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JOBS Act

Schulte, Cleary and MoFo Partners Discuss How the Final and Proposed JOBS Act Rules Will Impact Hedge Fund Managers and Their Funds

By Vincent Pitaro

On July 10, 2013, the SEC adopted and proposed various rules to implement the JOBS Act enacted last year. The adopted rules will (1) permit general solicitation and advertising for offerings made in reliance on Rule 506 under Regulation D and Rule 144A under the Securities Act of 1933 (Securities Act), and (2) disqualify certain "bad actors" from being able to offer securities in reliance on Rule 506. The SEC also proposed certain rule changes impacting Rule 506 offerings that would enhance Form D reporting; require legends on general solicitation and advertising materials; apply new anti-fraud rules to Rule 506 advertising materials; and require pre-filing of general solicitation and advertising materials with the SEC for a two-year period.

During a recent Practising Law Institute briefing entitled "JOBS Act: SEC's New Regime for Private Placements," expert panelists Paul N. Roth, a founding partner of Schulte Roth & Zabel LLP; Alan L. Beller and Nicolas Grabar, both partners at Cleary Gottlieb Steen & Hamilton LLP; and David M. Lynn, a partner at Morrison & Foerster LLP, explained the SEC rulemaking; dissected the differences between the adopted rules and the 2012 rule proposals; and considered the implications of the rule changes for hedge funds offering securities in reliance on Rule 506. This article summarizes the salient points raised by the expert panel during the briefing. See also "SEC JOBS Act Rulemaking Creates Opportunities and Potential Burdens for Hedge Funds Contemplating General Solicitation and Advertising," The Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013).

Lifting of General Solicitation and Advertising Ban

Rule 506(c)

Grabar explained that, prior to its amendment, the Rule 506 safe harbor permitted sales to an unlimited number of "accredited investors" and up to 35 non-accredited investor purchasers as long as the issuer satisfies enumerated conditions, including refraining from engaging in general solicitation and advertising. A newly-adopted rule, Rule 506(c), permits general solicitation and advertising in connection with private offerings of securities as long as (1) all buyers are accredited investors and (2) the seller takes "reasonable steps to verify" that all investors are accredited investors. The term "accredited investor," as defined in Rule 501 under Regulation D, includes individuals with a net worth greater than $1 million (excluding a primary residence) or income greater than $200,000 for the last two years (or $300,000 in combined income with a spouse); banks, insurance companies and registered investment companies; and certain entities with more than $5 million in assets. See "How Can Hedge Fund Managers Both Advertise and Accept Investments from Non-Accredited Employees, Friends and Family Members?," The Hedge Fund Law Report, Vol. 5, No. 24 (Jun. 14, 2012).

Grabar explained that firms could continue to rely on the longstanding Rule 506 safe harbor (and refrain from engaging in general solicitation and advertising without

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having to verify accredited investor status) because the adopting rule memorializes the old Rule 506 safe harbor in new Rule 506(b).

Verification of Accredited Investor Status

Grabar explained that the definition of accredited investor includes the categories of individuals and entities described in Rule 501, as well as persons the issuer "reasonably believes" to be in those categories. He explained that there has been no change to the "reasonable belief" standard. Therefore, funds relying on Rule 506(c) need only have a reasonable belief that all investors in the fund are accredited investors. However, as discussed below, Rule 506(c) requires a fund to take reasonable steps to verify accredited investor status. The fund must now check a box on Form D to indicate whether it is relying on Rule 506(c) or Rule 506(b).

Grabar indicated that the final rules are substantially similar to the rules that were proposed in the summer of 2012. The "most debated" element of the rule was the verification requirement: He stressed that, even if it turns out that all investors are in fact accredited investors, the offering will not be exempt if the fund did not take reasonable steps to verify accredited investor status. Grabar said the determination of what steps are reasonable is based on an objective, "principles-based" analysis of the particular facts and circumstances. For more on determining accredited investor status, see "How Can Hedge Fund Managers Wishing to Rely on the JOBS Act's Advertising Relief Enhance Their Accredited Investor Due Diligence Procedures?," The Hedge Fund Law Report, Vol. 6, No. 12 (Mar. 21, 2013).

He observed that the final rules contain one significant change from the proposed rule. The SEC added a safe harbor for verifying accredited investor status for natural persons: "There is a list of things you can do and be confident that you have met the requirements for the exemption." Such steps include the review of specified documentation with regard to the income and net worth tests and reasonable reliance on certain written third-party verifications of a prospective investor's accredited investor status. The panelists observed that the accredited investor verification process is much simpler with respect to corporate entities as opposed to individuals.

