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The Impact of Rule 506(c) on Private Funds and Their Managers Who Are Legally Avoiding Full Registration as Commodity Pool Operators Under the Commodity Exchange Act

Gregory J. Nowak | nowakg@pepperlaw.com
Matthew R. Silver | silverm@pepperlaw.com

The Jumpstart Our Business Startups Act (JOBS Act) directed the U.S. Securities and Exchange Commission (SEC) to eliminate the prohibition against general solicitation or general advertising in any offering of securities pursuant to Rule 506 under the Securities Act for all purposes of the "federal securities laws," provided certain conditions are met. Possibly as a simple oversight, the JOBS Act did not provide complementary directives to the Commodity Future Trading Commission (CFTC).

Starting September 23, 2013, issuers may take advantage of the new general solicitation allowances provided by Rule 506(c). While issuers relying on new Rule 506(c) may only accept investments from accredited investors and must take "reasonable steps" to verify the accredited investor status of investors subscribing to their offerings, the need to curtail Internet and other "public" disclosure about private investments and private funds has largely been eliminated in the context of these new rules.

Many managers of private funds engage in trading in futures and CFTC-regulated swap instruments. In doing so, such managers usually choose to take advantage of exemptions from CFTC registration, the most popular being the so-called "4.13(a)(3) exception" as discussed in greater detail below. Unfortunately, a key component of applicable CFTC exemptions presently prevents "exempt commodity pool operators" that have traditionally been regulated by the SEC from being able to advertise their "pools" or engage in general solicitations. In other words, to maintain their commodity pool operator exemption, they must avoid using Rule 506(c).

What Is a Commodity Pool?

The CFTC considers an investment trust, syndicate, or similar form of enterprise operated for the purpose (but not necessarily the primary purpose) of trading commodity futures (including many forms of swaps) or option contracts to be a "commodity pool." As noted by the CFTC, a commodity pool is typically thought of as an enterprise engaged in the business (at least in part) of investing the collective or "pooled" funds of multiple participants in trading commodity futures or options, where participants share in profits and losses on a *pro rata* basis.[1]

What Is a Commodity Pool Operator?

A commodity pool operator (CPO) is a party who solicits or accepts funds, securities, or property for a commodity pool for the purpose of trading commodity futures contracts (including CFTC-regulated swaps) or commodity options. The commodity pool operator either itself makes trading decisions on behalf of the pool or engages a commodity trading adviser to do so.[2]

Funds that are not primarily commodities/futures/swaps-based generally rely on Rule 4.13(a)(3) in seeking an exemption from registering with the CFTC. Applying for the registration

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exception is a simple online process. Aside from ensuring that the fund stays within limitations required by the exemption,[3] the only additional practical work for most reliant funds is the addition of specific disclaimer language in offering materials, and a yearly re-certification that Rule 4.13(a)(3) standards[4] have been met. A CPO seeking or maintaining exemption pursuant to Rule 4.13(a)(3) may not market interests in the pool to the general public.[5]

A more cumbersome and intensive alternative to Rule 4.13(a)(3) is CFTC Rule 4.7.[6] Rule 4.7 registration (sometimes referred to as "light touch" registration) allows a CPO to claim an exemption from certain reporting, recordkeeping and disclosure requirements imposed on a registered CPO. Use of 4.7[7] also requires that the fund must be offered or sold "*without marketing to the public*."

What Is a Commodity Trading Adviser?

Additionally, parties supplying CFTC product-related trading advice to CPOs need to deal with commodity trading adviser (CTA) issues. For CFTC purposes, a CTA is any person who, for pay, regularly engages in the business of advising others as to the value of commodity futures or options, or the advisability of trading in commodity futures or options, or issues analyses or reports concerning commodity futures or options. CTAs generally rely on one of the various provisions contained in Rule 4.14 for an exemption from registering with the CFTC. If a CTA is a registered investment adviser under the Investment Advisers Act of 1940 and chooses to rely, in whole or in part, on an exemption for CFTC regulation or a CTA pursuant to Rule 4.14(a)(8)(C)[8] that is designed for commodity pools organized and operated outside the United States, then that adviser becomes subject to the prohibition that states: "[n]o person affiliated with the pool conducts any marketing activity for the purpose of, or that could reasonably have the effect of, soliciting participation from other than non-United States persons." Thus, one more hurdle to enjoy the benefits of Rule 506(c) exists.

> ***Pepper Point:*** *Fully registered CPO pools (where the CPO is not relying on the 4.13(a)(3) or 4.7 exemption) are not restricted by the CFTC from engaging in public solicitation. However, fully registered CPO pools are subject to much more active regulation by the CFTC and the CFTC's primary self-regulatory organization – the National Futures Association (the NFA). Further, an adviser to a CPO can register with the CFTC as a CTA or, generally, take advantage of one or more of the various exclusions afforded under Rule 4.14 (other than Rule 4.14(a)(8)(C)).*

Short-Term Issues for Private Funds Employing CFTC Exemptions and Wishing to Use 506(c)

Many (if not most) U.S. hedge fund operators currently make use of 4.13(a)(3) or 4.7 CFTC exemptive rules.

As it stands, firms that *rely* on Rule 4.13(a)(3) or Rule 4.7 cannot publically solicit or advertise as of September 23, 2013, even if they make a Rule 506(c) filing with the SEC. Of course, a certain percentage of funds for which a Rule 4.13(a)(3) filing has been made do not actually trade in CFTC-regulated products or actually rely on the 4.13(a)(3) exemption – a 4.13(a)(3) filing is sometimes made as a prophylactic "just in case" filing to allow the manager to engage in certain types of transactions should the need (however unlikely) arise. Further, a CPO (registered or unregistered) can choose to advertise certain funds under Rule 506(c) (where a CFTC exemption is not otherwise needed) and use the reliable, no-advertising standby of Rule 506(b) for select other funds.

