

The real (and potential) impact of the JOBS Act

The uncertainty about what, if any, changes the JOBS Act will bring to hedge fund marketing has increased

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When the Jumpstart Our Business Startups Act (the JOBS Act) was signed into law on 5 April 2012, it set off a wave of expectation among hedge fund managers for a radical change in the way that hedge funds are marketed in the US. More than a year later, the excitement has ebbed considerably. And the uncertainty about what, if any, changes the JOBS Act will bring to hedge fund marketing has increased.

Keeping a placement private – the current regime

The initial excitement for change is understandable when one considers the strictures on marketing that currently apply. Like any other issuer that seeks to offer its equity without registration under the US's private-placement regime, hedge funds and funds of funds must be able to rely on an exemption from such registration, and, in most cases, they rely on the safe harbour provided by Regulation D (Reg D) under the US Securities Act of 1933 (the Securities Act).

Rule 506 of Reg D deems an issuer's offer and sales of its securities not to involve a public offering for purposes of the registration rules of the Securities Act, so long as the issuer reasonably believes that all of the purchasers in such offering meet the US Securities and Exchange Commission's (SEC) definition of 'accredited investors'.

Rule 506 does permit a relatively minimal allowance of up to 35 purchasers to be unaccredited, but even they must have access to requisite knowledge and experience in financial and business matters. The fairly well known 'accredited investor' test requires that the investor have either \$200,000 of annual income (or \$300,000 annual income combined with the investor's spouse) or a net worth of at least \$1 million.

Reg D does not, however, just look to the sophistication of the prospective purchaser. It also includes a limitation on the manner in which the offering is conducted. Rule 502(c) snatches the registration exemption away from any issuer that (either directly or through an agent) offers or sells its securities by any form of 'general solicitation' or 'general advertising'. Reg D does not define these terms with precision, although it does explicitly note that any "article, notice, or other communication published in a newspaper, magazine, or similar media or broadcast over television or radio" would be a general solicitation or general advertisement, and that any "seminar or meeting whose attendees have been invited by any general solicitation or general advertising" is itself a general solicitation.

In addition – and more problematic – is the guidance from the SEC in interpreting this rule that, to avoid a general solicitation, offers must be made only to prospective investors with whom there is a “pre-existing substantive relationship”. This guidance has led to the initial questionnaires and warming-up periods that many hedge fund managers are all too familiar with.

The promise...

Section 201(a) of the JOBS Act mandated that the SEC revise Rule 506 to provide that offers under that rule no longer be subject to the prohibitions against general solicitation and general advertising, so long as all purchasers of the offered securities are accredited (with no carve-out for any unaccredited investors). Many hedge fund managers and legal commentators immediately saw the promise of the JOBS Act to open the door to advertisements about hedge funds in mainstream publications and on websites. Without the spectre of the general solicitation prohibition, it seemed as if hedge funds would be able to assume a less secretive posture among financial institutions.

...meets the reality

But, in fact, the impact of the JOBS Act on hedge fund and fund of fund marketing has been non-existent.

- The wait for final implementing rules. First, and most critically, the SEC has yet to adopt final rules that would drop the general solicitation and general advertising prohibitions from Rule 506 – notwithstanding the JOBS Act’s express requirement that the necessary rule revisions be made by 4 July 2012. Although the statute’s acronym is clearly intended to remind us of the legislators’ firm commitment to creating new jobs, its double meaning has become evident as hedge fund managers (and their lawyers), awaiting the SEC’s issuance of final rules, have learned to exercise the patience of Job.
- Verification procedures. Although the mandated adoption date has passed, the SEC has issued proposed final rules to implement the required changes. As required by the statute, the proposed rules also address what “reasonable steps” an issuer relying on Rule 506 will be required to take to verify that purchasers of the securities are actually accredited investors.

While the traditional practice in hedge fund offerings has been to rely on a representation from an investor in its subscription documentation as to its status as an accredited investor, under the proposed rules an issuer will have to take additional, affirmative steps to verify the purchasers’ accredited-investor status.

The SEC has not set out detailed guidelines, however;; rather, the proposed rules would have the issuer look to the “facts and circumstances” to determine what level and types of verification are required, including: the nature of the purchaser and the type of accredited investor the purchaser claims to be; the amount and type of information the issuer has about the purchaser; the nature of the offering; and the terms of the offering.

- Required minimum investment amounts. For hedge fund and fund of fund sponsors and marketers, the last item in the list above may turn out to be the most useful. If, under the terms of the offering, a prospective investor’s minimum investment amount is so high that it could be met only by an accredited investor (eg \$1 million), then the verification obligation may crystallise into the relatively manageable task of confirming that the purchaser’s cash investment is not being financed and is reflective of the purchaser’s actual net worth.

- Treating private investment funds differently from other private issuers. As regulators and investor protection organisations have focused on the JOBS Act, they have frequently asked whether the SEC’s rules in this regard should treat private investment funds, such as hedge funds and funds of funds, differently from other private issuers.

Some of the SEC’s commissioners have specifically lamented the loss of the general solicitation prohibition as one more guard against fraud, and there is a palpable concern that the unscrupulous will increasingly find the form of private investment funds, which rarely have a tangible product beyond an account statement and audited financials, a fertile ground for fraud. In this vein, for example, the Investor Advisory Committee of the SEC (comprising industry and investor--protection representatives) has recommended that the SEC take steps in its rule--making in this area to ensure that any performance claims in materials used as part of general solicitations are based on appropriate performance reporting standards.

- Increased regulatory attention on failures to use registered broker-dealers. Concurrently with the SEC’s deliberations about how to implement the JOBS Act’s Section 201, the SEC seems to have strengthened its focus on the placement agents that private investment funds use.

As hedge funds and funds of funds contemplate the potential of being able to market more publicly and actively, they should expect that the placement agents they use will be under greater scrutiny to be sure they are properly registered and complying with their regulatory obligations. In at least one instance where the SEC found that a placement agent for a private investment fund should have been registered as a broker--dealer, it also pursued an action against the private fund’s adviser for causing the registration violation.

Conclusion

The alternative investment industry will have to continue to patiently monitor developments in the implementation of the JOBS Act. As the initial excitement wears off, it seems more likely that the marketing of hedge funds and funds of funds will not change dramatically. Compliance resources, however, will probably need to be shifted, away from monitoring and documenting pre--existing substantive relationships, to developing procedures to verify and document investors’ accredited investor status.

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