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Legal Risk Management Tip
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LIFT ON GENERAL SOLICITATION RESTRICTIONS FOR CERTAIN PRIVATE FUNDS

As discussed in last April's Legal Tip, the Jumpstart Our Business Startups Act ("JOBS Act"), signed into law on April 5, 2012, is legislation designed to reduce the costs of going public and to facilitate increased capital formation. While the JOBS Act focuses primarily on easing restrictions for small companies seeking to raise capital, it also modifies various rules affecting private funds and their managers, primarily by lifting the advertising and marketing restrictions of Regulation D under the Securities Act of 1933, as amended (the "Securities Act").

General Solicitation and Advertising

In general, issuers of securities in the U.S. may not make an offering of securities without filing a registration statement under the Securities Act, unless there is an applicable exemption[1]. Managers of private funds, in selling the funds' securities to raise capital, commonly rely on the exemption from registration provided by Rule 506 of Regulation D promulgated under the Securities Act, which allows for the offering of securities primarily to "accredited investors"[2] so long as such offering is not accomplished through general solicitation or advertising. This prohibition against general solicitation and advertising restricts fund managers from utilizing articles, advertisements, seminars, meetings or notices (whether in a newspaper, periodical, magazine, television, radio, Internet or social media) to promote their offering. It also generally means that the fund manager must have a "pre-existing relationship" with each potential investor in the new fund before offering a fund interest to such potential investor.

Changes to Rule 506 under Regulation D

The JOBS Act requires the Securities and Exchange Commission ("SEC") to adopt amendments to Rule 506 so that the prohibitions against general solicitation and advertising will not apply to the offer and sale of securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the fund manager has taken reasonable steps to verify that all purchasers are accredited investors.[3]

The JOBS Act also appears to provide that under the new amendments to Rule 506, funds engaging in general solicitation or advertising will not be deemed to be making a public offering under the federal securities laws, subject certain factors. 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

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[1] 15 U.S.C. §77e; *See* also 15 U.S.C. §77c-d.
[2] Rule 506 also allows a limited number of non-accredited investors, although this provision is seldom used by private funds (due in large part to the detailed disclosure requirements for non-accredited investors).
[3] Note that it is unclear whether merely obtaining representations from purchasers through questionnaires or subscription agreements that they are accredited investors will constitute "reasonable steps" under the amended Rule 506, or whether additional steps to verify their accredited investor status will be required.

"public offerings" of securities, so that the fund can remain exempt from registration as an investment company.[4]

Private funds that are exempt commodity pools under Commodities Futures Trading Commission ("CFTC") regulations should note that existing CFTC rules limit the offer or sale of interests to the public, and it appears that the JOBS Act has not amended those provisions.

Impact on Private Funds and Further Considerations

Once the SEC issues the amendments to Rule 506, fund managers will be permitted to market their funds through print, broadcast, Internet or social media advertisements, notices posted on their websites, media interviews, presentations at seminars, and other forms of broad-based interaction with potential investors. In addition, fund managers will likely no longer be required to have a "pre-existing relationship" with potential investors in their fund. Private fund managers 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 the rules promulgated thereunder, which include (in the case of registered investment advisers), prohibitions against the use of testimonials and specific requirements when listing past performance information in connection with the offer and sale of private fund securities and the investment activities of private funds. Furthermore, as with any offering of securities, fund managers will remain subject to the anti-fraud provisions contained in Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder.

Although the elimination of the general solicitation and advertising restriction is a welcome change by many, it is not formally effective until the final rule from the SEC is issued. While the JOBS Act gave the SEC until earlier this month to amend Rule 506, in her June 28, 2012, testimony before the U.S. House Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs Oversight and Government Reform Committee, SEC Chairman Mary L. Shapiro told lawmakers the agency would not be able to meet that deadline.[5] She stated in part, "…the 90 day deadline does not provide a realistic timeframe for the drafting of the new rule, the preparation of an accompanying economic analysis, the proper review by the Commission, and an opportunity for public input." As reported in JLG's July 13, 2012 blog[6], Chairman Shapiro did not give any specific dates as to when the proposed rulemaking lifting the general solicitation ban would be issued, but indicated the SEC would be in a position to act in the near future.

Conclusion

Until the SEC amends Rule 506, the current rules prohibiting general solicitations and advertising remain in place and private funds should not make any changes to their current practices. However, once final rules from the SEC are issued, private funds and their managers are advised to 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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[4] While the JOBS Act does not specifically amend the 1940 Act, new Section 4(b) of the Securities Act provides that offers and sales under Rule 506 shall not be deemed public offerings under the federal securities laws as a result of general solicitation or advertising.

[5] Shapiro's speech may be found in its entirety at http://www.sec.gov/news/testimony/2012/ts062812mls.htm.

[6] *See* http://jackolg.wordpress.com/.

For additional information about the JOBS Act and the potential impact to private funds, please contact Eric M. Willens, Esq. at eric.willens@jackolg.com or (619) 298-2880.

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