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CFTC Staff Responds to FAQs Regarding Rescission/Modification of CPO/CTA Registration Exemptions

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Introduction

The Division of Swap Dealer and Intermediary Oversight (“DSIO”) of the Commodity Futures Trading Commission (“CFTC”) issued responses on August 14, 2012 to frequently asked questions (“FAQs”)¹ submitted by several trade associations, the National Futures Association (“NFA”) and law firms in the wake of the CFTC’s amendments to its regulations governing commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”) adopted earlier this year.² The FAQs address who must register as a CPO and an associated person (“AP”) of such CPO, how to comply with the remaining CPO registration exemption under CFTC Regulation 4.13(a)(3), and various transition and compliance date issues.

The CFTC amendments rescinded the CPO registration exemption for operators of private funds who limit their investors to highly sophisticated persons (and rescinded the related exemption for advisers to private funds) and modified the exclusion relied on by operators of registered investment companies (“RICs”) from registration as a CPO or CTA under CFTC Regulations 4.5, 4.13(a)(4) and 4.14(a)(8). When the amendments were adopted, the CFTC permitted CPOs and CTAs that filed exemption/exclusion notices in accordance with these regulations prior to the effective date of the rescission/modification, April 24, 2012, to continue to operate under the prior exemption/exclusion through December 31, 2012. For commodity pools created on or after April 24, 2012, however, the rescinded exemption and unmodified exclusion can no longer be claimed by operators or advisers of such pools. On July 13, 2012, DSIO issued a no-action letter that essentially extends the effective date of the exemption rescission and the modification of the exclusion for pools launched after the issuance of the letter until December 31, 2012.³

Who Must Register as a CPO?

Many RICs use a controlled foreign corporation (“CFC”) to trade directly in the commodity interest markets, with the RIC only having exposure to the commodity interest markets through the CFC. When the CFTC adopted the amendments, it stated that the RIC’s adviser may be considered the CPO of the RIC and register as such. DSIO stated that the RIC’s CPO should also be the CPO for the CFC, to the extent that the RIC’s CPO makes the determination regarding the engagement of CTAs and the allocation of CFC assets. DSIO also stated that any wholly-owned trading subsidiary of a commodity pool shall be deemed to be and regulated as a commodity pool. DSIO further stated that, even though a RIC’s adviser may register as the CPO rather than the board of directors or trustees of the RIC itself,

¹ To view the FAQs and responses thereto, please click [here](#).

² 77 Fed. Reg. 11252 (February 24, 2012).

³ To view the K&L Gates Alert on that no-action relief, please click [here](#).

the board of directors or trustees are still subject to prohibitions under the CEA that are applicable to all market participants, including, but not limited to, the anti-fraud and anti-manipulation proscriptions, as well as the CEA's private right of action provisions.

DSIO also stated that the general partner, managing member or board of directors of a commodity pool may delegate its rights and obligations as CPO to another person, provided that such other person is registered as a CPO. The delegating entity must agree to remain jointly and severally liable with respect to any violations of the Commodity Exchange Act ("CEA").

AP Registration Exemption

DSIO confirmed that, if a securities limited representative with a Series 6 license restricts his commodity interest related activities to the sale of interests in commodity pools, the limited representative is exempt from AP registration under CFTC Regulation 3.12(h)(1)(ii).

Remaining CPO Exemption Under Regulation 4.13(a)(3)

The CFTC has retained the exemption for CPO registration under Regulation 4.13(a)(3), which contains trading limits that restrict aggregate initial margin and premiums on commodity interest positions to 5% of the pool's net asset value or, in the alternative, restrict the aggregate notional value of commodity interest positions to 100% of the pool's net asset value ("NAV"). DSIO confirmed that a CPO must determine whether it is in compliance with the trading thresholds *at the time a commodity interest position is established*; subsequent changes in the value of the position or the pool's NAV will not cause a CPO to come out of compliance unless and until another commodity interest position is to be entered into.

One questioner raised the issue of how to treat a situation where a pool, which will predominantly invest in non-derivatives but will enter into *de minimis* swap positions, is required to put the swap position on first. DSIO recognized that, due to certain deal structures, commodity interest positions are necessarily the first position entered into in furtherance of that structure and that, following the completion of the deal, the level of derivatives exposure will fall below the *de minimis* threshold. DSIO stated that CPOs claiming exemption under Regulation 4.13(a)(3) should have a "reasonable time" to comply with the trading limits, but declined to specify what is a "reasonable time" because what may be considered reasonable may vary depending on the facts and circumstances of each CPO and pool.

