

February 14, 2012

## CFTC Adopts Significant Changes to CPO and CTA Registration and Compliance Requirements

### Introduction

On February 9, the Commodity Futures Trading Commission adopted by a vote of 4 to 1 (Commissioner Sommers dissenting) final rules amending its Part 4 regulations governing commodity pool operators (CPOs) and commodity trading advisors (CTAs). As discussed at further length below, the amendments:

- Rescind the exemption from CPO registration under CFTC Rule 4.13(a)(4) for CPOs of commodity pools offered solely to certain qualified eligible persons and institutional investors;
- Adopt additional reporting obligations for registered CPOs and CTAs and new Forms CPO-PQR and CTA-PR under CFTC Rule 4.27;
- Require the provision of certified, audited annual financial statements by registered CPOs relying upon the reporting relief provided under CFTC Rule 4.7;
- Require additional risk disclosures regarding swap transactions in CPO/CTA disclosure documents that are required to be provided by registered CPOs and CTAs that are not relying on the disclosure exemptions provided by CFTC Rule 4.7;
- Require annual affirmation of eligibility for exemptions and exclusions from CPO and CTA registration; and
- Add limitations on futures and swaps trading by registered investment companies relying upon the exclusion from CPO registration set forth in CFTC Rule 4.5. (A second Client Advisory addressing the changes to Rule 4.5 will be published separately.)

### Changes to CPO Registration Exemptions

**Rule 4.13(a)(4) Exemption.** Since the adoption of Rule 4.13(a)(4) in 2003, fund sponsors, especially managers of hedge funds with only “qualified purchaser” investors, have frequently used the exemption in Rule 4.13(a)(4) to avoid both registration with the CFTC as CPOs and compliance with the CFTC’s disclosure, reporting and recordkeeping requirements. Certain fund sponsors who were registered with the CFTC as CPOs prior to 2003 have maintained their CPO registration but claimed the exemption and avoided compliance with the same disclosure, reporting and recordkeeping requirements. The CFTC has now rescinded this exemption.

Despite commentators urging the CFTC to “grandfather” pools that currently rely on Rule 4.13(a)(4), the CFTC declined to do so, instead giving these pools until December 31, 2012, to comply with the amendments. Operators of funds currently relying on the 4.13(a)(4) exemption will be required to: (i) stop trading in commodity futures, “retail” foreign exchange contracts and swaps (other than security-based swaps); (ii) rely upon a different

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registration exemption (for example, a pool operator could limit its trading of commodity interests in accordance with Rule 4.13(a)(3) and rely instead upon that registration exemption); or (iii) register with the CFTC as a CPO.

Commentators also proposed various other exemptions in the event that the CFTC rescinded Rule 4.13(a)(4), including exemptions for family offices, foreign advisers and funds of funds. The CFTC declined to adopt any new exemptions, citing a lack of information, but stated that it would revisit possible exemptions once the CFTC develops a more comprehensive view. However, the CFTC affirmed that family offices previously relying on existing interpretative letters may continue to rely on those letters “to the extent permissible under [the CFTC’s] regulations,” and invited entities to request fund of funds or family office relief on a case-by-case basis.

Eligible managers that register with the CFTC may still avail themselves of certain disclosure, reporting and recordkeeping relief under Rule 4.7 or CFTC Advisory 18-96, but will be subject to other compliance obligations for CPOs set forth in the CFTC regulations. It is important to note that not all managers who relied on the exemption from registration provided by Rule 4.13(a)(4) will be eligible to rely upon Rule 4.7. That is because Rule 4.13(a)(4) allowed for investments in a Rule 4.13(a)(4) pool by certain categories of entity investors who would not be eligible to invest in a pool operated pursuant to Rule 4.7.

The deadline for CPOs currently relying on the Rule 4.13(a)(4) exemption or, as we expect will continue to be permitted, claiming the exemption before it is repealed (which will occur 60 days after the final rules are published in the Federal Register), is December 31, 2012. Affected CPOs must be registered and otherwise comply with the Part 4 rules applicable to CPOs on or before that date.

**Rule 4.13(a)(3) “De Minimis” Exemption.** Contrary to its initial proposal, the CFTC decided to retain the “de minimis” exemption from CPO registration set out in CFTC Rule 4.13(a)(3). This exemption is available with respect to a pool for which either (i) the aggregate initial margin and option premiums required to establish its commodity interest positions do not exceed 5% of the pool’s liquidation value, or (ii) the aggregate net notional value of its commodity interest positions does not exceed 100% of the pool’s liquidation value. CPOs relying on this exemption will now be required to file an annual notice affirming their exempt status (discussed below in “Annual Notice for Continued Exemptive or Exclusionary Relief”).

