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CFTC Adopts Amendments to Registration Exemptions for CPOs and CTAs and Proposes Harmonization Rules for Registered Fund CPOs

On February 9, 2012, the Commodity Futures Trading Commission (the "**CFTC**") adopted final rule amendments (the "**Final Rules**") relating to the registration of commodity pool operators ("**CPOs**") under the Commodity Exchange Act (the "**CEA**"). The amendments, initially proposed by the CFTC in a February 2011 release (the "**Proposing Release**"), will significantly narrow the relief from CPO registration currently available for advisers to, and sponsors of, private funds and investment companies registered under the Investment Company Act of 1940 ("**RICs**").[1] The Final Rules will become effective 60 days after the publication of the release adopting the rules (the "**Adopting Release**") in the Federal Register, with compliance dates as discussed further herein.

For private funds, the amendments will rescind the exemption under CFTC Rule 4.13(a)(4) for CPOs of private funds offered only to certain highly sophisticated investors. The CFTC had also proposed to rescind the exemption provided by CFTC Rule 4.13(a)(3), but determined in the Adopting Release to retain that exemption. Rescission of the Rule 4.13(a)(4) exemption means that sponsors of private funds that invest in futures (including financial futures, such as interest rate, currency, index and security futures), commodity options and, upon the issuance of final rules defining the term "swap," most types of swaps (excluding security-based swaps, but including interest rate, currency and other financial swaps, and swaps on broad-based securities indices) (collectively, "**Commodity Interests**") will be required either to register with the CFTC as CPOs or to comply with the requirements of another exemption, such as Rule 4.13(a)(3), which permits limited trading in Commodity Interests.

With respect to RICs, the amendments will restrict the scope of the exclusion from CPO registration for RICs under CFTC Rule 4.5. The investment adviser to a RIC that invests in Commodity Interests will be required to register with the CFTC as a CPO, unless the RIC complies with specified limitations on trading in Commodity Interests and marketing restrictions under the amended Rule 4.5 exclusion. Concurrently with its issuance of the Adopting Release, the CFTC issued a separate release (the "**Harmonization Release**") proposing to amend certain disclosure, reporting and recordkeeping requirements for CPOs to address potential inconsistencies with the requirements of the Securities Exchange Commission ("**SEC**") for RICs.

Background

Registration of CPOs and commodity trading advisors ("**CTAs**") is required under Section 4m(1) of the CEA. CFTC rules require that CPOs and CTAs comply with disclosure, recordkeeping and other requirements, unless an exemption is available. A "commodity pool" is defined in the CEA to include "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in" Commodity

[1] In addition to the amendments to Rule 4.13 and Rule 4.5 described in this memorandum, the Final Rules also: (1) eliminate an exemption from the requirement to provide audited financial statements in annual reports under CFTC Rule 4.7 for commodity pools whose participants are "qualified eligible persons"; (2) incorporate by reference, rather than by full inclusion of its specific text, the accredited investor standard from Regulation D under the Securities Act of 1933 into the definition of "qualified eligible person" in Rule 4.7; (3) adopt new CFTC Rule 4.27, which requires registered CPOs and commodity trading advisors to file, respectively, Forms CPO-PQR and CTA-PR with the National Futures Association as the CFTC's delegatee; and (4) adopt a mandatory Risk Disclosure Statement for CPOs and commodity trading advisors addressing certain risks specific to swap transactions.

Interests.[2] CFTC staff have taken the position that any transaction by a fund in Commodity Interests, no matter how limited in scope and regardless of whether undertaken for hedging or speculative purposes, will bring the fund within the definition of a "commodity pool." The Rule 4.5 exclusion from the CPO definition for certain pooled investment vehicles subject to other regulatory frameworks and the Rule 4.13(a)(4) exemption available to managers of private funds offered only to qualifying investors, including "qualified purchasers" as defined in the Investment Company Act of 1940 (the "**Investment Company Act**"), have significantly reduced the impact of CPO registration requirements on RICs and privately offered funds.

