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PAUL HASTINGS

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The JOBS Act Loosens Private Fund Marketing Restrictions

BY THE INVESTMENT MANAGEMENT PRACTICE

This week, President Obama is expected to sign into law the Jumpstart Our Business Startups Act (the "JOBS Act"), which combines several bills that were introduced last year with the aim of reducing the costs of going public for private companies and facilitating increased capital formation. While the JOBS Act focuses primarily on easing restrictions for small companies seeking to raise capital and go public, it also modifies certain rules that affect private funds and their managers, primarily by loosening the marketing restrictions of Regulation D under the Securities Act of 1933, as amended (the "Securities Act").

Changes to Regulation D Private Placement Safe Harbor

The JOBS Act amends the Securities Act to provide that offers and sales exempt from registration under Rule 506 of Regulation D shall not be considered public offerings even if general solicitation and general advertising are used to conduct the offerings[1]. Rule 506 is a safe harbor exemption from Securities Act registration for non-public or private offerings of securities primarily to persons who are "accredited investors" under the Securities Act[2], and is commonly relied upon by private funds to raise capital. In addition, funds that offer and sell their interests pursuant to Rule 506 satisfy one of the conditions necessary for them to qualify for an exclusion from the definition of "investment company" under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), which in turn enables the funds to avoid registering as investment companies with the Securities and Exchange Commission ("SEC")[3].

The Regulation D prohibition against general advertising/solicitation restricts issuers relying on Rule 506 from utilizing any kind of article, advertisement, seminar, meeting or notice (whether in a newspaper, magazine, periodical, radio, television or online) to promote their offering, unless certain conditions are met[4]. This prohibition has meant that private funds have been prohibited from advertizing in any public way while engaged in a current offering of their interests. With the revocation of the general advertising/solicitation restrictions, private fund advisers may now conduct public advertising campaigns for their funds by taking out advertisements, discussing funds in media interviews, and sponsoring seminars and other broad-based capital raising meetings. The ability to advertise may prove of particular benefit to new and/or small funds that lack name recognition by allowing such funds to target a broader audience of prospective investors and potentially attract interest in otherwise inaccessible markets. Private fund advisers should keep in mind, however, that any such advertisements or solicitations will still be subject to the anti-fraud provisions of the Investment Advisers Act of 1940 and rules promulgated thereunder, which include prohibitions against the use of testimonials, past specific recommendations and restrictions on the presentation of performance data in connection with the offer and sale of private fund securities and the investment

activities of private funds. In addition, the antifraud provisions of Section 10(b)/Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), would apply to the offer and sale of private fund securities and the funds' investment activities relating to the purchase of sale of securities. The congressional mandate is clear, and it would be very difficult for the SEC to interpret the requirement to eliminate the Rule 506 marketing restrictions narrowly without legal challenge. The SEC does, however, retain broad anti-fraud authority under Section 206 of the Investment Advisers Act. The SEC could exercise this authority by issuing new rules that, in effect, make certain types of private fund general solicitation and advertising fraudulent or misleading, thereby diminishing the scope of permitted marketing by private funds and their managers.

The JOBS Act requires that the SEC amend Regulation D within 90 days of enactment to remove the prohibition against general advertising and general solicitation.[5]

Adjustment to Record Investor Caps

Currently, under Section 12(g) of the Exchange Act, private funds domiciled in the United States must ensure that they do not have 500 or more investors of record as of the end of any fiscal year or else they become subject to certain public company reporting requirements. Under the JOBS Act, this threshold would be raised from 500 to 2000 record investors. This change should benefit larger funds that rely on the Section 3(c)(7) Investment Company Act exclusion noted above (funds relying on the 3(c)(1) exclusion are, of course, limited to 100 investors). Advisers to offshore private funds should note that the JOBS Act made no change to the rules under the Exchange Act regarding foreign issuers under Section 12(g), which currently impose public company reporting requirements on foreign domiciled funds with 300 or more U.S. resident investors as of the end of any fiscal year. It is possible, however, that the SEC may revise such rules in response to the change in threshold for U.S. domiciled entities described above.

Private fund advisers should review their fund documents, including subscription documents, to ensure that they are consistent with the changes effected by the JOBS Act.

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[1] Private fund advisers should note that the changes to the general advertising/solicitation requirements do not affect the "accredited investor" requirements of Rule 506.

[2] Rule 506 also allows a limited number of non-accredited investors, although this provision is rarely utilized in the private fund space.

[3] While the JOBS Act does not specifically amend the Investment Company Act, new Section 4(b) of the Securities Act provides that offers and sales under Rule 506 of Regulation D shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation, which suggests that the treatment of Rule 506 compliant offerings as public offerings for purposes of the Sections 3(c)(1) and 3(c)(7) exclusions would be contrary to the plain meaning of the statute. See, *e.g.*, STARS & STRIPES GNMA Funding Corp., SEC Staff No-Action Letter (December 19, 1985). The views expressed in this client alert are predicated on our belief that the SEC is likely to continue to interpret the non-public offering element of the Sections 3(c)(1) and 3(c)(7) exclusions in a manner that is similar to the interpretation of the non-public offering exemption for purposes of Rule 506 of Regulation D. Our belief is based on the fact that the JOBS Act will not change the 'non-public offering' provision of Sections 3(c)(1) and 3(c)(7) and that there do not appear to be any good policy reasons to require that this provision be interpreted differently from the interpretation of this provision for purposes of Rule 506. As we note below, however, the SEC or its staff could take a contrary view, and could issue a change of position that is at odds with the new flexible marketing requirements of Rule 506 once it is amended to comply with the mandate of the JOBS Act.

[4] Generally, a private fund or its agent is required to have a substantive, pre-existing relationship with a prospective investor before an offer to invest in the fund may be made to this investor. This applies particularly for prospective investors that are individuals or small institutions.

[5] The JOBS Act also directs the SEC to remove similar restrictions with respect to Rule 144A offerings.