The JOBS Act: Implications for Private Fund Advisers

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On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups ("JOBS") Act, which includes many regulatory changes aimed at relaxing hurdles to capital raising activities of start-up companies and other small businesses. Of particular importance to investment advisers to private investment funds is Title II of the Act—"Access to Capital for Job Creators"—which directs the Securities and Exchange Commission ("SEC") to amend, within 90 days of enactment of the JOBS Act, its rules under Regulation D under the Securities Act of 1933, in order to eliminate the prohibition against general solicitation or advertising in connection with private placements conducted under Rule 506 of Regulation D (the private placement exemption relied on by most private funds), provided that such offerings satisfy certain specified investor qualification requirements. As a result, many private investment funds may have significantly greater flexibility to market the fund to qualified investors.

A summary of the effects of the anticipated changes to Rule 506 and certain additional related considerations applicable to advisers to private funds are set forth below. Advisers managing private funds should note, however, that pending adoption of final rules by the SEC, private funds relying on Rule 506 remain prohibited from conducting any general solicitation or advertising.

I. Amendments to Rule 506

Currently Rule 506 provides an exemption from registration for an offering of securities to "accredited investors" (defined in Rule 501 of Regulation D) and up to 35 non-accredited investors (subject to substantial information requirements with respect to any unaccredited investors), provided that such offering shall not involve offering or selling such securities "by any form of general solicitation or general advertising." With respect to an investor accepted as an accredited investor, an offeror, including a private fund offering its interests to investors, must have a "reasonable belief" that its investors are accredited.

The amendments contemplated by the JOBS Act will remove the prohibition on general solicitation and general advertising, provided that purchasers of securities in such offering consist solely of accredited investors, and the offeror (fund) will be required to take "reasonable steps to verify" that such purchasers are accredited. Methods that will constitute such reasonable steps will be determined by the SEC, but will likely involve a higher standard of diligence than the current "reasonable belief" standard. In addition, the amendment to Rule 506 promulgated by the SEC may impose conditions or restrictions on the ability of a private issuer, including a private fund, to engage in general solicitation or advertising. Notwithstanding these qualifications, it is expected that marketing communications will be significantly less restricted than under the present Rule 506 regime.

II. Impact on Other Exemptions and Regulations

In addition to the private placement exemption for the offering of their securities, private funds and advisers to private funds are subject to additional regulations that will impact their ability to engage in general solicitation and advertising, including compliance with the Investment Company Act of 1940, the Investment Advisers Act of 1940 and, to the extent that a private fund trades in commodities and/or futures, the Commodity Exchange Act, as well as the rules and regulations promulgated under these statutes. A brief discussion of the effect of the JOBS Act on such regulations is set forth below.

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. Title II of the JOBS Act includes a provision which specifies that an offering under Rule 506, as amended as contemplated by the JOBS Act, will not be deemed to be a "public offering" for purposes of other federal securities laws by reason of engaging in general solicitation or advertising. As such, funds relying on Section 3(c)(1) or Section 3(c)(7) should be permitted to engage in solicitation and advertising to the extent permitted by the revised Rule 506 without jeopardizing their Investment Company Act exemption.

Commodity Exchange Act

Many advisers to private funds that trade in futures, options and other instruments subject to oversight by the Commodity Futures Trading Commission ("CFTC") currently rely on an exemption from registration with the CFTC as a Commodity Pool Operator ("CPO") by reason of the fund qualifying as an exempt pool within the meaning of Regulation 4.13(a)(3) and/or Regulation 4.13(a)(4) under the Commodity Exchange Act. In order to qualify for treatment as an exempt pool, each of these Regulations requires that interests in the fund are offered and sold "without marketing to the public." As a result, it would appear that engaging in general solicitation or advertising may result in the loss of the fund adviser's CPO exemption, thus requiring registration as a CPO (and as a Commodity Trading Adviser) or altering the fund's strategy with respect to CFTC regulated instruments.

Investment Advisers Act of 1940

In addition to the above, any adviser to a private fund that wishes to engage in general solicitation or advertising to the extent permitted by Rule 506 following the adoption of a final rule should note that any such communications will be subject to the anti-fraud provisions of the Investment Advisers Act of 1940 (applicable to both registered and unregistered advisers), and, with respect to advisers that are registered with the SEC, the provisions of Advisers Act Rule 204-2 (the recordkeeping rule) and Rule 206(4)-1 (the advertising rule). As such, advisers will need to exercise particular care and consult with counsel prior to publication of any such communications.

Foley Hoag will continue to monitor the status of the above referenced amendments to Rule 506 and will provide additional guidance as further information is available.

Note: Advisers relying on the Regulation 4.13(a)(4) exemption should further note that this exemption will be abolished in the coming year, and as such, unless they qualify for the de minimus exemption provided by Regulation 4.13(a)(3), registration as a CPO or a change in investment strategy will likely be required.

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