Congress Passes JOBS Act

Legislation Eases Regulations Governing Offerings of Private Funds

On March 27, 2012, Congress passed the Jumpstart Our Business Startups Act, H.R. 3606, as amended (the "JOBS Act"). President Obama is expected to sign the bill shortly. The JOBS Act, which combines six different bills, is intended to make it easier for small businesses to access capital. Of particular interest to the funds industry, the JOBS Act eases the regulatory framework for private offerings by (a) removing the prohibitions against general solicitation and general advertising for securities offerings exempt from registration under Rule 506 of Regulation D, so long as all purchasers of such securities are accredited investors, and (b) raising the equityholder threshold that triggers public reporting in Section 12(g) of the Securities and Exchange Act of 1934 (the "Exchange Act") from 500 persons to either (i) 2,000 persons in total or (ii) 500 persons who are not accredited investors.[1] Once signed into law and implemented by the Securities and Exchange Commission (the "SEC"), the JOBS Act is expected to substantially ease restrictions on advertising and other offering practices that have historically been imposed on private fund sponsors, including sponsors of private equity funds, hedge funds and funds of funds, conducting offerings in the United States.

Removal of General Solicitation Prohibition under Regulation D

The JOBS Act directs the SEC to revise Rule 506 of Regulation D, promulgated under Section 4(2) of the Securities Act of 1933. Under Rule 506, the obligation to register the offer and sale of securities does not apply to an issuer so long as sales are made to no more than 35 persons (excluding accredited investors) regardless of the dollar amount of the offering. Currently, among the general conditions an issuer must meet for any Regulation D offering, Rule 502(c) prohibits an issuer relying on a Rule 506 exemption from using any form of "general solicitation or general advertising" to market the securities. While the current rules do not specifically define "general solicitation" or "general advertising," Rule 502(c) states broadly that these may include, but are not limited to, "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising."

The JOBS Act would direct the SEC to remove the prohibition against general solicitation and general advertising as applied to offers and sales of securities made pursuant to Rule 506, so long as all purchasers of the securities are "accredited investors." The JOBS Act also directs the SEC to require an issuer relying on Rule 506 to take reasonable steps to verify that purchasers of the securities are in fact "accredited investors," and to establish by rule methods by which issuers may so verify investors' status. In addition, the JOBS Act would exempt persons from registration as brokers and dealers who would otherwise be subject to registration in connection with a Rule 506 offering solely because "(a) that person 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) that person or any person associated with that person co-invests in such securities; or (c) that person or any person associated with that person provides

[1] The JOBS Act also creates a new category of issuers with less than $1 billion in annual gross revenue called "emerging growth companies," removes certain restrictions on "crowdfunding" (i.e., raising capital from many small investors), and increases the threshold for offerings of securities exempt from registration under Regulation A from $5 million to $50 million.

ancillary services[2] with respect to such securities," provided that any such person is not subject to certain statutory qualifications, receives no compensation in respect of the purchase and sale of such securities, and does not possess customer funds or securities in connection with any such purchase or sale.

This loosening of restrictions under Rule 506 is also relevant to private funds relying on either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 for exemption from registration under that statute (which includes most private funds offered in the United States), because such exemptions prohibit funds from making a "public offering" of their securities. The JOBS Act provides that offerings pursuant to Rule 506 will not be deemed "public offerings" under the "federal securities laws" as a result of general advertising or general solicitation. Thus, the JOBS Act is ultimately expected to allow a private fund relying on a 3(c)(1) or 3(c)(7) exemption to engage in general solicitation and general advertising. It is possible, however, that SEC rulemaking and guidance in the wake of the JOBS Act will specifically address the application of this provision to the term "public offering" in Sections 3(c)(1) and 3(c)(7).

The practical impact of the changes to be effected by the JOBS Act, assuming no new rulemaking or other guidance to the contrary by the SEC, is that they will allow sponsors of private funds to, amongst other things, issue press releases, be interviewed by the media, communicate information about fund offerings on publicly available websites and social media, and place advertisements during the course of fundraising, provided that, for offerings made under Rule 506, sales are made only to accredited investors. Such sponsors will also be able to solicit capital from investors with whom they do not have a substantive pre-existing relationship.[3]

Increase in Equityholder Threshold for Public Reporting

In addition to eliminating the prohibitions on general advertising and general solicitation for funds exempt from public reporting, the JOBS Act also increases the equityholder threshold for companies required to register under the Exchange Act. Under the existing framework, a company (including a private fund) that has at least 500 shareholders of record and more than $10 million in assets is required to register under Section 12(g)(1)(A) of the Exchange Act. Once a company has registered under Section 12(g), all of the public company reporting requirements under the Exchange Act apply, including the need to file annual, quarterly, and current reports, proxy statements, and certain transaction reports.

The JOBS Act amends Section 12(g)(1)(A) of the Exchange Act to require that an issuer must register its securities with the SEC when it has total assets exceeding $10 million and a class of equity security that is held of record by either (i) 2,000 persons in total or (ii) 500 persons who are not accredited investors. Section 502 of the JOBS Act further amends Section 12(g)(5) to provide that the definition of "held of record" does not include securities held by persons who received such securities under employee compensation plans.

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[2] "Ancillary services" include "(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."

[3] It remains unclear how elimination of the general solicitation restriction at the federal level will affect the application of relevant state "blue sky" exemptions, notwithstanding the pre-emption of these laws as they relate to "covered securities" as a result of the National Securities Markets Improvement Act of 1996. In addition, the JOBS Act does not address, and SEC rulemaking may have to confront, general solicitations in situations in which an offshore offering made pursuant to Regulation S (which prohibits "directed selling efforts" into the United States) is conducted in conjunction with a Regulation D private offering into the United States.

Further, Section 504 of the JOBS Act directs the SEC to examine its authority to enforce Rule 12g5-1, which defines "held of record," to determine whether new tools are needed to enforce the rule's anti-evasion provisions, and to submit its recommendations to Congress within 120 days of the enactment of the JOBS Act.

This change is helpful to sponsors of private funds, and particularly sponsors of funds that target high net worth individuals (such as funds of funds), because it allows them to organize funds with up to 2,000 accredited investors.

Timing

The JOBS Act does not specifically address when its provisions are intended to be effective. To date, the sponsors of this legislation have not responded to requests for clarification on this point. Nevertheless, once the JOBS Act is enacted, the SEC must amend Rule 506 within 90 days. Based on our experience with SEC rulemaking in connection with the Dodd-Frank Act, it is possible that the SEC may propose new rules within 90 days but not adopt final rules until after this deadline.

For more information, contact your regular Ropes & Gray attorney.