Act restrictions. In addition, the prohibition on general solicitation or advertising remains in effect until the effectiveness of final rules issued by the SEC, so no changes in marketing efforts should be made prior to that time.

- Greater diligence may be required to prequalify investors: it is not yet clear whether the "reasonable steps to verify" that investors are accredited will involve a greater standard than the "reasonable belief" standard currently in effect, which are most commonly pursuant through means of investor representations in their subscription materials. While many commenters have lobbied for adhering to current market practice, various proposals for higher standards have been advanced by commenters, including verification of accredited status by an independent third party retained for such purpose (to whom investors will submit, on a confidential basis, proof of income, net worth and investment experience sufficient to permit such verification), use of background checks by issuers to verify accredited status and requiring subscription materials to be submitted by investors under penalty of perjury.

- As noted, all of the above will be subject to the form of final rules from the SEC, which are currently subject to substantial debate. The Investment Company Institute, lobbying on behalf of the mutual fund industry, has issued a comment letter to the SEC, pushing for private funds to be subject to advertising restrictions at least as stringent as those applicable to mutual funds (including very precise methodology for reporting performance and conducting valuations) as well as for raising the accredited investor net worth qualification standards. In turn, the Managed Funds Association and others in the hedge fund industry have argued that these additional measures are not warranted given that hedge funds are not a retail product and do not present the same investor protection concerns.

© 2012 Foley Hoag LLP. All Rights Reserved.

Timing of Amendments

- The statute charged the SEC with issuing final rules dealing with the amendments to Rule 506 by July 4, 2012, although it appears unlikely that anything will be issued prior to that deadline.

- The CFTC has stated informally that they are considering whether to implement changes to Rule 4.13(a)(3) to harmonize with Rule 506 as amended, but no time frame has been set for proposed rule amendments (if any are to be forthcoming).

© 2012 Foley Hoag LLP. All Rights Reserved.