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CFTC Grants Temporary CPO Registration Relief for Private and Public Fund-of-Funds Managers

Introduction

In response to new commodity pool operator (CPO) and commodity trading advisor (CTA) compliance deadlines scheduled to go into effect on January 1, 2013 following the rescission of CFTC Regulation 4.13(a)(4) (Rule 4.13(a)(4)) and the amendment of CFTC Regulation 4.5 (Rule 4.5), the U.S. Commodity Futures Trading Commission (CFTC) has granted relief in a no-action letter for both public and private fund-of-funds managers. The no-action letter allows these managers to delay such compliance until the later of June 30, 2013, or six months from the date that the Division of Swap Dealer and Intermediary Oversight (Division) issues revised guidance (or the compliance date, if later) on the application of the calculation of the de minimis commodity interest trading tests in the context of Rules 4.5 and 4.13(a)(3), as long as certain criteria are met (Relief).¹ At that later date, a CPO of a fund-of-funds will have to be registered with the CFTC as a CPO and be a member of the U.S. National Futures Association (NFA) (not merely have submitted its application by then) or qualify for and effectuate an appropriate exclusion or exemption from such registration. This new relief has been granted in response to a request by the Investment Adviser Association (IAA), the Managed Funds Association (MFA), and Dechert LLP—on behalf of a group of fund-of-funds clients—made to the Division.²

Rescission of Rule 4.13(a)(4)

Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the instruments that would cause a commingled investment fund to become a commodity pool were exchange-traded futures contracts, options on futures contracts, and commodity options (among other instruments). The Dodd-Frank Act changed the regulatory landscape by giving the CFTC jurisdiction over the trading of security futures products and certain exchange-traded and over-the-counter derivatives (such as swap, forward, and option contracts), other than: swaps (including credit default swaps) referencing single securities or loans or baskets of nine or fewer securities; forward contracts on non-financial items; and certain limited currency swaps and forwards providing for physical delivery of two currencies. As a result of this sweeping change, the CFTC concluded that it was necessary to regulate managers that invested through commingled investment funds in the products over which the CFTC now had jurisdiction. As a consequence, and as part of the CFTC's overhaul of registration exemptions, on February 9, 2012 the CFTC adopted final rules (Final Rules) regarding CPOs and CTAs.³ The Final Rules rescinded Rule 4.13(a)(4), which exempted from CFTC registration those CPOs of commodity pools privately offered solely to qualifying investors. Private managers, including fund-of-funds managers,⁴ relied heavily on Rule 4.13(a)(4) to avoid CPO registration. Rule 4.13(a)(4) was especially attractive because it permitted managers to engage in unlimited or unknown commodity interest trading since Rule 4.13(a)(4) did not contain any commodity interest trading limits.⁵ The CFTC decided to rescind Rule 4.13(a)(4) because the lack of any commodity interest trading limits would not allow the CFTC to hold commodity pools that qualified for the exemption to the same transparency and accountability standards that are applied to publicly offered commodity pools whose interests are securities registered with the U.S. Securities and

Exchange Commission (SEC) under the Securities Act of 1933 as amended.⁶

Many commenters appealed to the CFTC to retain the Rule 4.13(a)(4) exemption for fund-of-funds structures that do not directly invest in commodity interests and are advised by an SEC-registered investment adviser. After consideration, the CFTC decided to withhold any fund-of-funds exemption until it received data regarding such firms on new CFTC Forms CPO-PQR and/or CTA-PR in order to better assess the industry and potential firms eligible for any future exemption. However, the CFTC stated that it would allow individual fund-of-funds to request exemptive relief.⁷

Absent relief, CPOs, including the sponsors of funds-of-funds, that were exempt from CPO registration under Rule 4.13(a)(4) must now rely on another exemption from CPO registration (such as CFTC Regulation 4.13(a)(3) (Rule 4.13(a)(3)) or register with the CFTC as a CPO and, if desired and eligible, claim relief under CFTC Regulation 4.7 (Rule 4.7) from certain disclosure, reporting, and recordkeeping requirements, or cease operating commodity pools (by ceasing operation, divesting investee fund investments, restructuring, or otherwise) subject to CFTC jurisdiction after December 31, 2012.⁸

CFTC Relief for Public and Private Fund-of-Funds Managers based on Rule 4.13(a)(3)

The CFTC has granted the Relief for private fund-of-funds managers to delay CPO compliance due in part to the fact that the ability of the managers of such funds to rely on the Rule 4.13(a)(3) CPO registration exemption is unclear. Due to indirect exposure to commodity interest trading, such managers often lack the access and visibility regarding underlying investee fund positions, margins, and notional values (unless all investor and investee funds are affiliated).