With respect to other issues arising under the trading limits of Regulation 4.13(a)(3), DSIO stated that:

- The "liquidation value of the pool's portfolio" includes both cash and the aggregate liquidation value of the pool's positions;
- Commodity options with the same underlying may be netted across designated contract markets and foreign boards of trade; and
- For cleared and uncleared swaps, the notional value of the swap is the amount reported by the reporting counterparty under Part 45 of the CFTC's regulations (Swap Data Recordkeeping and Reporting Requirements).

Because the trading limits under Regulation 4.5 (as amended) include the same criteria, the principles outlined above should also apply to RICs under Regulation 4.5. Under Regulation 4.5, unlimited *bona fide* hedging is also permitted. DSIO reiterated the CFTC's explicit statement in the preamble of the

Federal Register release announcing the final rules that equitization of cash and risk management are *not* properly included as *bona fide* hedging transactions for purposes of Regulation 4.5.

Regulatory Requirements for CPOs of CFCs

DSIO stated that a CFC and its parent RIC may be treated like a master-feeder fund arrangement, with the CFC as the master. Therefore, in a manner similar to that provided under CFTC Regulations 4.20 and 4.22 for master-feeder fund structures, the operators of CFCs would be exempt from providing disclosure documents and financial statements to investors under common control, such as the parent RIC.

Compliance Dates

DSIO stated that December 31, 2012 is the compliance date for many of the changes wrought by the amendments to the CFTC's Part 4 regulations, but we understand, based upon discussions with CFTC and National Futures Association ("NFA") staff, that this will be interpreted as January 1, 2013. That is the date by which:

- Persons previously exempt from registration under Regulations 4.5, 4.13(a)(4) or 4.14(a)(8) must either register as CPOs or CTAs, as appropriate, or operate in accordance with another exemption from registration,⁴ or cease engaging in activity that requires registration under the CEA;
- Persons who claim the no-action relief in accordance with the DSIO letter discussed above must either register as CPOs or CTAs, as appropriate, or operate in accordance with another exemption from registration, or cease engaging in activity that requires registration under the CEA;
- Persons who claimed CPO no-action relief prior to the adoption of Regulation 4.13(a)(3) and (a)(4) in 2003 must file an exemption notice in accordance with Regulation 4.13(a)(3), if eligible, register as a CPO, or cease engaging in activity that requires registration under the CEA;
- CPOs of CFCs must register under the CEA; and
- Swaps must be included in the trading limit computations of Regulation 4.5 and 4.13(a)(3).

Please note, however, that the term "commodity interest" will include swaps as of October 12, 2012. Accordingly, if the only commodity interests a person has been involved in are swaps, and the person is unable as of that date to claim an exemption from registration or the no-action relief referred to above given the amount of swap activity in pools operated by the person or about which the person has provided advice, registration as a CPO or CTA is required as of October 12, 2012.

Those CTAs that are exempt from registration under Regulation 4.14(a)(8) because they advise RICs, and that will be required to register as CTAs as of January 1, 2013 because the RIC cannot comply with amended Regulation 4.5, will not be required to comply with the CFTC's recordkeeping and disclosure requirements until 60 days following the effective date of final regulations implementing the CFTC's proposed effort to harmonize its CPO regulations for operators of RICs with the RICs' compliance obligations under regulations of the Securities and Exchange Commission ("SEC").⁵

⁴ For example, CFTC Regulation 3.10(c)(3) provides that a person located outside the United States may act as a CPO or CTA solely on behalf of persons located outside the United States without registering as such, provided trades executed on or subject to United States markets are submitted for clearing through a registered futures commission merchant.

⁵ 77 Fed. Reg. 11345 (February 24, 2012). DSIO did not address the regulatory obligations of CTAs that had previously advised private funds that claimed exemption under Regulation 4.13(a)(4), but must now register as CTAs because the

Transition Issues

NFA encourages persons who will be required to register as of January 1, 2013 because of the amendments to the CFTC's regulations discussed in this alert to apply for registration sooner rather than later. To ease concerns that registering "early," *i.e.*, before the end of this year, would subject a new registrant to other regulatory requirements for 2012, NFA has confirmed that persons with existing exemptions and no-action relief may defer the effective date of their registration until January 1, 2013, even if the processing of the application is completed prior to that date. For a registrant that has previously filed a Regulation 4.13(a)(4) notice, registration will be automatically deferred unless the registrant opts out. For an entity that has not previously filed such a notice (such as an adviser to a registered investment company), it will need to affirmatively request deferred effectiveness by contacting the NFA's staff.

DSIO makes clear that a newly-registered CPO as of January 1, 2013 would not be required to file a 2012 annual report for its commodity pools.

