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General Solicitation Under the JOBS Act: Practical Tips for CPOs and CTAs

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Background

The U.S. Securities and Exchange Commission (SEC) recently adopted amendments (Final Rule) to Rule 506 under the Securities Act of 1933, as amended (Act). The Final Rule, which becomes effective September 23, 2013, eliminates the prohibition on general solicitation or general advertising in Rule 506 offerings and provides guidance on how issuers of securities, including hedge funds, can verify purchasers of such securities are “accredited investors.” The Jumpstart Our Business Startups Act (JOBS Act), which was enacted on April 5, 2012, directed the SEC to eliminate the prohibition against general solicitation or general advertising in any offering of securities pursuant to Rule 506 under the Act, provided the sales are made to accredited investors, and the issuer, including a hedge fund, takes reasonable steps to determine that purchasers are accredited investors.

As discussed in [our previous update](#), some managers of private investment funds relying on the Final Rule may trade commodities or derivatives and rely on certain exemptions from complying with the rules of the Commodity Futures Trading Commission (CFTC); this bulletin provides additional information for managers and funds seeking to take advantage of the Final Rule while also seeking an exemption from the relevant CFTC rules.

The CFTC has yet to address the issues the Final Rule raises for commodity pool operators (CPOs) and commodity trading advisers (CTAs) seeking an exemption from certain CFTC rules. Although it remains to be seen how the CFTC will amend its relevant rules, CPOs are advised to refrain from engaging in general solicitation or general advertising activities until the CFTC amends the rules.

CPOs

A CPO is defined generally to include any person who solicits or accepts funds, securities or property for the purpose of trading commodity futures contracts or commodity options. CPOs generally rely on Rule 4.13(a)(3) in seeking an exemption from registering with the CFTC, and they rely on Rule 4.7(b) in seeking relief from certain reporting, recordkeeping and disclosure requirements otherwise applicable to a registered CPO.

Although other provisions in Rule 4.13 allow CPOs to avoid registering with the CFTC,¹ most, including hedge funds, generally rely on Rule 4.13(a)(3).² A CPO seeking exemption pursuant to Rule 4.13(a)(3) may not market interests in the pool to the general public. This requirement conflicts with the Final Rule, which most hedge funds would presumably rely upon in marketing interests in the fund. A CPO, including a hedge fund, seeking to take advantage of the Final Rule may either wait for additional guidance from the CFTC or abandon reliance on the exemption provided by Rule 4.13(a)(3).

Rule 4.7(b) allows a CPO to claim an exemption from certain reporting, recordkeeping and disclosure requirements imposed on a registered CPO. Pool interests must only be offered to “qualified eligible persons” as such term is defined by the Investment Company Act of 1940, as amended, and such persons must have at least a \$2 million investment portfolio. However, a CPO may only claim an exemption pursuant to Rule 4.7(b) if the pool interests are offered or sold without marketing to the public. As with the requirement under Rule 4.13(a)(3), the requirement that pool interests be offered or sold without marketing to the public conflicts with the Final Rule. A CPO, including a hedge fund, seeking to take advantage of the Final Rule may either wait for additional guidance from the CFTC or abandon reliance on the exemption provided by Rule 4.7(b).

CTAs

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 Rule 4.14 in seeking exemption from registering with the CFTC, and they rely on Rule 4.7(c) in seeking relief from certain reporting, recordkeeping and disclosure requirements otherwise applicable to a CTA. Unlike the exemptions for CPOs, the exemptions for CTAs pursuant to Rules 4.7(c) and 4.14 do not impose any limitations on general solicitation. However, if a CTA is relying on an exemption pursuant to Rule 4.14(a)(8)(C) and is a registered investment adviser advising commodity pools outside the United States, no person affiliated with such commodity pool may engage in marketing activity soliciting participation from non-U.S. persons or within the United States.

Final Rule

The Final Rule adds new paragraph (c) to Rule 506, which states that the prohibition against general solicitation or general advertising shall not apply provided all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify this. The Final Rule provides a non-exclusive list of steps an issuer may take to determine accredited investor status; however, an issuer must also develop a principles-based verification method whereby the “reasonable steps” shall be an objective determination by the issuer based on the facts and circumstances. If a hedge fund plans to engage in general solicitation or general advertising, a CTA should determine what role, if any, it can expect to play in marketing the hedge fund and what steps it is required to take to determine the accredited investor status of any fund investor.

Conclusion

While the SEC has adopted the Final Rule as required by the JOBS Act, CPOs are advised to refrain from engaging in general solicitation or general advertising lest they be unable to use the exemptions offered by Rules 4.7(b) and 4.13(a)(3). Although it's likely only a matter of time before the CFTC acts to reconcile differences with the Final Rule, the consequences of failing to register with the CFTC without a valid exemption warrants complying with the letter of the law in its current state. CTAs should begin to discuss with their managed hedge funds the CTA's responsibilities in complying with the Final Rule; namely, the allocation of responsibility for determining whether an investor in the hedge fund is an accredited investor.

FOR MORE INFORMATION

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¹Rule 4.13(a)(1) provides an exemption if the CPO does not receive any compensation for operating the pool, except reimbursement of administrative expenses; it operates only one commodity pool at any time; any of its business affiliates is not required to register with the CFTC; and it does not advertise in connection with the pool. Rule 4.13(a)(2) provides an exemption if none of the pools operated by the CPO has more than 15 participants at any time and the total gross contributions received for units of participation in all pools operated by, or intended to be operated by, the CPO does not exceed \$400,000 in the aggregate.

²Pursuant to Rule 4.13(a)(3), the CPO's commodity interest positions must meet either of the two following tests to qualify for exemption: the aggregate initial margin, premiums and required minimum security deposit for retail forex transactions required to establish such positions, determined at the time the most recent position was established, will not exceed 5 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into; or the aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into.
