ALERTS

JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation

September 11, 2014

On Sept. 9, 2014, the U.S. Commodity Futures Trading Commission staff granted broad relief intended to remove an obstacle to the ability of market participants, under rules previously promulgated by the U.S. Securities and Exchange Commission, to utilize general solicitation and general advertising in conducting placements of hedge fund and private equity fund interests (and other securities). This relief has certain conditions and does not represent a resolution of all of the questions and concerns surrounding the use of general solicitation and general advertising, as highlighted in this *Alert*.

Background

On July 10, 2013, the SEC approved final rules to comply with a Congressional mandate under the Jumpstart Our Business Startups Act (the "JOBS Act")[1] to permit general solicitation and general advertising in certain private offerings of securities made pursuant to an exemption from registration under Rule 506 or Rule 144A[2] of the Securities Act of 1933.[3] This development was codified in new Rule 506(c).

With the promulgation of Rule 506(c), hedge fund and private equity fund managers — in theory at least — were able to employ general solicitation and general advertising in conducting Regulation D offerings (subject to that Rule's limitations and certain additional obligations). This rulemaking effort, however, did not result in a widespread adoption of general solicitation and general advertising activities for private funds; in fact,

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during the last 14 months, use of Rule 506(c) by both emerging and established private fund managers has been rare.

The non-adoption of Rule 506(c) by the marketplace has several causes, but the most prominent impediment was the fact that certain commonly-claimed exemptions under the rules of the CFTC required compliance with private offering limitations contained within the CFTC rules, which were not affected by the Congressional mandate to the SEC or by the promulgation of Rule 506(c).

In particular, most observers concluded that commodity pool operators ("CPOs") relying on the Regulation 4.13(a)(3) *de minimis* exemption from CFTC registration, as well as registered CPOs relying on the Regulation 4.7 exemption from certain disclosure and financial reporting obligations, could not dispense with the traditional private offering constraints because:

- Under Regulation 4.13(a)(3), interests must be "offered and sold *without marketing to the public* in the United States" (which is a concept hostile to the concept of general solicitation and general advertising);
- Under Regulation 4.7, *offerings may be made solely to qualified eligible persons* ("QEPs") (which puts *general* solicitation activities, i.e., to QEPs and to non-QEPs, outside of that exemption); and
- Under Regulation 4.7, offerings must qualify for registration exemptions "pursuant to" Section 4(a)(2) of the Securities Act (as the genesis of Rule 506(c) is a JOBS Act-mandated amendment to Regulation D — and not to Section 4(a)(2) itself — there is a concern that a Rule 506(c) offering is not conducted under an exemption that is "pursuant to" Section 4(a)(2)).

2014 CFTC Relief

Formal and informal industry requests for harmonization of Regulation 4.13(a)(3) and Regulation 4.7 with Rule 506(c) had been tabled numerous times in 2013 and 2014, and on Sept. 10, the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") concluded that "it is appropriate to address [these] issues … by granting exemptive relief."[4] DSIO's relief specifically includes the following provisions:

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- *For Rule 506(c) offerings in which the CPO seeks to claim the reporting relief of Regulation 4.7,* relief from the requirements: (1) that an offering be exempt pursuant to Section 4(a)(2) of the Securities Act; and (2) that interests be offered solely to QEPs; and

- *For Rule 506(c) offerings in which the offering entity seeks to claim the* de minimis *registration exemption of Regulation 4.13(a)(3)*, relief from the requirement in Regulation 4.13(a)(3)(i) that securities be "offered and sold without marketing to the public."

(These provisions are subject to the conditions summarized below.)

This relief is effective immediately. It has no stated period of effectiveness nor does it set forth a predetermined or estimated expiration date; however, the letter noted that the relief may be modified or revoked in DSIO's discretion. DSIO also indicated that it may address this issue in the future through formal rulemaking, in which case the relief in this letter would expire.

Conditions of the CFTC Relief

The CFTC's JOBS Act relief is narrowly tailored to address "the discrepancy between marketing restrictions in current [CFTC] regulations and Reg D and Rule 144A, as amended pursuant to the JOBS Act." Therefore, the relief granted is strictly limited to CPOs involved in 506(c) offerings. (It does not, for example, extend to other Section 4(a)(2), Regulation D or Regulation A offerings.)

This relief is not self-executing; to take advantage of it, relying CPOs — irrespective of whether they are registered or exempt from registration with the CFTC—are required to file a notice with DSIO; this filing will elicit "basic information" on the claiming funds. Claims are effective upon the filing of a "materially complete and accurate" notice.[5]

Remaining JOBS Act Hurdles

Although the resolution of the SEC-CFTC discrepancy is a substantial step forward for private fund managers seeking to take advantage of Rule 506(c)'s general solicitation and general advertising liberalization, significant challenges and uncertainty still surround a Rule 506(c) offering, including the following:

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Verification Requirements. As noted in earlier SRZ publications,[6] managers will only be in a position to opt in to Rule 506(c) general solicitation and general advertising if they take reasonable steps, as required by the final rules, to verify that all investors meet the accredited investor standard. The SEC's final rules provide for both a "principles-based" approach to verification — which takes into account the surrounding facts and circumstances, including the nature of the investor and the size of the investment — as well as specific examples of documentation that will provide sufficient verification that individuals meet the accredited investor tests. Managers seeking to utilize general solicitation or general advertising under Rule 506(c) will need to be sure that they have a satisfactory verification process in place.