The eligibility of a fund-of-funds for the Rule 4.13(a)(3) exemption depends on decisions made by underlying managers of the investee funds. Funds-of-funds rely on underlying managers to manage the investee funds' exposure to commodity interests and to provide disclosure regarding the investee funds' portfolio composition.⁹ Without such information about the underlying investee funds' commodity interest positions, funds-of-funds are unable to conduct their own *de minimis* commodity interest trading testing to determine whether they qualify for the Rule 4.13(a)(3) exemption.¹⁰ Continuing uncertainty also exists because many managers of underlying investee funds have not yet decided what they are going to do for each of their funds (e.g., rely on Rule 4.7 or Rule 4.13(a)(3)). Although some underlying managers will register with the CFTC, they still have the ability to operate one or more of their investee funds as if the CPO was exempt from registration pursuant to Rule 4.13(a)(3). Most will not make decisions on registration and exemptions until very late in the 2012 calendar year, to be effective January 1, 2013. That situation gives insufficient time and guidance for fund-of-funds operators and advisers to make their own registration or exemption decisions.

In addition, reliance on Rule 4.13(a)(3) depends on the status of any direct trading of commodity interests at the fund-of-funds level. Where there is no direct trading at the fund-of-funds level, the look-through approach¹¹ to calculating compliance with the *de minimis* limits is not practical because (i) transparency may not be available, (ii) if it is available, underlying managers may not be willing to limit their use of commodity interests, and (iii) trading is dynamic (if one underlying fund exceeds a *de minimis* limit in a particular month, the fund-of-funds manager may be forced to register unless all other underlying funds are under the limit). The fund-of-funds has no control over the extent to which an underlying fund trades commodity interests. Accordingly, the fund-of-funds structure poses significant operational challenges.

The decision regarding whether Rule 4.13(a)(3) is available to a fund-of-funds manager is more complex now that most "swaps" are included in the definition of commodity interest.¹² The swaps exposure of a fund must now be included in the *de minimis* calculation of Rule 4.13(a)(3), compliance with which may lead to some underlying funds no longer being able to qualify for the Rule 4.13(a)(3) exemption. That situation gives insufficient time and guidance for fund-of-funds operators and advisers to register before December 31, 2012.

The Final Rules also amended Rule 4.5, which previously excluded mutual funds and their operators and other entities from the definition of CPO. The amendments came as a result of an NFA petition in August 2010 for the CFTC to place limitations on Rule 4.5 by requiring investment advisers to mutual funds and other registered investment companies with greater than *de minimis* investments in commodity interests to

register and be regulated as CPOs. Revised Rule 4.5 requires an investment adviser to a mutual fund to register as a CPO unless certain trading thresholds and marketing restrictions can be met.¹³

CFTC Relief for Public and Private Fund-of-Funds Managers based on Appendix A

The Division's decision to delay the effective date for fund-of-funds' CPO registration was also influenced by the continuing uncertainty over the interpretation of, and likely changes to, Appendix A to the CFTC's Part 4 Regulations - Guidance on the Application of Rule 4.13(a)(3) in the Fund-of-Funds Context (Appendix A).

The CFTC initially issued Appendix A in August 2003¹⁴ to provide guidance to funds-of-funds that were seeking to rely upon Rule 4.13(a)(3). It was issued prior to the expansion of the definition of commodity interests and the proliferation of funds-of-funds, their often complex structuring, and their investment in sleeves of investee funds and separately managed accounts as well as direct trading. As a result of these changes and given the widespread private fund use of derivatives, a much larger portion of the industry is expected to come within the definition.

The CFTC initially rescinded Appendix A with no explicit explanation.¹⁵ The Division thereafter reversed its position, when it indicated in a Frequently Asked Question provided by the Division that "CPOs of fund-of-funds may continue to rely on Appendix A until the [CFTC] adopts revised guidance."¹⁶ The release of an amended Appendix A is not anticipated until at least the first quarter of 2013. Absent the delay in the compliance deadline afforded by the Relief, managers would have been required to make decisions now based on certain limited situations specified in Appendix A and then change their analysis once the revised Appendix A is released with either modified or deleted situations, even if the fund-of-funds' commodity interest positions remain the same. This may cause some operators to proceed to register now (including having personnel become tested and licensed) and then de-register later, as long as the operator's funds continue to be in compliance with the limits under Rule 4.13(a)(3). Moreover, the current version of Appendix A is not particularly helpful in the current market because it provides guidance in limited situations, not accounting for how the *de minimis* restrictions apply to a wider array of fund-of-funds structures, and thus firms are not able to determine whether or not they are eligible for exemption.¹⁷

The Division has also stated that any future revised guidance for fund-of-funds managers will include the application of the *de minimis* test under Rule 4.5 to allow both public and private fund-of-funds managers to calculate the Rule 4.5 and Rule 4.13(a)(3) *de minimis* tests with respect to different CFTC regulations.¹⁸

