CFTC Paves Way For Broader Advertising Of Private Funds

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On Sept. 9, 2014, the staff of the U.S. Commodity Futures Trading Commission issued an exemptive letter providing relief to commodity pool operators (CPOs) from having to comply with certain conditions in CFTC Rules 4.7(b) and 4.13(a)(3).[1] These conditions had been an impediment to use of recently adopted Rule 506(c) under the Securities Act of 1933, as amended (the "Securities Act"), which allows an issuer to make a private offering without requiring that the issuer and its agents avoid "general solicitation" in connection with the offer and sale of the securities. The staff's action was intended to harmonize the CFTC's rules with Rule 506 and could expand the scope of communications and/or use of advertising in connection with the offer and sale of private funds that are commodity pools.

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Background

Section 201(a) of the Jumpstart Our Business Startups Act, the so-called "JOBS Act," required the U.S. Securities and Exchange Commission to adopt rules eliminating the prohibition against general solicitation[2] in connection with the offer and sale of securities under Rule 506 of Regulation D[3] under the Securities Act and Rule 144A under the Securities Act, provided that all purchasers are "accredited investors"[4] in Rule 506 offerings or "qualified institutional buyers" (QIBs")[5] in Rule 144A offerings.[6]

In response to the JOBS Act requirement, the SEC adopted new Rule 506(c) under Regulation D (the "general solicitation rule"), eliminating the prohibition against general solicitation and advertising in Rule 506 offerings, provided that:

- Sales satisfy all terms and conditions of Rule 501 and Rules 502(a) and (d);
- All purchasers of the securities are accredited investors (which includes anyone who the issuer reasonably believes is an accredited investor); and
- The issuer takes "reasonable steps to verify" that the purchasers of the securities are "accredited investors."

Operators of private funds that are considered commodity pools due to their use of futures contracts, futures options, swaps or other commodity interests that offer and sell interests in the pools pursuant to Rule 506 must ensure that they comply with applicable provisions of the Commodity Exchange Act and CFTC rules.

CFTC Rule 4.7 provides relief from certain of the disclosure, periodic and annual reporting, and record-keeping requirements under the CFTC's rules to CPOs in two situations: (1) a registered CPO may offer or sell participations in a commodity pool solely to qualified eligible persons

(QEPs) in an offering that qualifies for exemption from the registration requirements of the Securities Act pursuant to Section 4(a)(2) of the Securities Act[7] or pursuant to the SEC's Regulation S, or (2) a bank that is registered as a CPO in connection with a commodity pool that is a collective trust fund whose securities are exempt from registration under the Securities Act pursuant to Section 3(a)(2) of the Securities Act, provided that the offer and sale is made without marketing to the public and is made solely to QEPs.

CFTC Rule 4.13(a)(3) provides a registration exemption for CPOs that operate commodity pools with de minimis commodity interest exposure and that, among other requirements, are offered and sold without marketing to the public in the United States.

Due to the communication restriction conditions in these CFTC exemptions, most CPOs have taken the view (as has the CFTC staff) that they could not take advantage of the ability to engage in advertising pursuant to the general solicitation rule without losing such exemptions.

Exemptive Relief

The staff's exemptive letter grants exemptive relief from the Regulation 4.7(b) requirements that an offering be exempt pursuant to Section 4(a)(2) of the Securities Act and that the securities must be offered solely to QEPs, and from the requirement in Regulation 4.13(a)(3)(i) that securities must be "offered and sold without marketing to the public." The exemptive relief is available only for issuers relying on Rule 506(c) or resellers relying on Rule 144A and is not self-executing. To claim relief under the exemptive letter, a CPO must file a notice with the CFTC's Division of Swap Dealer and Intermediary Oversight.

The exemptive relief will remain in effect until the effective date of any final CFTC action in consideration of the JOBS Act and the SEC's amendments to Regulation D and Rule 144A pursuant to the JOBS Act.

This exemptive relief may lead to increased use of Rule 506(c) by private funds that are commodity pools, although it should be noted that private funds that are not commodity pools and so were not blocked from use by the CFTC exemptions to date have not used Rule 506(c) extensively.

Even with this hurdle cleared, there remain issues that fund managers should consider before conducting a Rule 506(c) offering or engaging in general solicitation, including the heightened verification standards for accredited investors in Rule 506(c) offerings, the lack of a fallback to Section 4(a)(2) in the event there is general solicitation, the proposed SEC rules relating to Rule 506(c) offerings, the impact on state securities law exemptions, and potential increased scrutiny from the SEC.

In addition, foreign securities and investment fund laws need to be considered. For example, a Rule 506(c) offering or general solicitation could, in certain circumstances, result in the fund manager being considered to be marketing its private funds in the European Union, in which case such offering or general solicitation would be subject to the EU Alternative Investment Fund Managers Directive.

Practical Implications

While Rule 506(c) has not been broadly used to date, the CFTC staff's exemptive relief may afford private fund managers the opportunity to more broadly communicate with the market regarding their business and operations without potentially running afoul of the ban on general solicitation set forth in Rule 506(b), including where there is no desire to broaden existing distribution channels for fund interests. It is also possible that the establishment of a harmonized, clear safe harbor regarding general solicitation may put more regulatory pressure on communications by private fund managers that in the past may have relied on "pattern and practice" in the industry.

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[1] See CFTC Letter No. 14-116 (Sept. 9, 2014), available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-116.pdf.

[2] "General solicitation" and "general advertising" include newspaper and magazine advertisements, television and radio communications and seminars where persons in attendance were invited by general solicitations or advertisements. The SEC has construed other media accessible to the public, such as websites not protected by password, as possible general solicitations or advertisements.

[3] Rule 506 allows unregistered offerings in unlimited dollar amounts to an unlimited number of investors, provided that no more than 35 of the purchasers are unaccredited investors.

[4] "Accredited investor," as defined in Rule 501(a), means anyone who comes within certain categories, or who the issuer reasonably believes to come within those categories. A similar "reasonable belief" standard appears in Rule 2a51-1(h) under the Investment Company Act of 1940 regarding the term "qualified purchaser" as used in Section 3(c)(7) of the Investment Company Act. The proposing and adopting releases of Rule 2a51-1 indicate the SEC intended the reasonable belief standard in Rule 2a51-1(h) to reflect the same approach taken in Rule 501(a) of Regulation D and Rule 144A(d)(i).

[5] Rule 144A is a safe harbor from registration under the Securities Act for resales of certain eligible securities to QIBs.

[6] "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings," Securities Act Release No. 9415 (July 10, 2013), available at: http://www.sec.gov/rules/final/2013/33-9415.pdf. Previous Sidley updates on this topic can be found at:

SEC Adopts Significant Changes to Private Offering Rules

SEC Takes Step toward Fulfilling Congressional Mandate to Eliminate Ban on General Solicitation in Connection with Certain Unregistered Securities Offerings

Congress Liberalizes Securities Offering Regulation

U.S. Congress Enacts JOBS Act, Increasing 499 Investor Limit for Private Funds to 1,999 and Eliminating Prohibition Against General Solicitation in Connection with Certain Private Offerings

[7] The SEC has indicated that an offering made pursuant to Rule 506(c) is not an offering pursuant to Section 4(a)(2) of the Securities Act, as the use of general solicitation remains incompatible with a statutory private offering.