CFTC Issues Relief from CPO Registration to Funds of Funds, BDCs and Family Offices; NFA Issues Guidance on the Annual Affirmation Requirement

December 7, 2012

On November 29 and December 4, the Commodity Futures Trading Commission's (CFTC) Division of Swap Dealer and Intermediary Oversight (DSIO) issued a series of no-action letters that afford relief from registration as a commodity pool operator (CPO) to operators of certain funds of funds (the Fund of Funds Letter), business development companies (the BDC Letter) and family offices (the Family Offices Letter) that engage in commodity interest (*i.e.*, futures, options and swaps) trading. Also, on December 3, the National Futures Association (NFA) issued guidance that addresses the manner in which CPOs and commodity trading advisors (CTAs) that are exempt or excluded from registration can satisfy the new CFTC requirement to affirm eligibility for exemption or exclusion from registration. The CFTC no-action letters and NFA guidance are summarized below.

1. The Fund of Funds Letter

Under the Commodity Exchange Act and CFTC regulations promulgated thereunder, collective investment vehicles that indirectly obtain exposure to commodity interests by investing in commodity pools (Funds of Funds) are themselves commodity pools. As a result, operators of Funds of Funds would be CPOs and could be required to register as CPOs depending on their eligibility for a regulatory exemption or exclusion therefrom.

Previously, CPOs of Funds of Funds could use Appendix A to Part 4 of the CFTC's regulations when determining whether they were eligible for an exemption from CPO registration available under CFTC Regulation 4.13(a)(3), which exempts from registration CPOs of commodity pools that only engage in a *de minimis* level of commodity interest trading. Appendix A presented a series of scenarios prepared by the CFTC to assist CPOs of Funds of Funds in applying CFTC Regulation 4.13(a)(3)'s *de minimis* thresholds. Without explanation, the CFTC rescinded Appendix A as part of final regulations that the CFTC adopted last February to amend CPO and CTA compliance obligations.[1] After the adoption of these regulations, the CFTC staff indicated that it would revise the guidance in Appendix A. However, until that guidance is issued, market participants may continue to rely on Appendix A.[2]

[1] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012); correction 77 Fed. Reg. 17, 328 (March 26, 2012). For more information, please see Sutherland's February 29, 2012 Legal Alert.

[2] See Sutherland's August 16, 2012 Legal Alert.

The Fund of Funds Letter was issued in response to a request from the Investment Adviser Association and the Managed Funds Association for new Fund of Funds guidance and additional time for affected CPOs to come into compliance with the new guidance. In part, the request for relief was based on the CFTC's adoption of a *de minimis* threshold for purposes of CFTC Regulation 4.5(a)(1), which excludes investment advisers of registered investment companies from CPO status.[3] The *de minimis* threshold that was added to CFTC Regulation 4.5 is nearly identical to the *de minimis* threshold in CFTC Regulation 4.13(a)(3).

The Fund of Funds Letter affords no-action relief from the CPO registration requirement to CPOs of Funds of Funds until the later of: (1) June 20, 2013; or (2) the CFTC staff's issuance of revised guidance regarding the application of the *de minimis* thresholds in CFTC Regulations 4.5 and 4.13(a)(3). The DSIO's no-action relief is conditioned on the following:

- The CPO currently structures its operations in whole or in part as the operator of one or more Funds of Funds;
- The amount of commodity interest positions with respect to which the Fund of Funds is directly exposed does not exceed the levels specified in CFTC Regulations 4.5 or 4.13(a)(3);
- The CPO does not know, and could not have reasonably known, that the Fund of Funds' indirect exposure to commodity interests derived from its contributions to other commodity pools exceeds the levels specified in CFTC Regulations 4.5 or 4.13(a)(3), either calculated directly or through the use of Appendix A; and
- The Fund of Funds for which the CPO seeks relief is either a registered investment company (RIC) or in compliance with the provisions of CFTC Regulation 4.13(a)(3)(i), (iii) and (iv).

The no-action relief afforded by the Fund of Funds Letter is not self-executing. Therefore, persons eligible for the relief must file a claim of no-action relief directly with the DSIO prior to December 31, 2012. The claim of no-action relief must contain certain basic information specified in the Fund of Funds Letter.

2. The BDC Letter

In the BDC Letter, the DSIO issued no-action relief from CPO registration requirements for advisers of business development companies (BDCs). Specifically, pursuant to the BDC Letter, the DSIO will treat BDCs as RICs for purposes of an exclusion from CPO registration requirements under CFTC Regulation 4.5 (the Regulation 4.5 Exclusion). The Regulation 4.5 Exclusion is an exclusion from the definition of CPO available to advisers of RICs that trade commodity interests subject to certain conditions, namely that the relevant RIC's commodity interest trading falls below certain *de minimis* thresholds. Rather than make the Regulation 4.5

[3] This amendment to CFTC Regulation 4.5 was part of the CFTC's Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations regulations. *See* note 1, *supra*.

