The JOBS Act: Important Questions For Private Funds

Law360, New York (March 07, 2013, 11:00 AM ET) -- On Aug. 29, 2012, the U.S. Securities and Exchange proposed amendments to Rule 506 of Regulation D of the Securities Act of 1933 (Securities Act) that would eliminate its long-standing ban on general solicitation and general advertising for certain securities offerings. The proposal, which implements certain components of the Jumpstart Our Business Startups Act (JOBS Act), would require (1) all purchasers of securities sold in such offerings to be accredited investors and (2) that issuers take reasonable steps to verify that their purchasers are accredited investors.

The proposed amendments remain subject to further change prior to being finalized. In comment letters regarding JOBS Act rulemaking submitted in May and October 2012, the Investment Company Institute (ICI) recommended, among other things, that the SEC investigate the feasibility of crafting a rule similar to Rule 482 under the Securities Act for private fund advertisements. Rule 482 governs any registered fund advertisement containing performance advertising. It prescribes specific calculation methodologies for current yield, tax-equivalent yield, average annual total return and after-tax return, as well as requirements for the disclosures that must accompany performance data.

In late 2012, an SEC representative, speaking unofficially, indicated that the staff was seeking industry input on the ICI's recommendation, but that it was plausible to expect that certain standardized requirements for private fund performance advertising in the context of general solicitations will be established at the time the final Rule 506 amendments take effect.

The SEC representative also confirmed that such standardized performance requirements would not apply to the content of materials presented in one-on-one meetings, whether a fund relies on the old or new provisions of Regulation D (Rule 506 (b) and Rule 506(c), respectively). The scope and character of the standardized requirements remain unknown at this time, although the ICI is continuing to press for requirements that are similar to those of registered fund advertisements.

Regardless of the nature of the standardized requirements, private fund advertisements will remain subject to the Investment Advisers Act of 1940 (Advisers Act), specifically the anti-fraud provisions set forth in Section 206 and the rules promulgated thereunder. It should be noted that the definition of advertisement under the Advisers Act includes information communicated "by radio or television." Advisers that avail themselves of the opportunity to conduct radio or television interviews in connection with a general solicitation should be careful to ensure that such communications do not run afoul of the existing advertising rules or the new standardized requirements.

Important Questions

It is expected that a number of private funds will want to make prophylactic 506(c)

filings to give themselves the flexibility to speak to the media and engage in other related activities. However, many unresolved questions remain surrounding 506(c) general solicitations by private funds, including:

- Will a 506(c) election by an issuer that previously relied on 506(b) require the issuer to perform due diligence regarding the accredited investor status of its pre-existing investors? The SEC has not yet provided guidance on this question. In the event that the SEC requires due diligence, we expect that many private funds will break their existing offerings under 506(b) and, after a certain period of time has elapsed, commence new offerings under 506(c).

- Will an adviser be permitted to make separate concurrent offerings of similar products under 506(b) and 506(c)? Logically, two issuers should not be integrated, but the matter is not free from doubt.

- Will the CFTC harmonize its existing prohibition on advertising by certain commodity pools, including exempt commodity pools under CFTC Rule 4.13(a)(3)? Given the expansion of the commodity pool definition to include entities using swaps and the removal of the primary exemptions historically used by hedge funds and private equity funds, CFTC regulations present significant open issues. Since the JOBS Act does not mention private funds in its text or the legislative history, the CFTC could conclude that commodity pool rules do not need to be addressed, although this extreme outcome seems unlikely. However, the pace is slow, and the impediment is real.

- How will issuers resolve the "world sky" requirements related to prohibitions on public offerings that exist in virtually all non-U.S. jurisdictions? Such prohibitions will need to be analyzed on a country-by-country basis to ensure that a U.S. general solicitation does not taint the offshore offering.

- How will the states respond? Several states also have raised concerns regarding general solicitations. Given the federal override in Section 18 of the Securities Act regarding Regulation D offerings, such concerns may seem moot. However, in view of the recent activity of the states to prosecute fraud, great care needs to be taken with respect to the content of advertisements to avoid state law issues in addition to Section 206 anti-fraud requirements.

- How will private funds verify accredited investor status? The SEC has stated that it is a facts-and-circumstances determination, and standards are evolving. We anticipate that every adviser will ask each new investor to affirm that its subscription was funded without the use of financing.

Responses to these questions will emerge over the next year or two. We expect that standard practices will be established in due course for private fund offerings in the context of general solicitations.

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