March 23, 2012

Senate Passes Legislation To Raise the 500 Shareholder Threshold for SEC Registration and To Relax General Solicitation Prohibition in Reg D Offerings

Yesterday, by a vote of 73 to 26, the U.S. Senate passed the Jumpstart Our Business Startups Act, which was approved by the U.S. House of Representatives on March 8, 2012, but voted to amend the so-called "crowdfunding" section of the House-passed bill (as amended, the "**JOBS Act**").[1] Because of the crowdfunding amendment, the JOBS Act will now return to the House (a House vote is expected early next week) and ultimately, once the House and Senate reach agreement on a single version, will need to be signed into law by President Obama. If enacted, the JOBS Act would, among other things, (i) raise the equity holder threshold in Section 12(g) of the Securities Exchange Act of 1934 (the "**Exchange Act**") that triggers public company reporting and (ii) relax the general solicitation and general advertising prohibition for offerings made pursuant to Rule 506 of Regulation D of the Securities Act of 1933 (the "**Securities Act**"). These amendments, both of which address issues that have been the focus of recent congressional and regulatory attention,[2] would introduce significant and beneficial changes to the regulations governing the offering processes for private funds.

Exchange Act Section 12(g)

If enacted, Section 501 of the JOBS Act would amend Section 12(g)(1)(A) of the Exchange Act to provide that an issuer would be required to register its securities with the Securities and Exchange Commission (the "**SEC**") (and thus become subject to public company reporting requirements) if it has total assets exceeding $10 million (consistent with the current threshold found in Rule 12g-1) and a class of equity security (other than an exempted security) that is "held of record" by either (i) 2,000 persons or (ii) 500 persons who are not "accredited investors."[3] The JOBS Act would thus significantly increase the 499-record holder limit that issuers—including private funds relying on the exemption from registration under Section 3(c)(7) of the Investment Company Act of 1940 (the "**Investment Company Act**")—must currently abide by pursuant to Section 12(g)(1)(B) of the Exchange Act.[4] Because funds exempt under Section 3(c)(1) of the Investment Company Act are limited to 100 beneficial owners pursuant to Section 3(c)(1), such funds do not typically have to contend with the 499-record holder limit.

[1] The House-passed version is accessible here. The Senate crowdfunding amendment is accessible here.

[2] For example, on March 9, 2012, the SEC's Advisory Committee on Small and Emerging Companies (the "**Committee**") recommended that the SEC increase shareholder limits in Section 12(g) of the Exchange Act from 500 to 1,000 record holders, which the Committee had previously considered at a meeting on February 1, 2012. On January 6, 2012, the Committee also recommended that the SEC "take immediate action to relax or modify the restrictions on general solicitation and general advertising to permit general solicitation and general advertising in private offerings of securities under Rule 506 where securities are sold only to accredited investors." These recommendations are available at http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-020112-registration.pdf and http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-010612.pdf, respectively.

[3] For banks and bank holding companies, Section 601 of the JOBS Act (through an amendment to Section 12(g)(1)(B)) would require registration if such entities have total assets of more than $10 million and a class of equity security (other than an exempted security) held of record by 2,000 or more persons, regardless of accredited investor status.

[4] A proposed amendment to the JOBS Act in the Senate would have amended Section 12(g) to count beneficial owners instead of record holders. This amendment was voted down in the Senate.

Section 502 of the JOBS Act would amend Section 12(g)(5) to provide that the definition of "held of record" for purposes of Section 12(g)(1) would not include securities held by persons who received such securities under employee compensation plans in transactions that were exempt from the registration requirements of Section 5 of the Securities Act, and Section 503 of the JOBS Act would direct the SEC to adopt a safe harbor for issuers in determining whether a security holder satisfies such exclusion. Section 303 of the JOBS Act would also direct the SEC to promulgate rules exempting from Section 12(g) securities acquired in a "crowdfunding" transaction.[5] In addition, the JOBS Act (Section 504) would require the SEC to consider whether it needs new tools to enforce the anti-evasion provision of Rule 12g5-1(b)(3) under the Exchange Act and to submit its recommendations to Congress within 120 days of the enactment of the JOBS Act.[6]

Rule 506 of Regulation D

Section 201 of the JOBS Act would direct the SEC, within 90 days of its enactment, to revise Rule 506 of Regulation D under the Securities Act to eliminate the prohibition on general solicitation and general advertising as it applies to private offerings made pursuant to Rule 506, *provided* that the only purchasers are "accredited investors."[7] According to the JOBS Act, the SEC rules must require an issuer offering securities pursuant to Rule 506 "to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the [SEC]." Because the JOBS Act would not directly amend Rule 506, there may be some uncertainty, even after the JOBS Act is enacted, as to the precise extent of the relief from the general solicitation and general advertising prohibition until the SEC promulgates its rules on the topic.

It should be noted that a private fund relying on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act for exemption from registration as an investment company must also satisfy the prohibition on making a "public offering" of its securities contained in those sections. There is thus a question whether a private fund offering, under a modified Rule 506, that included general solicitation and general advertising would comply with Sections 3(c)(1) and 3(c)(7). The JOBS Act (Section 201(b)(2)), however, appears to answer that question by providing that transactions under Rule 506 "shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation." Further, the SEC has previously issued guidance to the effect that an offering that complies with Rule 506 would not constitute a public offering for purposes of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.[8] Thus, the JOBS Act would seem to afford a private fund relying on Section 3(c)(1) or Section 3(c)(7) the ability to use general solicitation and general advertising to offer securities under a modified Rule 506 without running afoul of the prohibition on public offerings contained in the Investment Company Act (subject, of course, to the SEC's rules implementing the JOBS Act).

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[5] If enacted, the JOBS Act (Section 301) would open the door to so-called "crowdfunding" by amending Section 4 of the Securities Act to create a new registration exemption permitting certain U.S. issuers (excluding any registered investment company or an issuer excluded from the definition of "investment company" under the Investment Company Act by Section 3(b) or 3(c) thereof) to sell not more than $1,000,000 of securities over a 12-month period in unregistered transactions, subject to certain conditions.

[6] Rule 12g5-1(b)(3) under the Exchange Act states that if an issuer "knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g) or 15(d) of the [Exchange] Act, the beneficial owners of such securities shall be deemed to be the record owners" of such securities.

[7] Section 201(a)(2) of the JOBS Act also directs the SEC to provide that securities sold pursuant to Rule 144A under the Securities Act may be offered to persons other than "qualified institutional buyers," including by means of general solicitation or general advertising, *provided* that sales are made only to persons that the seller (and any person acting on behalf of the seller) reasonably believe to be qualified institutional buyers.

[8] *See, e.g.,* STARS & STRIPES GNMA Funding Corp., SEC No-Action Letter (Apr. 17, 1986); *see also* Advisers Act Release No. 22597 (Apr. 3, 1997).

The JOBS Act includes certain other measures that are of less relevance to private funds, including ones that would ease the IPO process and certain reporting requirements for public companies with annual revenues of less than $1 billion. These other measures are discussed in the March 9, 2012 Davis Polk Client Memorandum, ***Quicker to Market? U.S. House of Representatives Passes the Jumpstart Our Business Startups Act***.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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