Rule 4.13(a)(4) and 4.13(a)(3) exemptions

Many private fund sponsors have relied upon either the Rule 4.13(a)(4) exemption or the Rule 4.13(a)(3) exemption to avoid CPO registration requirements since these exemptions became available in 2003.[3]

The Rule 4.13(a)(4) exemption currently is available to CPOs of private funds whose participants are limited to persons that the CPO reasonably believes at the time of investment are either: (i) natural persons who are "qualified eligible persons" ("**QEPs**") under Rule 4.7(a)(2), which includes "qualified purchasers" and "knowledgeable employees," as defined in Rule 3c-5 under the Investment Company Act or (ii) non-natural persons who are either QEPs under CFTC Rule 4.7 or institutional "accredited investors" as defined in Regulation D under the Securities Act of 1933 (the "**Securities Act**"). The exemption requires interests in the fund to be exempt from registration under the Securities Act. Private funds that meet the requirements of the Rule 4.13(a)(4) exemption currently are permitted to undertake unlimited trading in Commodity Interests, whether for hedging or speculative purposes. Because the Rule 4.13(a)(4) exemption is available to private funds whose investors are all "qualified purchasers," most private funds that rely on the Section 3(c)(7) exclusion from the Investment Company Act and transact in Commodity Interests have made use of the Rule 4.13(a)(4) exemption.

The Rule 4.13(a)(3) exemption is available to CPOs of private funds that engage only in a limited amount of trading in Commodity Interests. The exemption is limited to CPOs of funds whose Commodity Interest trading satisfies one of two quantitative standards: (i) the aggregate initial margin and premiums required to establish Commodity Interest positions, determined at the time the most recent position was established, will not exceed 5 percent of the liquidation value of the fund's portfolio (taking into account unrealized profits and losses) (the "**Margin Test**") or (ii) the aggregate net notional value of the fund's Commodity Interest positions does not exceed 100 percent of the portfolio's liquidation value (the "**Net Notional Test**"). Interests in the fund must be exempt from registration under the Securities Act, and the fund may not be marketed as a vehicle for trading in Commodity Interests. While the Rule 4.13(a)(3) exemption limits the extent of trading in Commodity Interests by a fund, the investor qualification standards are less restrictive than those of the Rule 4.13(a)(4) exemption.[4]

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[2] Section 1a(10) of the CEA. Prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), commodity pools were defined as vehicles transacting in futures or commodity options. Dodd-Frank amended the definition of "commodity pool" to include vehicles that transact in swaps. The CFTC and the SEC have issued proposed rules to define the term "swap" and other terms used in Dodd-Frank, and certain requirements described herein will not become effective until the effective date of the definitional rules.

[3] To claim either the Rule 4.13(a)(4) or Rule 4.13(a)(3) exemption, a private fund sponsor is required to (i) file a notice of eligibility with the National Futures Association ("**NFA**"), (ii) provide a cautionary statement to investors that the CPO is exempt from registration and therefore is not required to comply with disclosure and reporting requirements applicable to registered CPOs, and (iii) agree to provide certain books and records and other information to the CFTC upon request.

[4] In addition to persons eligible to participate in a Rule 4.13(a)(4) exempt pool, investors in a Rule 4.13(a)(3) exempt pool may include any "accredited investors" as defined in Regulation D under the Securities Act, family trusts formed by accredited investors, (*cont.*)

The Proposing Release contemplated the elimination of both the Rule 4.13(a)(3) and (4) exemptions. In the Proposing Release, the CFTC attributed its proposed rescission of these exemptions to the lack of "transparency or accountability" in the activities of the "large group of market participants" relying upon the exemptions, changes in the regulatory environment evidenced by Dodd-Frank, and the recently adopted requirement that advisers to private funds register with the SEC as "private fund advisers."

Rule 4.5 Exclusion

The Rule 4.5 exclusion from the CPO definition was adopted in 1985.[5] Currently, a RIC whose CPO relies on the exclusion is permitted to engage in unrestricted trading in Commodity Interests, provided that the requisite notice of eligibility for the exclusion has been filed with the NFA and the RIC complies with the disclosure requirements set forth in the rule.