Impact of Lifting of General Solicitation and Advertising Ban

Roth expressed skepticism regarding whether new Rule 506(c) would have a substantial impact on hedge fund offerings because most hedge funds focus on raising capital from high net worth investors that typically do not have difficulties clearing the "accredited investor" threshold. Therefore, it is uncertain as to whether such funds would engage in general solicitation and advertising to attract new capital. Additionally, other securities laws relied upon by hedge fund managers and their funds typically cause a manager and its funds to focus on investor financial qualification thresholds far above the accredited investor threshold. For instance, under the Investment Advisers Act of 1940 (Advisers Act), managers seeking to charge investors performance fees must ensure that such investors are "qualified clients," defined as a person having a net worth of at least $2 million or assets under management with the adviser of more than $1 million). See "SEC Order Increasing the Dollar Threshold for 'Qualified Client' Status Further Chips Away at the Utility of the 3(c)(1) Fund Structure," The Hedge Fund Law Report, Vol. 4, No. 28 (Aug. 19, 2011). Moreover, funds relying on the exemption from registration under Section 3(c)(7) of the Investment Company Act of 1940 (Investment Company

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Act) must ensure that all beneficial owners are "qualified purchasers," which include individuals with $5 million in qualifying investments. Nonetheless, he stressed that funds will still need to adopt appropriate verification procedures to determine accredited investor status and maintain records to demonstrate that they followed those procedures.

Lynn explained that a primary goal of lifting of the general solicitation and advertising ban was to "open up capital raising." He is not sure that funds that have traditionally relied on Rule 506 will do anything differently, but believes that Rule 506(c) may offer comfort in the event that information is inadvertently released. Roth observed that one impact of Rule 506(c) is that managers will now be permitted to explain their fund offerings on the public portions of their websites and still rely on Regulation D and the traditional Section 3(c)(1) and 3(c)(7) exclusions from the definition of an investment company. Roth added that reliance on Rule 506(c) for new offerings will not affect sales prior to the rule's effective date. Also, since many funds are offered on a continuous basis, existing investors will be able to remain invested in a fund. However, if the fund decides to rely on Rule 506(c), existing investors will not be able to purchase new securities unless they are accredited investors.

Next, Roth explained that, despite the SEC's removal of the restriction on general solicitation, the issue remains whether CFTC rules would still restrict fund managers who are commodity pool operators (CPOs) from engaging in general solicitation and advertising. CPOs relying on the Rule 4.13(a)(3) *de minimis* exemption from registration and registered CPOs using the short form registration based on Rule 4.7 face uncertainty absent any further action taken by the CFTC or its staff, because the CFTC rules were based on the prior private placement rules and do not contemplate general solicitation. Specifically, Rule 4.13(a)(3) contains a general restriction on marketing to the public as one of the requirements to be able to rely on that exemption, and Rule 4.7 is only available if a fund is offered or sold solely to qualified eligible persons (QEPs). The definition of a QEP is more restrictive than that of an Accredited Investor.

The panelists also noted that amended Rule 506 would not affect other private offering exemptions, such as private placements under Section 4(a)(2) of the Securities Act. Finally, Beller added that the use of general solicitation and advertising in a Regulation D offering would not cause integration problems for simultaneous securities offerings conducted by foreign funds pursuant to Regulation S.

Rule 144A

Rule 144A has provided a safe harbor for the offer and resale of securities to large institutional investors known as "qualified institutional buyers (QIBs) that own and invest at least $100 million in the securities of unaffiliated issuers. The adopted rule change eliminates the requirement that securities be "offered" only to QIBs. Therefore, after the rule change, offerors can rely on the safe harbor as long as securities are sold only to QIBs. Grabar explained that the recently-adopted change to Rule 144A means that general solicitation and advertising will be permissible with respect to a Rule 144A offering as long as the securities are sold only to QIBs.

New Rule 506(d): "Bad Actor" Disqualification

The Dodd-Frank Act called for the SEC to issue rules to disqualify felons and other "bad actors" from participating in offerings relying on the Rule 506 safe harbor. Lynn explained

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that a broad array of players in an offering may be subject to disqualification, including (1) issuers, investment managers to issuers, promoters, paid solicitors and other such entities; (2) managing members, general partners, directors and executive officers of those entities and other officers actually participating in the offering; and (3) those with 20 percent or more of the voting power of the issuer. Lynn also outlined the "bad" events that would lead to disqualification: Such events include, among others, criminal convictions, court orders and injunctions regarding or arising out of securities offerings or fraudulent or deceptive conduct; orders barring a person from the securities industry; suspensions and expulsions from national securities exchanges; and SEC cease and desist orders.