Changes to the definition of “commodity interest” and the application of the net notional test may substantially impact who is eligible to claim this exemption, however.

**“Commodity Interest.”** In an earlier proposed rulemaking on March 3, 2011, the CFTC proposed to amend the term “commodity interest” to include swaps, which would require their inclusion in assessing a CPO’s eligibility to rely upon the Rule 4.13(a)(3) exemption. Because of that proposal, many commentators urged the CFTC to increase the trading thresholds under Rule 4.13(a)(3), but the CFTC declined to do so. While the CFTC may reassess the trading threshold after collecting data from registered CPOs through new Form CPO-PQR (discussed in detail below), the CFTC’s proposed amendments to the definition of “commodity interest,” if coupled with an expansive definition of “swap,” may significantly limit the availability of the “de minimis” exemption.

**Net Notional Test.** The CFTC amended § 4.13(a)(3)(ii)(B) to provide that the notional value of a cleared swap is determined consistent with the provisions of proposed Part 45 of the CFTC’s regulations and to provide that swaps cleared by the same derivatives clearing organization may be netted where appropriate.

## Rule 4.27 (Forms CPO-PQR and CTA-PR)

The CFTC also adopted new forms to elicit periodic reporting information from CPOs (on Form CPO-PQR) and CTAs (on Form CTA-PR). These forms are analogous to the Form PF adopted by the Securities and Exchange Commission for reporting by registered investment advisers. A CPO or CTA that is dually registered with the SEC as an investment adviser must file Form PF with the SEC. As adopted, CFTC Rule 4.27(d) permits a dually registered CPO to file Form PF in lieu of completing Schedules B, applicable only to “Mid-Sized” and “Large” CPOs, and/or C of Form CPO-PQR, relating to “Large Pools” of Large CPOs. However, dually registered CPOs or CTAs must still file with the CFTC either Schedule A of Form CPO-PQR, relating to the CPO and its pools, or a full Form CTA-PR (for CTAs). The CFTC declined to adopt Schedule B of Form CTA-PR. All other CPOs or CTAs that are not also registered as investment advisers with the SEC or that are otherwise ineligible to file on Form PF must file part or all of either Form CPO-PQR or CTA-PR, depending on the amount of aggregated pool assets under management by such a CPO or CTA.

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In the case of a pool with co-CPOs, the CPO with the greater assets under management is required to report for the shared pool. However, if one of the co-CPOs is also a registered investment adviser filing on Form PF, the co-CPO that is not dually registered as an investment adviser is still obligated to file Form CPO-PQR.

**Schedule A of Form CPO-PQR.** All registered CPOs that are not “Large CPOs” (as defined below) must file Schedule A of the Form CPO-PQR annually, within 90 days of the close of each calendar year. A CPO that had at least \$1.5 billion in aggregated pool assets under management as of the close of business on any day during a calendar quarter (a “Large CPO”) must file Schedule A within 60 days of the close of such calendar quarter.

**Schedule B of Form CPO-PQR.** A CPO that had at least \$150 million in aggregated pool assets under management as of the close of business on any day during a calendar year (a “Mid-Sized CPO”) must file a separate Schedule B for each pool it operated during such calendar year within 90 days of the close of such calendar year. Within 60 days of the close of each calendar quarter during which a CPO satisfied the definition of “Large CPO,” such CPO must file a separate Schedule B for each pool it operated during such calendar quarter.

**Schedule C of Form CPO-PQR.** Within 60 days of the close of each calendar quarter during which a CPO satisfied the definition of “Large CPO,” such CPO must file a separate Schedule C for each “Large Pool” (that is, a pool with a net asset value individually, or in combination with any parallel pool structure, of at least \$500 million) it operated during such calendar quarter.

**Form CTA-PR.** All CTAs that advise pools must file Form CTA-PR annually, within 45 days of the end of a CTA’s fiscal year. The CFTC has modified the Form CTA-PR, as originally proposed, to solicit only general demographic data in an effort to reduce the regulatory burden of the form.