Prior to August 2003, a RIC whose CPO that relied upon the Rule 4.5 exclusion was required to limit its futures and commodity option positions to bona fide hedging positions and positions for which aggregate initial margin or premiums did not exceed 5 percent of the liquidation value of its portfolio. In 2010, the NFA petitioned the CFTC to reinstate these trading restrictions. NFA's petition noted its concern that a number of publicly offered RICs were investing primarily in futures and other derivatives and marketing themselves as actively managed commodity futures funds, without complying with the requirements that would apply to registered CPOs. The RICs identified by the NFA obtained their exposures to futures and other derivatives primarily by investing a portion of their assets in wholly owned controlled foreign corporations ("**CFCs**") transacting in futures and other derivatives. The NFA commented that because, according to the NFA, such CFCs were not subject to regulation under the Investment Company Act, reliance by the parent RIC on the Rule 4.5 exclusion might be inappropriate. The Proposing Release sought comment on possible rule amendments requested by the NFA.

Final Rule Amendments

Rule 4.13(a)(4) and 4.13(a)(3) Exemptions

The CFTC's Final Rules eliminate the Rule 4.13(a)(4) exemption but retain the Rule 4.13(a)(3) exemption. Despite requests from commenters, the CFTC declined to adopt any exemptions for foreign private advisers, funds of funds or family offices at this time, but indicated that the CFTC has directed its staff to consider a possible family office exemption in the future.

Application of net notional test. The Final Rules specify how the "notional value" of futures, options and cleared swaps is to be calculated for purposes of the Net Notional Test under Rule 4.13(a)(3) and provide for netting of futures contracts with the same underlying commodity across designated contract markets, foreign boards of trade, and swaps cleared on the same designated clearing organization, where appropriate.

Annual notice requirement. The Final Rules amend the notice filing requirement for the Rule 4.13(a)(3) exemption. Currently, a single notice must be filed to claim the exemption. Under the amended rule, persons relying on the exemption are required to reaffirm their claim by filing a notice with the NFA on an annual basis within 60 days of the calendar year-end.

(*cont.*)

"knowledgeable employees" as defined in Rule 3c-5 under the Investment Company Act, and certain other employees of the operator or advisor.

[5] Rule 4.5 also provides an exclusion from the CPO definition for several other types of entities that are subject to separate regulatory regimes, such as insurance companies managing separate accounts, banks and trust company fiduciaries for trust or custodial accounts, and benefit plan trustees and fiduciaries. The Final Rules did not amend the exclusions for these entities.

Amendment to Rule 4.14(a)(8). Rule 4.14(a)(8) permits commodity interest trading advice to be provided to certain entities by an investment adviser that is registered or exempt from registration with the SEC, or is excluded from the definition of "investment adviser" under Section 202(a)(2) or 202(a)(11) of the Investment Advisers Act of 1940, and that does not otherwise hold itself out as a CTA. Such advice must be "solely incidental" to the securities advice provided by the investment adviser. The exemption is currently available with respect to advice that is provided to CPOs exempt from registration under Rule 4.13(a)(4) or (3) (among others). Due to the rescission of the Rule 4.13(a)(4) exemption, the Final Rules also amend Rule 4.14(a)(8) to eliminate the reference to Rule 4.13(a)(4). However, an investment adviser/manager to a private fund whose CPO is exempt under Rule 4.13(a)(3) may continue to rely on the Rule 4.14(a)(8) exemption from CTA registration.

Compliance date for Rule 4.13(a)(4) and 4.13(a)(3) amendments. The Final Rules will become effective 60 days after publication in the Federal Register. The Rule 4.13(a)(4) exemption will cease to be available as of the effective date with respect to a fund for which the CPO has not previously claimed the exemption. A CPO that has claimed the Rule 4.13(a)(4) exemption with respect to a fund prior to the effective date will not be required to comply with the exemption's rescission for such fund until December 31, 2012. The compliance date for all other changes is December 31, 2012.

Rule 4.5 Exclusion

The Final Rules reinstate the pre-2003 conditions for the Rule 4.5 exclusion for CPOs of RICs, but with several significant changes, as discussed below.