Lynn noted that the Dodd-Frank Act called for the SEC to adopt bad actor provisions in a number of other areas, such as crowdfunding, but for now, the rule covers only Rule 506 offerings.

Lynn explained that that the look-back period with respect to "bad acts" under Rule 506(d) is generally five to ten years before the date of the Rule 506 offering, depending on the particular bad act. The Rule includes a mechanism to seek a waiver of disqualification from the SEC. Finally, the Rule has a "reasonable care" exemption for people who did not have reason to know about a disqualifying event. For the exemption to be available, a fund will need to have conducted a factual inquiry to see if there were any disqualifying events. Lynn said that this exemption will result in an enormous amount of additional work for funds, which will need to use questionnaires to solicit this type of information from all participants in an offering.

The panelists explained that adopted Rule 506(d) differed from the proposed rule in several significant ways:

- It is limited to executive officers and other officers participating in an offering; it does not automatically cover all officers.
- The voting control trigger was increased to 20 percent from 10 percent.
- The final rule covers SEC cease and desist orders. This means that the availability or offer of a waiver may affect the dynamics of settlement discussions with the SEC. Roth observed that, if a fund is engaged in cease and desist settlement negotiations with the SEC, there now must be discussions about what the fund must offer to the SEC to avoid any Rule 506 disqualification. He also explained that the rule also raises the issue of whether a bad actor in one fund will represent a taint for an affiliated fund.
- Rule 506(c) is not retroactive. Therefore, it only covers disqualifying events that occur after the effective date of the Rule. Beller and Roth concurred that that was the most significant change from the proposed rule.

Lynn noted that that the adopted changes to Rule 506 would take effect 60 days after publication in the Federal Register. Consequently, they are expected to become effective as of September 23, 2013.

Proposed Rules

Proposed Rule 503: Form D

Rule 503 presently requires issuers to file notice of an exempt offering on Form D within 15 days after the first sale of securities. The panelists observed that compliance with this rule has been "spotty" and is often observed "in the breach." The proposed amendment to this Rule would impose additional filing requirements. As discussed below, other proposed rule changes are designed to encourage compliance with Rule 503.

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Grabar explained that, if the proposed Rule changes are adopted, a fund would need to file an initial Form D at least 15 days *before* any general solicitation and advertising (Advance Form D) with respect to a Rule 506(c) offering. Because the SEC does not define general solicitation and advertising, confusion may arise as to when the issuer triggers the filing obligation. A fund would still be required to Form D within 15 days after the first sale of securities. He said it is not clear whether the second filing would have to be an amendment to the Advance Form D or a stand-alone filing. Finally, a "Closing Form D" would be required to report what the fund actually did no later than 30 calendar days after termination or abandonment of the offering. The Closing Form D would be required for any Regulation D offering , not only Rule 506(c) offerings.

Grabar also discussed the additional disclosures that the SEC is proposing to require on Form D: For any Rule 506 offering, a fund would have to report the total number of purchasers who qualified as accredited investors and the basis for their qualification. There would also be several new requirements specific to Rule 506(c) offerings. Grabar highlighted the three that he considered most important, including the need to:

- identify each person who "controls" the issuer;
- report each type of solicitation or advertisement used by the issuer; and
- report each method used to verify accredited investor status.

With respect to Advance Form D filings, Roth expressed concern that the principal reason funds would use Rule 506(c) would be if they were fearful of having already inadvertently engaged in general solicitation and advertising and still wanted to qualify for a safe harbor. The problem is that in the event of inadvertent general solicitation and advertising, it would already be too late to make an Advance Form D filing because the general solicitation and advertising activity will have already occurred.

Proposed Rule 507(b): Disqualification for Form D Non-Compliance

Lynn observed that the SEC intends to monitor Form D filings to collect data on Rule 506 offerings. As a result, the SEC wants to ensure that relying issuers file their Form D filings in compliance with Regulation D. Presently Rule 507 disqualifies an issuer from relying on Rules 504, 505 and 506 of Regulation D only if the issuer has been enjoined from violating Rule 503. The proposed new paragraph (b) of Rule 507 would prevent the use of Rule 506 prospectively if a fund has not complied fully with Rule 503 in connection with a prior Rule 506(b) or (c) offering. Issuers would be given one-time relief from the disqualification as long as they cure the violation within 30 days of discovery. Rule 507(b) would apply to any failure to file within the last five years. However, the Rule would not look back prior to the Rule's effective date. In the event of a disqualification, an issuer could use Rule 506 again one year after correcting prior failures to file. According to Lynn, the proposed rule would also have a mechanism for seeking a waiver of disqualification. As an example, he explained that if a change of control of a fund occurred after a failure to file, the new controlling persons could argue that it would not be fair to subject the new owners, who were not responsible for the failure, to disqualification.

