

LEGAL UPDATE

April 2012 By: Bertrand C. Fry, Jonathan T. Shepard, and Jill C. Braibanti

JOBS ACT LIFTS THE GENERAL SOLICITATION PROHIBITION AND INCREASES THE RECORD HOLDER THRESHOLD FOR PRIVATE INVESTMENT FUNDS

With a signing ceremony scheduled for April 5, the Jumpstart Our Business Startups Act (or “JOBS Act”) will significantly alter the regulations affecting how private investment funds are marketed. While the wide ranging JOBS Act touches on many areas of capital formation that will likely be of interest to managers, sponsors, and marketers of private investment funds¹, two changes are particularly relevant to participants in this sector:

- amending Section 4 of the Securities Act of 1933 (the “Securities Act”) to provide that a private placement complying with Rule 506 shall not be deemed to be a public offering solely as a result of general solicitation or general advertising; and
- amending Section 12(g)(1)(A) of the Securities Exchange Act of 1934 (the “Exchange Act”) to increase the number of holders of record that will trigger the requirement that private investment funds register their securities, from 500 persons to 2,000 persons (provided that the number of non-accredited investors does not exceed 499).

¹ The full scope of the JOBS Act is covered in Pryor Cashman’s Legal Update, *JOBS Act Seeks to Facilitate Access to U.S. Capital Markets* (April 2012). In addition to the changes discussed in the main text, the JOBS Act introduces changes to a variety of areas, including creating the “IPO On-Ramp,” which facilitates the initial public offering process for a new category of issuers referred to as “emerging growth companies”; providing an exemption for “crowdfunding” for qualified securities offerings; and increasing the cap on offerings utilizing Regulation A under the Securities Act to \$50 million per 12-month period.

LIFTING THE GENERAL SOLICITATION PROHIBITION IN CERTAIN PRIVATE OFFERINGS

Private investment funds generally rely on Rule 506 under Regulation D to issue their securities in the United States without being required to register the securities under the Securities Act. Rule 506 permits a private fund to raise virtually unlimited amounts of U.S. domestic capital so long as the investors are all accredited investors.

However, private investment funds and their sponsors still have to find a way to reach accredited investors. Issuers relying on Rule 506 have been prohibited by Rule 502(c) from engaging in any form of “general solicitation or advertising” to attract investors. The SEC has never precisely specified what constitutes a “general solicitation,” although a number of no-action letters have set out guidance on the “manner of offering” restrictions of Rule 502(c). Issuers have often been cautioned that to avoid a general solicitation an issuer must approach only offerees with whom the issuer has a “pre-existing substantive relationship.”² Over the last several years, many commentators have noted the deleterious effects on private investment funds’ capital raising created both by this “general solicitation” limitation and by the vagueness and apparent internal contradiction in its interpretation.

Title II of the JOBS Act amends Section 4 of the Securities Act to state specifically that a Rule 506 private placement shall not be deemed a public

² See Use of Electronic Media, Exchange Act Release Nos. 33-7856, 34-42728, 65 Fed. Reg. 25843, 25852 (May 4, 2000); see also, e.g., Bateman, Eichler, Hill Richards, Inc., SEC No-Action Letter (Dec. 3, 1985); Lamp Technologies, SEC No-Action Letter (May 29, 1997).

offering solely as a result of general solicitation or general advertising. It also orders the SEC to modify Rule 506 within 90 days of enactment of the JOBS Act to eliminate its prohibition against general solicitation or general advertising for offers and sales of securities so long as all purchasers of the relevant securities are accredited investors.³ While the elimination of this prohibition should remove significant restrictions that have previously hampered private funds' marketing, such marketing will continue to be subject to substantial regulatory requirements, including, to the extent applicable, state securities laws, the Investment Advisers Act and related rules, and the rules of the Commodity Futures Trading Commission, National Futures Association, and Financial Industry Regulatory Authority.

Moreover, the statute mandates that the SEC's rule also specify methods constituting "reasonable steps" that the issuer must take to verify that the purchasers of securities in a Rule 506 offering are accredited investors. While the exact methods the SEC will require must await final rulemaking, it is clear that issuers will not be able to rely on an unsupported representation by the purchaser that the purchaser is an accredited investor.⁴ Private investment funds will need to update their subscription booklets to take full advantage of the change in Rule 506 and possibly also to comply with the SEC's required verification steps once they are final.

