Compliance Corner

*— By Paul M. Miller**

The JOBS Act: Implications for Private Fund Advertising and for Compliance Programs of Registered Advisers to Private Funds

On March 27, 2012, Congress approved the Jumpstart Our Business Startups (JOBS) Act. The JOBS Act was signed into law by President Obama on April 5, 2012. This article discusses the JOBS Act mandate to the Securities and Exchange Commission (SEC) to amend Rule 506 under the Securities Act of 1933 (Securities Act); the implications of such amendments for private fund advertising and marketing activities; and suggested changes registered advisers to private funds should make to their compliance policies and procedures to reflect the flexibility expected to result from the amendments.

JOBS Act Mandate

Section 201(a) of the JOBS Act directs the SEC to amend Rule 506 of Regulation D (sometimes referred herein to as the "Private Offering Exemption") to provide that the condition incorporating the prohibition in Rule 502(c) against general solicitation or general advertising shall not apply to offers and sales of securities made pursuant to the Private Offering Exemption, provided that all purchasers of the securities are accredited investors. The amended Rule 506 must require issuers to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the SEC. Section 201(b) of the JOBS Act amends Section 4 of the Securities Act to provide that offers and sales exempt under amended Rule 506 shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation activities.

The mandated amendments to Rule 506 raise interesting questions, which the SEC may address in its rulemaking process, concerning the definition of the term "offering" under the Securities Act and the apparent disparate treatment of the term for private funds and registered funds. In the case of registered funds, the mere use by a fund of its name in any advertising material may constitute an offering of the fund requiring the use of a compliant prospectus or compliance with specific rules (*e.g.,* Rule 482) in lieu of the compliant prospectus. Under the amendments to Rule 506 mandated by the JOBS Act, the mere mention of a private fund by name or on a limited basis would not apparently require similar disclosures.

Implications for Private Fund Advertising and Marketing Activities

Many private funds conduct offers and sales of securities in the United States in reliance on the Private Offering Exemption. Currently, the Private Offering Exemption permits offers and sales in unlimited dollar amounts to an unlimited number of investors, provided that (i) the offers and sales comply with the terms and conditions of Rule 501 and Rule 502, including the prohibition in Rule 502(c) against offering or selling securities by any form of general solicitation or general advertisement, and (ii) there are no more than 35 purchasers who are not "accredited investors." The general solicitation and general advertising prohibitions of Rule 502(c) restrict private funds relying on the Private Offering Exemption from offering their shares in any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio. The prohibitions also prohibit such funds from offering their securities in seminars or meetings whose attendees have been invited by any general solicitation or advertising. The SEC staff has interpreted the prohibitions against general solicitation and advertising broadly, effectively limiting solicitations and advertising by private funds and their advisers to those potential investors with which the fund or its adviser has a substantive, pre-existing relationship. Private funds and their advisers typically employ questionnaires and other procedures to document the existence of a pre-existing, substantive relationship, or rely on their agents who have such a relationship with potential investors.

The elimination of the general solicitation and general advertising prohibitions from the Private Offering Exemption will have a significant effect on private fund industry marketing activities. While the full extent of the effects will depend on the SEC's final rulemaking, the amendments will eliminate for private funds intending to engage in

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general advertising the requirement to establish and document a substantive, pre-existing relationship with potential investors. This change should permit private funds to advertise in periodicals, newsletters and other publications with public distribution, sponsor events or seminars accessible to the public, set up publicly accessible websites and conduct other forms of general advertising. The change should also permit portfolio managers of private funds to have more flexibility in discussing the funds in interviews with the press, at conferences and in other public forums. Finally, the change should permit private funds to conduct general solicitations of potential investors, including solicitations through social media.

Changes to Registered Adviser Compliance Programs

Registered advisers to private funds often incorporate into their compliance programs the private placement offering requirements, and these requirements are often the focus of the SEC staff during an examination of a registered adviser. During an examination, the SEC staff seeks information about the exemptions under the Securities Act upon which each private fund relies and the names of current investors and investors who previously purchased and redeemed securities of the private funds. The SEC staff also seeks copies of the offering memorandum and subscription agreement for each fund and, in the area of advertising, information about the registered adviser's website, including sections of the site that are accessible only with a username and password.

As noted above, the amendments to the Private Offering Exemption will eliminate the requirement that private funds intending to engage in general advertising establish and document a substantive, pre-existing relationship with potential investors. Consequently, the compliance procedures and questionnaires used by these funds and their advisers to document the existence of the substantive, pre-existing relationship with potential investors may be modified substantially or, depending on the SEC's rulemaking in connection with the amendments, eliminated. Registered advisers to these funds may, nonetheless, determine to maintain certain of the procedures or aspects of current questionnaires going forward for compliance control or other purposes.

Anti-Fraud and Advertising Issues. While amended Rule 506 will likely permit private funds and their advisers to modify substantially or eliminate the procedures and questionnaires addressing when and to whom a private fund may advertise or make solicitations, the amended rule will not alter the content requirements applicable to private fund advertisements and solicitations. The anti-fraud provisions of the federal securities laws, including those under the Investment Advisers Act of 1940, will continue to govern the content of such advertisements and solicitations. These provisions generally provide that it is unlawful to make any untrue statement of material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to an investor or prospective investor in a private fund.