Uncertainty on Regulation D Amendments. In 2013, the SEC proposed (and subsequently re-opened a comment period for the discussion of) amendments to Regulation D and Rule 156 that would:

- Require the filing of a Form D in Rule 506(c) offerings before the issuer engages in general solicitation and amend the Form D itself to solicit additional information about offerings conducted in reliance on Regulation D;
- Require the filing of a closing amendment to Form D after the termination of any Rule 506 offering;
- Require written general solicitation materials used in Rule 506(c) offerings to include certain legends and other disclosures;
- Extend the anti-fraud guidance contained in Rule 156 to the sales literature of private funds;
- Require the submission, on a temporary basis, of written general solicitation materials used in Rule 506(c) offerings to the Commission; and
- Disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering.

These proposed amendments could, individually or in the aggregate, constitute a material change in the private funds offering process and could require material changes in the preparation, distribution, review and

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approval of advertising and marketing materials and other documentation. There is considerable uncertainty with respect to these proposed rules because, at this time, there is no obligation that the SEC issue final rules on these matters and it is possible that some may be adopted while others are modified or dropped.

Uncertainty on Future CFTC Requirements. As noted above, the DSIO guidance is interim relief. If and when formal rulemaking to address Rule 506(c) offerings is instituted, it is possible that there would be additional disclosure or substantive requirements; statements by CFTC staff officials indicate that additional requirements are a distinct possibility.

Inconsistent Foreign Offering Requirements. Also, in addition to U.S. requirements, many managers conduct concurrent foreign offerings. In other capital centers, U.S. managers may have no option under local law other than to conduct a private placement; in these cases, managers will have to ascertain (well) in advance — perhaps through the advice of local counsel — whether public advertising and general solicitation for the U.S. leg of an offering will taint or adversely affect the offshore offering.

Examination Risks. The SEC has stated that OCIE examinations will in particular focus on compliance by managers utilizing general solicitation or general advertising under Rule 506(c). The conventional wisdom is that conducting a 506(c) offering may materially increase the risk of being selected for an examination and that the ensuing examination will have a deeper and more thorough than average review of marketing processes, procedures and materials.

Enforcement Inquiries and Actions. With this liberalization of the offering process comes SEC concerns (expressed publicly) about the potential for fraud. There are existing anti-fraud rules applicable to private fund marketing materials, and those rules will continue to apply to any marketing materials used as part of a general solicitation. Marketing activity itself can also be scrutinized on anti-fraud grounds.

Next Steps

With the CFTC's relief, a significant impediment to a general solicitation and general advertising regime for private fund placements has been eliminated, but challenges and questions remain. Managers that seek to take advantage of general solicitation or to engage in general advertising will need to extensively prepare and design bespoke supervisory and

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compliance procedures and will also, given the uncharted nature of this regime, need to be flexible in their approach.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Section 201(a)(1) of the JOBS Act requires that “[n]ot later than 90 days after the date of the enactment of this Act, the Securities and Exchange Commission shall revise [Rule 506] … to provide that the prohibition against general solicitation or general advertising contained in [Rule 502(c)] … shall not apply to offers and sales of securities made pursuant to [Rule 506], provided that all purchasers of the securities are accredited investors. Such rules shall require the issuer to take reasonable steps to verify that purchasers are accredited investors using such methods as determined by the Commission.”

[2] While the general solicitation developments under the JOBS Act, the SEC rulemakings, and the new CFTC relief apply to Rule 144A offerings as well as to Rule 506(c) offerings, the remainder of this *Alert* will focus only on the impact on Rule 506(c) offerings.

[3] Release No. IA-3624, *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings* (July 10, 2013).

[4] “Exemptive Relief from Provisions in Regulations 4.7(b) and 4.13(a)(3) Consistent with JOBS Act Amendments to Regulation D and Rule 144A,” CFTC Letter No. 14-116 (September 9, 2014).

[5] The claim of exemptive relief must:

a. State the name, business address and main business telephone number of the CPO claiming the relief;

b. State the name of the pool(s) for which the claim is being filed;

c. State whether the CPO claiming relief is a 506(c) Issuer or is using one or more 144A Resellers;

d. Specify whether the CPO intends to rely on the exemptive relief pursuant to Regulation 4.7(b) or 4.13(a)(3), with respect to the listed pool(s)

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and: (1) if relying on Regulation 4.7(b), represent that the CPO meets the conditions of the exemption, other than that provision's requirements that the offering be exempt pursuant to section 4(a)(2) of the Securities Act and be offered solely to QEPs, such that the CPO meets the remaining conditions and is still required to sell the participations of its pool(s) to QEPs; and (2) if relying on Regulation 4.13(a)(3), represent that the CPO meets the conditions of the exemption, other than that provision's prohibition against marketing to the public;

e. Be signed by the CPO; and

f. Be filed with DSIO via email using the email address *dsionoaction@cftc.gov* and stating "JOBS Act Marketing Relief" in the subject line of such email.

[6] *See* "General Solicitation and General Advertising to be Permitted in Private Placements Starting September 23" (Aug. 13, 2013); "The SEC'S JOBS Act Rulemaking: What It Means for Private Fund Managers" (July 24, 2013); "The Long View: How Hedge Fund Advertising Has Been Impacted by the JOBS Act" (August 2012); and "The JOBS Act: Provisions Relating to Private Funds and Facilitating Access to Capital" (Mar. 28, 2012).

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