The data reporting rules in revised Rule 4.27 will become effective on July 2, 2012 and will apply to all registered CPOs regardless of whether they are still relying on Rule 4.13(a)(4) at that time. The first reports will be due within 60 days after September 30 for CPOs having at least \$5 billion in commodity pool assets under management as of June 30, and will be due within 90 days after December 31 for all other registered CPOs and CTAs, with subsequent reports for the various entities due in accordance with the schedule above.

**Confidential Treatment.** A CPO or CTA may request confidential treatment for the following portions of Forms CPO-PQR and CTA-PR, respectively:

- Form CPO-PQR Schedule A: Question 2, subparts (b) and (d); Question 3, subparts (g) and (h); Question 9; Question 10, subparts (b), (c), (d), (e) and (g); Question 11; and Question 12.
- Form CPO-PQR Schedule B: All.
- Form CPO-PQR Schedule C: All.
- Form CTA-PR: Question 2, subparts (c) and (d).

## Rule 4.7

The CFTC also adopted two minor amendments to Rule 4.7.

First, the CFTC amended Rule 4.7(a)(3)(ix) and (a)(3)(x) to incorporate by reference the accredited investor standard from SEC Regulation D, rather than by direct inclusion of its specific terms. As a result, the provisions of the rule that relate to the SEC’s definition of “accredited investor” will automatically incorporate any subsequent changes made to that definition by the SEC (including inflation adjustments).

Second, the CFTC rescinded the relief in Rule 4.7(b)(3) from the annual report certification requirement of Rule 4.22(d). Thus, CPOs relying on the exemption in Rule 4.7 will now need audited, annual financial statements, prepared in accordance with U.S. generally accepted accounting principles and certified by an independent accountant. In adopting this amendment, the CFTC noted that a substantial portion of registered CPOs already provide audited financial statements to pool investors.

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## Other Amendments

**Annual Notice for Continued Exemptive or Exclusionary Relief.** Under the amended rules, CPOs and CTAs relying upon registration exemptions or exclusions will be required to annually reaffirm their eligibility therefor. Specifically, a CPO or CTA claiming exemption or exclusion under Rules 4.5, 4.13 or 4.14(a)(8) will need to file an annual notice of reaffirmation within 60 days of the end of each calendar year.

**Standardized Risk Disclosure Statements (Rules 4.24(b) and 4.34(b)).** The CFTC adopted an amendment requiring certain new standardized risk disclosure statements for CPOs and CTAs that engage in swap transactions. Despite the concerns of several commentators who noted that the proposed risk disclosures were inconsistent with SEC guidance to registered investment companies regarding generic disclosures, the CFTC felt those concerns would be addressed through the proposed modifications to the CFTC's compliance regime (see "CFTC Proposed Harmonization Initiative" below).

**Removal of Appendix A to Part 4.** Although not addressed by the CFTC in the accompanying Federal Register release, the amendments deleted existing Appendix A to the CFTC's Part 4 Rules and inserted the new Forms CPO-PQR and CTA-PR as new Appendices A and C, respectively. The existing text of Appendix A provided guidance to fund-of-funds managers on the treatment of underlying fund investments for purposes of applying the Rule 4.13(a)(3) "de minimis" exemption. The CFTC intends to revise the guidance previously set forth in Appendix A and has informally indicated that funds may rely on the existing guidance until the new guidance is issued.

**CFTC Proposed Harmonization Initiative.** Also on February 9, the CFTC proposed amendments to certain CPO reporting, disclosure and recordkeeping rules to harmonize the obligations of registered investment companies who otherwise might be subject to duplicative, inconsistent, and possibly conflicting requirements of the SEC under the Investment Company Act of 1940. Specifically, the CFTC proposed to amend Rule 4.12(c) to offer relief from the disclosure document delivery and acknowledgement requirements under Rule 4.21, certain periodic financial reporting obligations under Rule 4.22 and the requirement that records be maintained at the CPO's main office under Rule 4.23. The CFTC is also soliciting comments as to any other areas where harmonization may be needed. Funds that are required to register as CPOs due to the CFTC's amendments to Rule 4.5 will become subject to compliance with the CFTC's recordkeeping, reporting and disclosure requirements no later than 60 days after the CFTC implements final rules harmonizing the CFTC and SEC requirements.

**Effectiveness and Compliance Deadlines.** Except as noted above in respect of particular provisions, the general effective date of the amended rules will be 60 days after publication in the Federal Register, and compliance with the new rules is required by December 31, 2012.

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