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Proposed Rule 509: Legends

Lynn pointed out that, under proposed Rule 509, a legend would be required on all "written communication" that constitutes general solicitation and advertising in relation to Rule 506(c) offerings. The proposed rule contemplates a "prominent" legend disclosing that (1) the securities are to be sold only to accredited investors, and specifying accredited investor requirements for natural persons; (2) the securities are offered in reliance on an exemption from registration and without the disclosures required in a public offering; (3) the SEC has not passed on the merits of the offering or offering materials; (4) resales of the securities are restricted; and (5) securities investments involve risk. Private funds would have to add that the offering was not subject to the protections of the Investment Company Act and disclose certain limitations on the usefulness of any performance data that is disseminated. On presentation of performance data generally, see "A Step-By-Step Guide to GIPS Compliance for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2011). Lynn noted that the proposed rule does not address how such extensive disclosures could be made in relation to social media, such as Twitter. See "How Can Fund Managers Address the Regulatory, Compliance, Privacy and Ethics Issues Raised by Social Media," The Hedge Fund Law Report, Vol. 5, No. 44 (Nov. 21, 2012). Roth stated that it is not yet clear how frequently the legend would have to be included. He also added that there is no definition of "written communication" that would constitute general solicitation and advertising.

Lynn explained that the rule would disqualify an issuer from relying on Rule 506 if the issuer were subject to an injunction for failing to comply with new Rule 509. He considers this to be a more restrained approach by the SEC because disqualification would be limited to cases where there has been an actual enforcement action.

Proposed Rule 156: Extending Antifraud Provisions to Private Fund Sales Literature

Rule 156 provides guidance as to when an investment company's sales literature is materially misleading. Roth explained that the proposed change would extend the guidance found in Rule 156 to private fund sales literature. He noted that the SEC and consumer advocacy groups fear investor confusion about the distinctions between private funds and registered funds. However, Roth pointed out that there is already significant regulation of hedge fund performance advertising. See "SEC Charges Hedge Fund Manager and Its Founder with Securities and Investment Adviser Fraud Based on 'Cherry Picking' of Trades," The Hedge Fund Law Report, Vol. 6, No. 1 (Jan. 3, 2013).

Pursuant to existing Advisers Act Rule 206(4)-1, it is already a deceptive act to present performance data without full disclosure and there are letter rulings that provide guidance on what constitutes misleading performance data. In light of that history, Roth is particularly concerned about the proposed rule change and the wisdom of "imposing a retail structure on a wholesale market." Beller added that Rule 156 refers to "sales literature," which could include oral statements. Consequently, he expressed concern that the proposed rule could cover in-person marketing communications involving a private fund. He also noted that Rule 156 constitutes, by its terms, interpretive guidance with respect to the antifraud provisions of the Securities Act and the Securities Exchange Act of 1934 (Exchange Act). Consequently, a Rule 156 violation could provide ammunition for private rights of action under Section 10(b)

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of the Exchange Act and Rule 10b-5 thereunder. Roth added that the guidance under this proposed Rule is not entirely consistent with the guidance found in Advisers Act Rule 206(4)-1.

Proposed Rule 510T: Filing Solicitation Materials

Beller noted that, pursuant to this proposed Rule, for two years after the effective date, an issuer would be required to submit all Rule 506(c) general solicitation and advertising materials to the SEC.

Closing Observations

According to Beller, the "major consequence" of the relaxation of the general solicitation and advertising rules will be to give comfort with respect to "inadvertent foot faults" in a private offering. However, he thinks that if that comes with all the extra baggage of the proposed rules, it may not have the desired effect. Beller observed that the proposed rules are a response to a "speculative concern" about what might happen following relaxation of the general solicitation and advertising rules. Given the poor history of Form D compliance, he agreed with Lynn that the SEC is trying to encourage compliance with Form D filing. Beller also noted that the SEC would not be surprised if it received a great deal of comments on the proposed rules. Grabar noted that the SEC also has a "506(c) workplan" under which all SEC divisions are working together to evaluate the impact of the relaxation of the ban on general solicitation and advertising.

Beller added that the proposing release also seeks comment on whether the definition of accredited investor should be changed. That definition has not been changed since 1982, except that the Dodd-Frank Act recently removed the value of an investor's primary residence from the calculation of an individual's net worth. See "Implications for Hedge Fund Managers of the Rule Amendments Recently Adopted by the SEC to Raise Accredited Investor Standards," The Hedge Fund Law Report, Vol. 5, No. 1 (Jan. 5, 2012).

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