> ***Pepper Point:*** *The ball is now in the CFTC's court. We understand that multiple parties have asked, formally or informally, that the CFTC provide relief to parties seeking to employ CFTC exemptions and simultaneously take advantage of Rule 506(c). Possibilities would include the adoption of full CFTC rules to work in concert with Rule 506(c), some sort of temporary relief, or a "patch" approach that might state that "marketing to the public" in a Rule 506(c) context would not be deemed to violate Rule 4.13(a)(3), Rule 4.7 or Rule 4.14(a)(8)(C).*

> ***Pepper Point:*** *Private funds seeking to make use of the provisions of Rule 506(c) should either wait for additional guidance from the CFTC or operate their funds (at least temporarily) so as not to need to rely on the exemption provided by Rule 4.13(a)(3). Funds relying on Rule 4.7 generally engage in a higher degree of CFTC-regulated transactions so they may be more dependent on CFTC action.*

> *As the value of Rule 506(c) ultimately depends on what action the CFTC decides to take for exempt pools and what additional limitations the CFTC (and SEC)[9] places on funds making use of Rule 506(c), we would expect clarifications to be issued sooner rather than later. Given how the SEC and CFTC have successfully been working together on harmonizing CFTC Rule 4.5 (as applicable to registered investment companies), we would hope that the CFTC would issue some sort of guidance or relief for at least 4.13(a)(3) reliant funds.*

> ***Pepper Point:*** *There are three options for affected funds: (1) do not use Rule 506(c) and remain under 4(a)(2) of the Securities Act or Rule 506(b) instead, and do not engage in a public offering or general solicitation; (2) split the fund into a Rule 506(c) securities part and a non-publicly solicited CFTC part, which may prove difficult in practice; or (3) embrace regulation and become a fully registered CPO. This last option provides the most complete protection, and provides the greatest degree of manager freedom, but at the cost of additional regulation by the CFTC and NFA, and the need for certain adviser personnel to take and pass the necessary qualification exams (primarily the Series 3 examination).*

If you have any questions, please contact the authors or any member of the Pepper Hamilton Investment Funds Group.

Endnotes

1. See http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_co.

2. Although not clear from the statutes themselves, for a hedge fund or private equity fund that is effectively managed or controlled by a general partner or managing member and does not have an internal, self-managing structure, the CFTC and the National Futures Association have informally asserted that it is the general partner or manager that is the CPO and not (also) the legal fund entity itself (which is just considered to be the commodity pool). This is in contrast to the registered fund world, where that "fund" is the CPO.

3. These limitations include, chiefly, (a) selling to only accredited investors or other allowable parties, and (b) at all times, the pool meets one or the other of the following tests with respect to its commodity interest positions: (i) the aggregate initial margin, premiums, and required minimum security deposits does not exceed 5 percent of the liquidation value of the fund's portfolio after taking into account unrealized profits and losses on any such positions; *or* (ii) the aggregate net notional value of such positions does not exceed 100 percent of the liquidation value of the fund's portfolio after taking into account unrealized profits and losses on any such positions. "Commodity interest positions" include such things as futures, options on futures, CFTC-regulated swaps and retail forex transactions.

4. A handy reference sheet for all major CPO exemptions is available at http://www.nfa.futures.org/nfa-compliance/NFA-commodity-pool-operators/easy-reference-guide-part4.pdf.

5. Specifically, Section 4.13(a)(3) requires that "Interests in the pool are exempt from registration under the Securities Act of 1933, *and* such interests are offered and sold without marketing to the public in the United States." It is the "and" and the following dependent clause that appears to be problematic. If that clause didn't exist, arguably the incorporation of the Securities Act exemptions would carry with it the new JOBS Act protocols, allowing general solicitation.

6. When Rule 4.7 was adopted in 1992, it was intended to be generally consistent with Regulation D, other than Rule 4.7's somewhat more restrictive investor suitability criteria. Rule 4.13(a)(3), which was adopted in 2003, generally requires investors to be accredited investors as defined in Regulation D. Thus, each of the rules generally worked well and in concert with Regulation D before JOBS Act notifications.

7. Rule 4.7(b) states, in part, "(b) *Relief available to commodity pool operators*. Upon filing the notice required by paragraph (d) of this section, and subject to compliance with the conditions specified in paragraph (d) of this section, any registered commodity pool operator *who offers or sells participations in a pool solely to qualified eligible persons in an offering which qualifies for exemption from the registration requirements of the Securities Act pursuant to section 4(2) of that Act or pursuant to Regulation S*, 17 CFR 230.901 *et seq*., and any bank registered as a commodity pool operator in connection with a pool that is a collective trust fund whose securities are exempt from registration under the Securities Act pursuant to section 3(a)(2) of that Act and are *offered or sold, without marketing to the public, solely to qualified eligible persons*, may claim any or all of the following relief with respect to such pool."

   Although Rule 506 was originally intended as a safe harbor for firms employing Section 4(2) of the Securities Act, Section 4(2) of the Securities Act still does not permit public offerings or general advertising. Taking such an approach required employing Rule 506(c).

[8] The text of the rule is available at http://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&rgn=div5&view=text&node=17:1.0.1.1.4&idno=17#17:1.0.1.1.4.1.7.12.

[9] See new 506(c)-connected proposals made by the SEC in the form of SEC Release 33-9416, with comments due September 23, 2013, available at http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

More Resources on the JOBS Act

For additional information, please visit Pepper's JOBS Act Resource Center available online at http://www.pepperlaw.com/news.aspx?AnnouncementKey=1957.

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