The JOBS Act: Implications for Private Fund Sponsors

Introduction

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the "JOBS Act"), a collection of reforms to the U.S. federal securities laws designed to reduce the regulatory burdens on small businesses and facilitate capital formation.[1] Although the JOBS Act is primarily aimed at helping small and emerging businesses grow and create jobs, private fund sponsors will also see significant benefits from the new legislation.[2] In particular, the JOBS Act (i) raises the threshold for the number of equity holders a private fund can have before it becomes a public company subject to periodic and current reporting under the Securities Exchange Act of 1934 (the "Exchange Act") and (ii) permits general solicitation or general advertising in connection with offerings conducted pursuant to Rule 506 of Regulation D under the Securities Act of 1933 (the "Securities Act").

Increased Threshold for Exchange Act Reporting

Prior to the JOBS Act, Section 12(g) of the Exchange Act required a company with more than $10 million in total assets and a class of equity security "held of record" by 500 or more persons to register the class of equity security with the SEC. Because Exchange Act registration triggers public company reporting obligations, sponsors of private funds that rely on the exemption from registration under Section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") have tended to limit the number of investors in those funds to no more than 499 persons.[3] Section 501 of the JOBS Act raises the record holder threshold in Section 12(g)(1)(A) of the Exchange Act from 500 persons to either (i) 2,000 persons or (ii) 500 persons who are not "accredited investors."[4] In addition, Section 502 of the JOBS Act amends Section 12(g)(5) of the Exchange Act to provide that the definition of "held of record" excludes securities held by persons who received the securities pursuant to an employee compensation plan in a transaction exempt from the registration requirements of Section 5 of the Securities Act. To assist issuers in structuring their employee compensation plans, Section 503 of the JOBS Act directs the SEC to adopt safe harbor provisions that issuers can follow when determining whether an employee security holder meets the exclusion. The JOBS Act amendments to the Section 12(g) record holder provisions take effect immediately; however, no deadline is given for the SEC to adopt safe harbor provisions for the employee security holder exclusion.

[1] The text of the JOBS Act, as passed by the House on March 27, 2012, is available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

[2] For a more comprehensive discussion of the changes to U.S. federal securities laws instituted by the JOBS Act, please see our earlier client alert, *The U.S. Jumpstart Our Business Startups Act (The JOBS Act)*, available at http://www.curtis.com/siteFiles/Publications/Public%20Company%20Client%20Alert.pdf

[3] The 500 record holder threshold is generally not a concern for a private fund relying on the exemption from registration provided by Section 3(c)(1) of the Investment Company Act, as that exemption is only available if the fund has no more than 100 beneficial owners.

[4] In general, an "accredited investor" includes (i) any entity with assets in excess of $5 million and (ii) any natural person (a) whose net worth, either alone or together with the person's spouse, exceeds $1 million, excluding the value of the person's primary residence, or (b) whose income exceeded $200,000 (or $300,000 together with a spouse) in each of the two most recent years and who has a reasonable expectation of the same income level in the current year.

Because a private fund relying on the Section 3(c)(7) exemption is limited to investors who are "qualified purchasers"[5] – each of whom would also qualify as an accredited investor – these changes effectively increase the number of investors the fund can accept for each class of its securities from 499 to 1,999, plus any excluded employee security holders.

Anti-Evasion Rules to be Reconsidered

The 500 record holder limitation in Section 12(g) of the Exchange Act received significant media attention last year when it was revealed that Goldman Sachs had organized a special purpose vehicle ("SPV") to allow its clients to invest in Facebook.[6] Under Rule 12g5-1, securities held of record by a single entity such as an SPV will generally be treated as held of record by one person, regardless of how many beneficial owners the SPV has. If Goldman's clients had invested in Facebook directly, each of them would have counted toward the 500 record holder limit, which could have forced Facebook to become a public company subject to Exchange Act reporting before it was ready to conduct its IPO. To many, the investment by Goldman's SPV appeared to run afoul of the anti-evasion provision in Rule 12g5-1(b)(3), which provides that if the issuer (e.g., Facebook) "knows or has reason to know that the form of holding securities of record is used primarily to circumvent" the 500 record holder limitation, then "the beneficial owners of such securities shall be deemed to be the record owners thereof."

The scrutiny of Goldman's Facebook investment prompted concern in the private fund industry that sponsors of so-called "master funds" may be required to count the beneficial owners of "feeder funds" formed to invest in the master fund as record holders, even in cases where the feeder funds were formed by persons unaffiliated with the master fund's sponsors. SEC Chairman Mary Schapiro has acknowledged that SPV investments in private companies such as Facebook raise a number of policy questions, including whether SEC rules should count the holders of the SPV as record holders for purposes of Section 12(g) registration, regardless of the purpose for which the SPV was formed.[7]

In light of the uncertainty surrounding the application of Rule 12g5-1(b)(3), Section 504 of the JOBS Act directs the SEC to examine its authority to enforce Rule 12g5-1, determine if new anti-evasion enforcement tools are needed, and submit its recommendations to Congress within 120 days.

General Solicitation and General Advertising of Private Offerings Under Rule 506 of Regulation D

In addition to increasing the number of potential investors that a private fund can have before becoming a public company, the JOBS Act makes it easier for private fund sponsors to offer interests in their private funds without having to register the offering under the Securities Act. Private funds relying on either the Section 3(c)(1) or 3(c)(7) exclusion from the Investment Company Act registration are prohibited from engaging in a public offering of their securities. Interests in such funds are thus typically offered and sold in private offerings pursuant to Rule 506 of Regulation D under the Securities Act, which prohibits any

[5] In general, a "qualified purchaser" includes (i) an entity that owns and invests at least $25 million on a discretionary basis for its own account or for the accounts of other qualified purchasers and (ii) a natural person who, either alone or together with a spouse, owns at least $5 million in investments.

[6] *See, e.g.*, Steven M. Davidoff, *Facebook and the 500-Person Threshold*, New York Times, Jan. 3, 2011, available at http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/

[7] Letter from Mary L. Schapiro, Chariman of the SEC, to Hon. Darrell E. Issa, Chairman, Committee on Oversight and Government Reform, U.S. House of Representatives (April 6, 2011) at 20-21, available at http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf

general advertising or general solicitation in connection with the offering.

Section 201 of the JOBS Act directs the SEC to revise Rule 506 to remove the prohibition against general solicitation or general advertising in connection with Rule 506 offerings where all purchasers of the securities sold in the offering are accredited investors. The SEC's rules must also require that the issuer take reasonable steps to verify that purchasers of the securities are accredited investors using such methods as will be determined by the SEC. The JOBS Act gives the SEC 90 days following the passage of the Act to make the necessary rule revisions.

Furthermore, Section 201(b)(2) of the JOBS Act clarifies that offers and sales conducted pursuant to Rule 506 "shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." Accordingly, subject to the adoption of the SEC's amendments to Rule 506, private fund sponsors should be able to use general advertising or general solicitation to offer interests in their Section 3(c)(1) or 3(c)(7) funds without jeopardizing their ability to rely on those exemptions from Investment Company Act registration. As a result, we expect that private fund sponsors will expand their use of websites and social media to market private funds under Rule 506.

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