INCREASED RECORD HOLDER THRESHOLD

Prior to the enactment of the JOBS Act, an issuer would have been required by Section 12(g) of the Exchange Act, together with related rules, to register a class of equity securities with the SEC if,

on the last day of the issuer's fiscal year, such class of securities is held of record by 500 or more record holders and the issuer has assets of more than \$10 million. Registration of a class of equity securities subjects an issuer to the periodic reporting requirements of Section 13, the proxy requirements of Section 14, and the insider reporting and short swing profit provisions of Section 16 of the Exchange Act.

Title V of the JOBS Act amends Section 12(g) of the Exchange Act to dramatically increase the number of record holders that a company can have before it is obligated to register under the Exchange Act. Specifically, an issuer (other than a bank or bank holding company) will not have to register its securities with the SEC until such time as it has total assets exceeding \$10 million and a class of equity securities that is held of record either by 2,000 persons or by 500 persons who are not accredited investors. The measurement date for determining whether the asset and record holder thresholds have been met is the last day of the issuer's fiscal year.

Many private investment funds, including hedge funds and private equity funds, rely on Section 3(7) of the Investment Company Act of 1940 (the "ICA"), and related rules, to be excluded from the definition of "investment company" and thus from the ICA's registration and other requirements.⁵ Under the ICA, an investment fund that is not making (or proposing to make) a public offering of its securities is permitted to have an unlimited number of investors so long as the fund's outstanding securities are owned exclusively by persons who, at the time of the acquisition of the fund's securities, are "qualified purchasers."⁶ Consequently, the Exchange Act's record holder

³ A parallel provision allows for general solicitation in a Rule 144A offering, provided the offered securities are ultimately purchased by qualified institutional buyers.

⁴ In this regard, it is worth taking note of the hostility that Commissioner Luis Aguilar has expressed towards the JOBS Act. The SEC seems likely to use its power to impose verification steps, and possibly to reassess the definition of accredited investor, to ameliorate some of the investor protection concerns that have been raised in connection with the JOBS Act. See Statement of Commissioner Luis A. Aguilar, SEC, Investor Protection is Needed for True Capital Formation, (Mar. 16, 2012), <http://www.sec.gov/news/speech/2012/spch031612laa.htm>.

⁵ A private investment fund relying on Section 3(c)(7) is nonetheless deemed to be an "investment company" for purposes of certain statutory limitations relating to its acquisition of securities issued by registered investment companies.

⁶ In general, a "qualified purchaser" is defined under Section 2(a)(51)(A) of the ICA, and related rules, to be a person that the issuing private investment fund reasonably believes is a natural person who owns not less than \$5 million in investments or a non-natural person that owns and invests on a discretionary basis not less than \$25 million in investments. The SEC has defined term "investments" for this purpose in Rule 2a51-1 under the ICA.

threshold acts effectively as a cap on the number of investors a private fund can have. By significantly increasing the threshold for record holders, the JOBS Act will make it much easier for private investment funds to raise capital, and potentially permit them to sustain a more diversified investor base, without becoming subject to the requirements of the Exchange Act.

As a result of the amendments to Section 12(g), private investment funds should review their internal record keeping functions to ensure that they maintain an accurate record of those issuances that will and will not count against the record holder limits. Fund sponsors should also note that the JOBS Act directs the SEC to evaluate whether it requires additional enforcement tools to enforce the anti-evasion provision in Rule 12g5-1(b)(3). The SEC's evaluation and any additional rule-making in this area may impose further requirements for private investment funds seeking to rely on Section 12(g).

The foregoing is merely a discussion of the potential impact of the JOBS Act on private investment funds. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Bertrand C. Fry at 212-326-0134; Jonathan T. Shepard at 212-326-0496; or Jill C. Braibanti at 212-326-0138.

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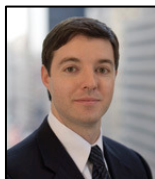
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Bertrand Fry is a partner in Pryor Cashman's Corporate Group and is co-head of the firm's Investment Management Group. Bert has nearly twenty years of general corporate and transactional experience that includes extensive experience with alternative investment vehicles. In addition to having launched and advised a diverse array of U.S. and non-U.S. investment products, including vehicles engaged in macro, distressed, private equity, venture capital, and real estate investing, debt origination, and quantitative trading of securities and futures, his practice has included, among other things, structuring and advising investment managers and advisers, private company mergers & acquisitions, and joint ventures.