Compliance Criteria for Temporary Registration Relief for CPOs of Funds-of-Funds

In the Relief, the Division stated that it will not recommend enforcement action against a fund-of-funds manager that may be required to register as a CPO as a result of the investor fund-of-fund's indirect exposure to commodity interests, so long as the CPO submits a claim for exemption and the CPO remains in compliance with the following criteria until the extended deadline for CPO registration:¹⁹

1. the CPO currently structures its operations in whole or in part as a CPO of one or more fund-of-funds; and
2. the amount of commodity interest positions to which the fund-of-funds is directly exposed does not exceed the levels specified in Rule 4.5 or Rule 4.13(a)(3)(ii)(A) or (B); and
3. the CPO does not know and could not have reasonably known that the fund-of-fund's indirect exposure to commodity interests derived from contributions to underlying investee funds exceeds the levels specified in Rule 4.5 or Rule 4.13(a)(3)(ii)(A) or (B), either calculated directly, or through the use of prior Appendix A; and
4. the commodity pool for which the CPO seeks relief is either:
 - (a) an investment company registered as such under the U.S. Investment Company Act of 1940 as amended; or
 - (b) compliant with the provisions of Rule 4.13(a)(3)(i), (iii), and (iv).

The Relief is not self-executing. A qualifying CPO must file with the Division a claim for the Relief (in proper form via email) prior to December 31, 2012, to be effective upon filing.

Footnotes

1. See CFTC Staff Letter 12-38 (Nov. 29, 2012). The Division has indicated that such revised guidance will also encompass the trading tests for public and private funds-of-funds in CFTC Regulation 4.12(b).
2. Dechert LLP submitted its position paper to the CFTC on October 2, 2012. The IAA and MFA also submitted a letter requesting similar relief on November 9, 2012.
3. Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11252 (Feb. 24, 2012) (to be codified at 17 C.F.R. pts. 4, 145, and 147) (Adopting Release).
4. See 7 U.S.C. § 1a(10) and CFTC Regulation 4.10(d) (a commodity pool is defined as any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests.) A fund-of-funds is considered to be a commodity pool itself because it is a commingled investment vehicle that invests in other commodity pools, including hedge funds, which trade commodity interests. Each commodity pool must have at least one CPO (the sponsor, promoter, or operator of the pool), which must either register with the CFTC or seek an exclusion or exemption.
5. Adopting Release at 11265 (“That is, it is possible that a commodity pool that is exempted from registration under [Rule] 4.13(a)(4) could be invested solely in commodities, which, in the Commission’s view, necessitates Commission oversight to ensure adequate customer protection and market oversight.”).
6. [For further information, refer to CFTC Changes Rules Affecting Public and Private Funds, DechertOnPoint \(Mar. 2012\) \(PDF\).](#)
7. See Adopting Release at 11264.
8. [For further information, refer to CFTC Adopts Rule Changes and Rescinds Rule 4.13\(a\)\(4\), DechertOnPoint \(Feb. 2012\) \(PDF\).](#)
9. See the Relief (Fund-of-funds also rely on the investee funds to redeem their participations in such funds should the fund-of-funds need to make changes to its commodity interest positions).
10. The Rule 4.13(a)(3) *de minimis* trading condition requires an exempt fund to meet one of two alternate tests with regard to its commodity interest trading. Either (i) the aggregate initial margin, option premiums, and independent amounts (in the case of swaps) required to establish such commodity interest positions will not exceed 5% of the liquidation value of the fund’s portfolio (i.e. net asset value) taking into account unrealized profits and losses on such positions and excluding in-the-money amounts for options that were in-the-money at the time of purchase, or (ii) the aggregate net notional value of such commodity interest positions does not exceed 100% of the liquidation value of the fund’s portfolio (with the same treatment of profits and losses as above).
11. The look-through approaches are outlined in hypothetical situations in Appendix A.
12. As noted above, the Dodd-Frank Act expanded the definition of commodity interest to include most over-the-counter derivatives, such as swaps.
13. At Dechert’s request, the Division recently granted no-action relief to business development companies comparable to that afforded under Rule 4.5. See [CFTC Letter No. 12-40, No-Action Relief from the Commodity Pool Operator Registration Requirement \(Dec. 4, 2012\) \(PDF\)](#) and [DechertOnPoint, CFTC Grants CPO Registration No-Action Relief to Business Development Companies \(Dec. 2012\).](#)
14. See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues, 68 Fed. Reg. 47221, 47236 (Aug. 8, 2003).
15. See Adopting Release at 11286.
16. See CFTC “Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendment to Compliance Obligations” (Aug. 14, 2012).
17. See IAA and MFA Request Letter at 2.
18. See the Relief at 2 (stating that the *de minimis* calculation tests for Rule 4.13(a)(3) and Rule 4.5 are identical). See *also* footnote 1 above.
19. See *id.* at 3.

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