Alternative net notional test. The Proposing Release sought comment on a proposed requirement that eligibility for the exclusion be limited, with respect to RICs, by a condition that initial margin and premiums required for Commodity Interest positions for non-bona fide hedging purposes not exceed 5 percent of the liquidation value of the RIC's portfolio. The Final Rules include this condition as proposed but also provide an alternative net notional test, under which the aggregate net notional value of a RIC's Commodity Interest positions may not exceed 100 percent of the liquidation value of its portfolio, excluding Commodity Interests held solely for bona fide hedging purposes.[6]

The Final Rules also define the "notional value" and permissible netting of Commodity Interest positions for purposes of the net notional test under Rule 4.5, in a manner consistent with the Rule 4.13(a)(3) amendments, discussed above.

Marketing restriction. The Rule 4.5 exclusion also requires that a RIC not be marketed to the public as "a vehicle for trading in the commodity futures, commodity options, or swaps markets." The Proposing Release also included the parenthetical "(or otherwise seeking investment exposure to)" after "trading in" in the marketing restriction, but this language was rejected in response to concerns from commenters that the term was ambiguous and offered no significant benefit.

Many commenters had expressed concern that the marketing restriction, even without the excised parenthetical, would be difficult to apply. The Adopting Release includes guidance on the factors to be considered in determining compliance with the marketing prohibition, which include: (i) the name of the fund; (ii) whether the fund trades in Commodity Interests through a CFC; (iii) whether the fund's "primary

[6] The net notional test under Rule 4.5 differs from the test under Rule 4.13(a)(3), in that Rule 4.13(a)(3) does not carve out the use of futures, options, or swaps for bona fide hedging purposes from the 100 percent calculation. Although bona fide hedging transactions do not count toward the thresholds described above for RICs that rely on Rule 4.5, it should be noted that, under recent amendments to CFTC Rule 1.3(z) and new CFTC Rule 151.5, bona fide hedging transactions for RICs are likely to be limited to those involving the hedging of positions in certain financial commodities. See Position Limits for Futures and Swaps, 76 Fed. Reg. 71626 (Nov. 18, 2011), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-28809a.pdf

investment objective is tied to a commodity index"; (iv) whether the fund's marketing materials refer to the benefits of derivatives or use a derivative index as a point of reference; (v) whether the fund indirectly or directly has net speculative commodity exposure through Commodity Interests in the normal course of trading; (vi) whether the fund's primary source of income and losses are directly or indirectly from Commodity Interests; and (vii) whether a managed futures strategy is explicitly offered. The CFTC stated that no factor is dispositive and while the final factor would be weighted more heavily, its absence would not prevent the finding of a violation if other indicia were present. The CFTC also clarified that mere disclosure of the possibility of derivatives trading incidental to a RIC's main investment strategy, and disclosure of the attendant risks, would not violate the marketing prohibition.

Annual notice requirement. The Final Rules amend the NFA notice filing requirement for RICs claiming the Rule 4.5 exclusion to require reaffirmance of such claims by annual notice filing with the NFA.

Additional Guidance

The Adopting Release also provided the following additional guidance on the application of CPO requirements to RICs.

Adviser as CPO. In the Adopting Release, the CFTC agreed with commenters that, for RICs that are unable to rely upon the Rule 4.5 exclusion, the RIC's investment adviser would be the entity required to register as the CPO, noting that to require members of a RIC's board to register would raise "operational concerns" for the RIC.

Use of Controlled Foreign Corporations. In the Adopting Release, the CFTC noted that some RICs that invest in Commodity Interests through CFCs had taken the view that the CFC was merely a "subdivision" of the RIC, rather than a separate commodity pool, and therefore could rely on the RIC's Rule 4.5 exclusion. The CFTC rejected this view, as well as calls from commenters that, in the event the CFTC were to consider a CFC a separate commodity pool, relief from CPO registration should be provided. Because the Rule 4.13(a)(4) exemption will no longer be available, the CFTC's position that the CFC is a separate commodity pool would require, absent other available relief, that the CPO of a CFC register with the CFTC.