Bert is particularly well attuned to the business needs of his clients, based on more than a decade of in-house experience at the D. E. Shaw group, where Bert was a Senior Vice President and served for a period as Acting General Counsel. During his tenure there, the D. E. Shaw group included several SEC-registered investment advisers and, at its apex, managed approximately \$40 billion across various strategies and multiple funds. Bert also launched and advised a wide range of hedge funds, funds of funds, and their managers as a member of the London office of Dechert LLP.

Bert earned his J.D., with honors, from The University of Texas at Austin School of Law, where he was also an articles editor for the Texas Law Review and received the Outstanding Second-Year Member Award from the Texas Law Review, the Gilbert I. Low Endowed Presidential Scholarship in Law, and Highest Achievement in Contracts.



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Jonathan T. Shepard is a partner in the firm's Litigation Group and Co-Chair of the Investment Management Group. He represents clients across a broad spectrum of complex legal and business litigation matters, including those in the areas of hedge funds and private equity funds, securities, bankruptcy, intellectual property and general commercial litigation. Jonathan has successfully tried cases in both federal and state courts across the country and handled complex AAA, JAMS and FINRA arbitration proceedings.

Jonathan was recently selected as a 2011 "Rising Star" in Business Litigation by New York Super Lawyers, a distinct honor given to only 2.5 percent of the lawyers in the state. He was also selected as a National Finalist for the Top 40 Investment Management Professionals Under 40 by M&A Advisor.

Jonathan has significantly developed the firm's Investment Management Practice, representing some of the leading global hedge funds and private equity firms (with assets under management of more than \$29 billion) as well as entrepreneurial start-ups. He regularly represents such clients in connection with litigation and bankruptcy proceedings and advises them on the formation and operation of all types of alternative investment vehicles, including hedge funds, funds-of-funds, venture capital funds, private equity funds and private real estate funds. His representative experience includes:

- Representing group of investment funds in a multimillion dollar Chapter 11 bankruptcy adversary proceeding against debtor investment fund and Committee of Equity Security Holders in a precedent-setting case for the industry concerning the treatment of effective investor redemptions
- Representing multiple leading global investment funds in a \$25 million dollar breach of contract action concerning senior subordinated convertible note obligations
- Successfully represented major investment fund in a multimillion dollar breach of contract AAA arbitration against a trader in connection with the operation of an options trading account
- An investment fund in bankruptcy adversary proceedings arising out of the Bayou Group's Ponzi scheme
- Several investment funds in an SEC enforcement action in connection with the fraud committed by Thomas Petters
- Representing one of the largest global institutional alternative asset management firms in a trademark infringement action

Jonathan has also successfully handled numerous complex commercial, securities, real estate development, construction, bankruptcy and intellectual property litigation matters. His representative experience in those areas includes:

- Successfully obtained precedential summary judgment ruling for leading construction company and global insurance company, dismissing over \$4 million in claims made by a subcontractor in connection with a major NYC construction project
- Successfully defended a publicly traded specialty pharmaceutical company in a multimillion dollar breach of contract arbitration against a major banking and financial institution; obtained a dismissal of all claims against the client
- Second-chair of trial team that obtained a favorable post-trial settlement for indenture trustee in Chapter 7 bankruptcy adversary proceeding concerning complex collateralized note-obligations; one of the first sub-prime bankruptcies
- Successfully defended a major international publicly-traded telecommunications company in a multimillion dollar breach of contract arbitration in connection with the construction of its fiber network
- Successfully defended an international real estate development company in a federal court breach of contract action in connection with the construction of a luxury residential building in Manhattan
- Represented a famous radio personality and agent in a multimillion dollar breach of contract action against a leading television network in which a favorable settlement was reached prior to trial
- Represented a famous recording artist, global media company, major record label and film director in a trademark and trade dress infringement action brought by a motorcycle daredevil legend; a favorable settlement was reached prior to trial

Jonathan is a 2001 *cum laude* graduate of Syracuse University College of Law, where he was an Articles Editor of the Syracuse Law Review, a Dean's Scholarship Recipient and a member of the Justinian Honorary Law Society. He was awarded honors of excellence in the areas of Appellate Advocacy and Legal Research and Writing.



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Jill Braibanti's practice focuses on corporate, intellectual property and digital media matters, including copyright issues, social media and promotions compliance, licensing, acquisitions and corporate governance. Her practice also includes general commercial and entertainment litigation.

Jill received her B.A. from the College of William & Mary in 2003 and her J.D. from New York University School of Law in 2009. She served as an editor of the NYU Journal of Law and Business.