Like the anti-fraud requirements, the advertising requirements under the Advisers Act will continue to apply to advertising and marketing materials of private funds for which a registered adviser serves as adviser. These advertising requirements prohibit advertisements that, among other things, contain (i) testimonials about the adviser's services, (ii) past specific profitable recommendations of the adviser, or (iii) any untrue statement of material fact, or which is otherwise false or misleading. These requirements also impose restrictions on presenting performance information.

In light of the foregoing content requirements, the new, permitted audience for private fund information and the SEC staff's focus on this area during examinations, the marketing and advertising materials of a private fund should include disclosures alerting potential investors that securities of the private fund may only be purchased by investors who are accredited investors. In addition, registered adviser compliance programs should continue to require the review of advertising and marketing materials of private funds for purposes of compliance with the anti-fraud provisions and the advertising requirements under the Advisers Act. The compliance program should also incorporate guidance for portfolio managers and other fund personnel conducting public interviews.

Documents and Procedures Supporting Reasonable Belief. Although private placements of securities conducted in reliance on the Private Offering Exemption currently are limited primarily to accredited investors, the SEC may provide additional guidance concerning the methods for establishing a reasonable belief that each investor in a fund relying on amended Rule 506 is an accredited investor, particularly in light of the JOBS Act mandate that all purchasers be accredited investors. The SEC may provide, for example, a list of non-exclusive methods for establishing a reasonable belief for this purpose. Such a list could include a requirement for a fund to obtain specific documentation of an investor's net worth and income. Private funds currently satisfy the accredited investor standard by requiring each investor, in the subscription agreement with the fund, to provide a representation to the fund that the investor meets one or more of the criteria of an accredited investor and by concluding that it is reasonable for the fund to rely on that representation.

Amended Rule 506 will in effect

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eliminate the availability of the 35 non-accredited investor condition of the Rule for private funds that intend to engage in general advertising or solicitation. This change will likely have greater implications for Section 3(c)(1) private funds (including those funds accepting, under the current rule, investments from knowledgeable employees who are not accredited investors) than for Section 3(c)(7) private funds whose investors must be qualified purchasers under applicable requirements of the Investment Company Act of 1940. This change will also likely place added weight on the documentation and procedures used to support the reasonable belief that all purchasers of the fund's securities are accredited investors.

Conclusion

The amendments to the Private Offering Exemption mandated by the JOBS Act create new opportunities for private funds and their advisers to market private fund securities to potential investors - some would argue permitting activities that may be occurring in the industry today. These new opportunities should not, however, be undertaken without due consideration for the continuing obligations of funds and their advisers under the federal securities laws.

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House Committee Set to Act on Chairman's Investment Adviser SRO Bill—continued from front cover

fund companies as well as hedge fund and private equity advisory firms."

Unlike the previously-circulated discussion draft, the bill that Bachus is expected to introduce is likely to limit SRO coverage of state-registered advisers and to include a requirement that the SRO (referred to as a "national investment adviser association") perform a cost-benefit analysis as part of any rulemaking. There could also be changes to the exemptions.

If Chairman Bachus brings up the bill for a vote, he is likely to obtain majority support from the Republican members of the Financial Services Committee. Further action by the full House could follow at a later date.

Bachus is introducing the legislation in response to the SEC's January 19, 2011 report to Congress mandated under Section 914 of the Dodd-Frank Act. That report recommended that Congress consider three options to enhance the frequency of examinations of registered investment advisers: (1) authorize the SEC to impose user fees to fund examinations, (2) authorize the SEC to designate one or more SROs to examine advisers, or (3) authorize FINRA to examine firms dually registered as both broker-dealers and advisers.

The IAA is strongly opposed to investment adviser oversight by a private, quasi-governmental regulator and is committed to maintaining the SEC as advisers' sole regulator. In order to bolster the SEC's resources without further burdening U.S. taxpayers, the IAA believes that Congress should—in lieu of an SRO—consider authorizing the SEC to assess fairly apportioned user fees on advisory firms that would be dedicated to providing an enhanced level of examinations by the SEC.

Given the the extraordinary regulatory burdens and costs that this legislation would impose on advisers, the IAA is strongly encouraging advisers to visit IAA's web site in order to contact their elected representatives in Congress and voice their strong opposition to the Bachus investment adviser SRO bill. Additionally, advisers should plan to come to Washington, DC on June 7 to participate in IAA's 5th Annual Lobbying Day on Capitol Hill. ■

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the IRS (and did not qualify for an exemption), any U.S.-source payment to the FFI would be subject to 30% withholding. Under this regime, even assets sold at a loss could be subject to FATCA withholding on the sale proceeds. Withholding would be phased in, starting in 2014 for interest, dividends, and similar payments, and in 2015 for the gross proceeds from the disposition of assets.

The proposed FATCA regulations are available at: http://www.irs.gov/pub/newsroom/reg-121647-10.pdf. Please contact IAA Associate General Counsel Kathy D. Ireland at (202) 293-4222 or kathy.ireland@investmentadviser.org with any questions. ■