

Investment Services Bulletin

JOBS Act to Eliminate Prohibition against General Solicitation for Private Funds and Increase Investor Limit That Requires Exchange Act Registration

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (JOBS Act), which had been passed by the US Senate on March 22, 2012 and the US House of Representatives on March 27, 2012. The JOBS Act is intended to encourage the funding of domestic businesses by easing various securities laws.

The JOBS Act will fundamentally change the offer and sale of securities of private funds, including those of hedge funds, private equity funds and venture capital funds. Most notably, it removes the prohibition on general solicitation and advertisement by issuers that rely on Rule 506 of Regulation D under the Securities Act of 1933,¹ which is the most frequently used exemption for hedge funds, private equity funds and venture capital funds. It also increases from 499 to 1,999 the threshold number of investors that an issuer may not exceed before it is considered a reporting company under Section 12(g) of the Securities Exchange Act of 1934 (the Exchange Act).

Elimination of General-Solicitation and Advertising Ban for Rule 506 Offerings

The JOBS Act requires the Securities and Exchange Commission (SEC) to adopt amendments to Rule 506 so that the prohibitions against general solicitation or general advertising set forth in Rule 502(c) of Regulation D will not apply to the offer and sale of securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors.

Private funds will also be required to take “reasonable steps” to verify that each purchaser is an accredited investor.

The JOBS Act appears to provide that funds engaging in general solicitation or advertising under the modified Rule 506 will not be deemed to be making a public offering under the federal securities laws. Accordingly, private funds relying on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the 1940 Act) should be able to engage in general solicitation or advertising without violating the provisions contained in those sections regulating “public offerings” of securities.

The SEC has 90 days from enactment of the JOBS Act to adopt amendments to Rule 506; such amendments may include additional requirements or guidance on what will be permissible.

Increase in Exchange Act Reporting Threshold

The JOBS Act increases from 500 to 2,000 the number of shareholders of record a company may have before being required to register its securities with the SEC under the Exchange Act, provided that not more than 499 holders are nonaccredited investors.² The total asset threshold for registration has also been raised to \$10 million. Before the enactment of the JOBS Act, if an issuer had total assets of more than \$1 million and any class of its equity securities had 500 or more record holders, the issuer had to register that class of equity securities under the Exchange Act.

¹ Rule 506 permits an offering to an unlimited number of investors without a limitation on the size of the offering, provided that no more than 35 of the purchasers are not accredited investors, as defined under Rule 502. Congress did not propose to eliminate the general-solicitation ban for Rule 504 or Rule 505 offerings.

² Certain employees receiving issuer securities under equity compensation plans and under certain provisions in the JOBS Act will not count toward the new threshold.

Impact on Private Funds

While it is premature to determine the impact the JOBS Act will have on private fund offerings without the required SEC rulemaking, private funds likely will be permitted to engage in some form of the following:

- Print, broadcast, Internet or social media advertisements
- Soliciting investors through websites
- Hosting investment seminars

The scope of any additional SEC requirements beyond “reasonable steps” to verify accredited-investor status will determine whether the modified Rule 506 will truly revolutionize the offering of private funds.

The increase in the Exchange Act reporting threshold will benefit private funds that rely on the exclusion in Section 3(c)(7) of the 1940 Act by enabling them to have up to 1,999 investors (the previous limit was 499). In addition, the change may increase the likelihood that securities of private funds will trade on platforms for secondary-market transactions. The increased threshold does not benefit funds that rely on Section 3(c)(1) of the 1940 Act, which are limited to 100 investors.

Private funds that are exempt commodity pools under Commodity Futures Trading Commission (CFTC) Regulation 4.13(a) should note that the CFTC regulations limit the offering or sale of interests to the public in the United States, and it appears that the JOBS Act has not amended that provision. In addition, under the Commodity Exchange Act and the rules thereunder, a commodity pool will need to consider the disclosure document delivery requirements to the extent a commodity pool that was offered privately is now offered publicly for purposes of CFTC regulations.

The JOBS Act includes certain other provisions, including changes to regulation for emerging growth companies, an increase in Regulation A offerings, a crowdfunding provision for raising capital for nonaccredited investors, and a broker-dealer exemption for funding portals. Please see other Vedder Price client updates for more information on these provisions.

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