Harmonization Proposal

In response to concerns raised by commenters concerning potential conflicts between the CFTC's requirements for CPOs and those of the SEC applicable to RICs, the CFTC issued the Harmonization Release at the same time as the Adopting Release for the Rule 4.13 and Rule 4.5 amendments. In this release, the CFTC proposed exemptions or modifications to certain requirements of the Part 4 rules (the "**Harmonization Amendments**") for RICs whose advisers will be required to register as CPOs with the CFTC, including the following.

- Registered CPOs generally are required by CFTC rules to provide a Disclosure Document containing prescribed information to investors no later than the time at which a subscription agreement is delivered, and must receive a signed and dated acknowledgment of the Disclosure Document before accepting any funds for purchase of participations in the pool. Registered CPOs are also required to provide periodic (generally monthly) statements to investors that indicate, among other things, the NAV of the fund and the NAV per share. The Harmonization Amendments would permit the CPO of a RIC to provide the information required under CFTC rules in the RIC's prospectus (rather than in a separate Disclosure Document). A RIC also would be permitted to satisfy the delivery requirements by posting its prospectus/Disclosure Document and periodic statements on the RIC's website, and would be exempted from the requirement to receive a signed acknowledgment from investors.
- Registered CPOs are generally required by CFTC rules to maintain their books and records at their main business office. The Harmonization Amendments would permit the CPO of a RIC to

maintain books and records with a third party, such as the RIC's broker, custodian, transfer agent or administrator, provided that the CPO files a notice with the NFA specifying the location of such books and records.

- Registered CPOs are required by CFTC rules to provide certifications of their annual and periodic reports. The Harmonization Amendments propose that the CFTC would accept certifications filed by RICs with the SEC on Form N-CSR.
- Registered CPOs are required by CFTC rules to provide a "break-even point," which is the amount of trading profit that the pool must realize in the first year in order for an investor to recoup its initial investment. Such information, along with other information that is required by CFTC rules to be provided in the forepart of a Disclosure Document, may be presented immediately following the summary prospectus (for an open-end RIC) or in the forepart of the prospectus (for a closed-end RIC). Registered CPOs are also required to disclose certain fees and expenses that are not required to be disclosed by the SEC registration forms for RICs. The Harmonization Amendments would require a RIC to disclose such fees and expenses along with an analysis of how the break-even point was calculated.
- Registered CPOs currently are required by CFTC rules to update their Disclosure Documents every nine months. The Harmonization Amendments would extend this period to twelve months for all CPOs, which is more consistent with requirements applicable to RICs under the federal securities laws.
- Registered CPOs are required by CFTC rules to provide certain performance information, the inclusion of which in the RIC's prospectus would conflict with SEC requirements. The Harmonization Amendments would permit such information to be provided in a RIC's Statement of Additional Information, which is filed as part of its SEC registration statement and available on request to prospective investors. The Harmonization Release acknowledges that the CFTC requirement may conflict with SEC requirements regarding presentation of past performance for RICs, and states that in preliminary discussions with the SEC on the issue, the SEC has stated that it would "consider requests for no-action relief regarding the performance presentations, if necessary and appropriate."
- Registered CPOs are required by CFTC rules to provide a cautionary disclaimer on the cover page of a Disclosure Document, which differs from the cautionary statement that the SEC requires on the cover of a RIC prospectus pursuant to Rule 481 under the Securities Act. The Harmonization Amendments propose an alternative statement that combines the CFTC and SEC language.

Compliance date for Rule 4.5 amendments. In the Adopting Release, the CFTC acknowledged that a "short implementation period" for the implementation of the Rule 4.5 amendments is "not practicable," due to the need for harmonization between applicable CFTC and SEC requirements and the inclusion of swaps in the threshold tests for the Rule 4.5 exclusion. Accordingly, compliance with the amendments to Rule 4.5 for purposes of registration only will occur on the later of either December 31, 2012 or within 60 days following the adoption of final rules defining "swap" and establishing margin requirements for such instruments. CPOs required to register due to the amendments to Rule 4.5 will be subject to the CFTC's recordkeeping, reporting, and disclosure requirements within 60 days following the effectiveness of final rules implementing the CFTC's proposed harmonization effort.

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