Exclusion directly applicable to BDCs, however, the DSIO opted to restate the requirements of the Regulation 4.5 Exclusion in the BDC Letter.

In the BDC Letter, the DSIO noted that even *one* commodity interest trade can cause an entity (*e.g.*, a BDC) to be a commodity pool, thereby potentially triggering the CPO registration requirement. Since BDCs are substantially similar to RICs, the DSIO concluded that relief equivalent to the Regulation 4.5 Exclusion should be available to them. Accordingly, the BDC Letter's no-action relief is conditioned on the following requirements, which are based on and substantively the same as the conditions for the Regulation 4.5 Exclusion:

- The BDC has elected to be treated as a BDC under the Investment Company Act of 1940, and continues to be regulated by the Securities and Exchange Commission (SEC) as a BDC;
- The BDC is not being marketed to the public as a commodity pool or as a vehicle for investing in futures, options or swaps; and
- Either:
  - The BDC uses commodity interests for bona fide hedging purposes; provided, however, that the aggregate initial margin and premiums required for the BDC's nonhedge (*i.e.*, speculative) commodity interest positions cannot exceed 5% of the liquidation value of the BDC's portfolio; or
  - The aggregate net notional value of the BDC's nonhedge commodity interest positions does not exceed 100% of the liquidation value of the BDC's portfolio.

Similar to the Regulation 4.5 Exclusion, the relief afforded by the BDC Letter is not self-executing. However, rather than file a claim for relief with the NFA, which is the process by which the Regulation 4.5 Exclusion may be obtained, BDCs must submit a claim for relief with the DSIO directly. Moreover, since BDCs are afforded relief under the BDC Letter rather than CFTC Regulation 4.5, they will not be required to affirm their eligibility for the no-action relief on an annual basis.

For more information about the BDC Letter, please see Sutherland's December 5, 2012 Legal Alert.

3. The Family Offices Letter

Generally, family offices are professional organizations that are wholly owned by clients in a family and are exclusively controlled, directly or indirectly, by one or more members of a family and/or entities controlled by a family. Previously, most family offices that engaged in commodity interest trading were able to rely on an exemption from CPO registration available to "sophisticated investors" under CFTC Regulation 4.13(a)(4). However, as noted above, the CFTC adopted final regulations in February that amended the compliance obligations for CPOs and CTAs and rescinded the exemption from registration under CFTC Regulation 4.13(a)(4).[4] As a result, persons that relied on the CFTC Regulation 4.13(a)(4) exemption prior to April 24, 2012 (the effective date of the CFTC's final regulations rescinding the Regulation 4.13(a)(4) exemption) must register as CPOs or claim an alternate exemption or exclusion from CPO registration by December 31, 2012.

Pursuant to the Family Offices Letter, family offices that engage in commodity interest trading will not be required to register a CPO, so long as such family offices comply with SEC regulations applicable to them.

The relief afforded by the Family Offices Letter is not self-executing and, therefore, family offices must file a claim of relief with the DSIO containing certain basic information specified in the Family Offices Letter. The claim for relief must be filed prior to December 31, 2012 or, for a family office that begins to operate after December 1, 2012, within 30 days after it commences operations. Further, prior to March 31, 2013 (or, for a family office that commences operations after March 31, 2013, 30 days after the date it commences operations), a family office must confirm that it is a family office within the meaning and intent of applicable SEC regulations.

4. NFA Guidance on the Annual Affirmation Requirement

On December 3, the NFA issued guidance concerning the annual affirmation of eligibility for certain exemptions and exclusions from CPO and CTA registration requirements. Pursuant to the CFTC's final regulations to amend CPO and CTA compliance obligations that were issued in February (discussed above),[5] persons claiming an exemption or exclusion from CPO or CTA registration under CFTC Regulations 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3), 4.13(a)(5) or 4.14(a)(8) must affirm their eligibility for exemption or exclusion on an annual basis, within 60 days of the calendar year end, beginning with the calendar year ending on December 31, 2012. Failure to affirm the relevant exemption or exclusion within 60 days of the calendar year end results in automatic withdrawal of the exemption or exclusion, which would then subject a person to all applicable CPO or CTA compliance requirements. Affected persons may complete the annual affirmation via the NFA's Exemptions Filing System. Going forward, the NFA will provide an annual e-mail reminder of the affirmation process.

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[4] *See* note 1, *supra*.

[5] *Id.*

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