It is likely that many entities that filed exemption notices under the now-rescinded CFTC Regulation 4.13(a)(4) could qualify for exemption under Regulation 4.13(a)(3)⁶ or, if not, they could qualify for relief from certain regulatory requirements in accordance with CFTC Regulation 4.7 because of the nature of the investors in such pools. If the exempt CPO wants to transition from relying upon Regulation 4.13(a)(4) to relying upon Regulation 4.13(a)(3) instead, the CPO must first submit a written request to NFA (exemptions@nfa.futures.org) to withdraw the exemption under Regulation 4.13(a)(4). NFA will contact the CPO when the exemption has been withdrawn, at which point the CPO may file the new exemption under Regulation 4.13(a)(3) electronically. The exempt CPO must provide notice to its pool participants of the change in the exemption claimed.

For those CPOs that will be required to register as of January 1, 2013, DSIO stated that the CPO may claim relief under Regulation 4.7 because the pool interests that have previously been offered and sold were done so consistent with the then-effective provisions of Part 4.⁷ NFA has requested that such new registrants not request that NFA withdraw their existing Regulation 4.13(a)(4) notices individually, as NFA intends to withdraw such notices itself on December 31, 2012.

DSIO also stated that the CPO will *not* be required to confirm that all of the participants in an existing pool operated pursuant to Regulation 4.13(a)(4) continue to meet the QEP standard, but the CPO must reasonably believe that any new participants meet the QEP standard at the time of investment to maintain regulatory relief under Regulation 4.7.⁸ Similar treatment and the ability to claim relief under Regulation 4.7 is accorded to CTAs that advised previously-exempt pools.

operator of the private fund must register as a CPO. These CTAs should comply with disclosure and recordkeeping obligations when they become registered.

⁶ DSIO clarified that Regulation 4.13(a)(3) continues to include all qualified eligible persons ("QEPs"), particularly non-U.S. persons, as eligible investors. The CFTC intends to amend Regulation 4.13(a)(3) to make this inclusion explicit as a typographical correction that would not change the substance of the regulation.

⁷ DSIO did not address the issue of whether a CPO transitioning into a Regulation 4.7 status would be required to provide participants who object to this change with disclosure and reporting in accordance with what is required for full compliance under the Part 4 regulations or a three-month window in which to redeem their units of participation in the pool. Because transitioning from operating in accordance with Regulation 4.13(a)(4) to operating under Regulation 4.7 results in greater regulatory coverage for participants, we believe full Part 4 reporting and disclosure or the right to redeem are not necessary or required.

⁸ Although DSIO stated that a CPO is "required to ensure" that new participants are QEPs, Regulation 4.7 contains the "reasonable belief" standard.

To start the process for claiming relief under Regulation 4.7, the CPO must apply for registration under the CEA and NFA membership. This processing is handled through NFA's Online Registration System.⁹ The applicant should also advise NFA that it wants to make its registration and claim for regulatory relief under Regulation 4.7 effective as of January 1, 2013, and NFA has developed a mechanism to accomplish this and prevent any gap. DSIO reminded CPOs that withdrawing the Regulation 4.13(a)(4) exemption prior to December 31, 2012 could subject them to financial reporting requirements under CFTC and NFA regulations.

CFTC Advisory 18-96¹⁰ remains effective and registered CPOs can continue to claim relief pursuant to its terms. In light of the mechanism developed by NFA to prevent gaps in coverage, DSIO does not believe that a grace period beyond January 1, 2013 is necessary for relief under either Regulation 4.7 or Advisory 18-96.

CPOs of funds-of-funds may continue to rely on the rescinded Appendix A until the CFTC adopts revised guidance.

Forms CPO-PQR and CTA-PR

DSIO did not provide specific guidance with respect to Forms CPO-PQR and CTA-PR. However, DSIO did note that, to the extent it does release guidance on the Forms in the future, it is currently contemplated that DSIO would not expect immediate compliance with such guidance. DSIO also stated that persons filing such Forms prior to the issuance of any DSIO guidance are entitled to make reasonable assumptions consistent with a good faith effort in executing their compliance obligations.

Conclusion

The CFTC and SEC have jointly published final regulations that further define the term "swap," so DSIO's responses to the FAQs confirm that the exemptions, exclusion and no-action relief under which many RICs and private funds have been operating will expire at the end of the year. Although the CFTC and NFA have developed some steps designed to ease the transition from exempt status to a registered status, this change will require substantial operational adjustments for many firms. All exempt firms, if they have not already done so, should review their commodity interest activities immediately and, if necessary, begin the process of changing the exemption claimed or registering under the CEA and becoming an NFA member.

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⁹ When a firm files its Form 7-R and is assigned an NFA ID number, it should confirm that this is the same number under which it filed its exemption notices. If this is not the case, the firm should contact the NFA staff.

¹⁰ Advisory 18-96 contains disclosure, reporting and recordkeeping relief for registered CPOs with respect to their operation of offshore funds with no investors that are U.S. persons if certain conditions are met.

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