

Commodity Futures Trading Commission Proposes to Rescind Registration Exemptions

On January 26, 2011, the Commodity Futures Trading Commission (the “CFTC”) proposed to rescind the exemptions from registration as a commodity pool operator (a “CPO”) typically relied on by private investment fund sponsors (Rules 4.13(a)(3) and 4.13(a)(4)), and to limit the availability of the exclusion from the definition of a CPO for certain registered investment companies (Rule 4.5). The text of the proposals has not yet been published.

If the proposals are adopted, sponsors of private funds will have to register with the CFTC if they use futures, options on futures or commodities, swaps and other over-the-counter derivatives (other than securities-based swaps, such as equity swaps and single-name credit default swaps) (beginning July 2011), and certain foreign currency transactions in those funds. Further, registered investment companies that use more than a de minimis amount of futures and options (in addition to bona fide hedging transactions) or that are marketed as vehicles for exposure to futures or options will also have to register with the CFTC. Advisers to these funds will need to consider whether these changes will result in an obligation to register with the CFTC as commodity trading advisors (“CTAs”). Registered CPOs and CTAs must comply with disclosure, reporting and recordkeeping rules, and implement certain policies and procedures. They are also subject to periodic audits by the National Futures Association (the self-regulatory organization for the futures industry). The registration process involves filings, fingerprinting, proficiency examinations and fees.

The CFTC further proposed to (i) revise Rule 4.7 so that registered CPOs may no longer claim exemption from the requirement that an exempt pool’s annual report contain certified financial statements, (ii) modify the participant qualification criteria of Rule 4.7 to incorporate the Securities and Exchange Commission’s (“SEC”) accredited investor standard by reference rather than by direct inclusion of its terms (which will mean these criteria will automatically reflect any changes the SEC may adopt); and (iii) require CPOs and CTAs claiming relief under Rules 4.5, 4.13 and 4.14 to confirm their claims annually.

These proposals are not mandated by the Dodd-Frank Act. Rather, the CFTC believes that it is necessary to rescind or modify the exemptions and exclusions following recent economic turmoil to more effectively oversee market participants and manage market risk, consistent with the tenor of the Dodd-Frank Act. Accordingly, operators of Rule 4.13(a)(3) and (a)(4) funds should be subject to regulatory obligations similar to those applicable to private fund investment advisers required to register with the SEC as investment advisers, and trading and marketing limitations that were a part of Rule 4.5 prior to 2003 should be restored to protect investors in light of product developments. For example, the CFTC notes that at least three funds operating under the Rule 4.5 exclusion recently have been marketed as commodity futures investments to retail investors seeking exposure to actively managed futures strategies.

A CPO is defined under the Dodd-Frank Act as “any person engaged in a business that is of the nature of a commodity pool... or similar form of enterprise, and who, in connection therewith, solicits ... from others, funds... for the purpose of trading in commodity interests, including any . . . commodity for future delivery,

security futures product, or swap” and certain foreign currency transactions. A CPO is usually the general partner of a limited partnership or the investment manager of an offshore company that may trade in commodity interests. Rule 4.13(a)(4) allows a CPO to claim an exemption from registration if fund interests are privately offered and investors are either “qualified purchasers” (or “accredited investors” if an investor is an entity) or “knowledgeable employees” as defined in the rules of the SEC, or non-U.S. persons as defined in the CFTC rules. Similarly, Rule 4.14(a)(3) allows a CPO to claim an exemption from registration if fund interests are privately offered and trading in commodity interests is limited so that 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% of the liquidation value of the fund’s portfolio, or the aggregate net notional value of commodity interest positions, determined at the time the most recent position was established, does not exceed 100% of the liquidation value of the pool’s portfolio, in each case after taking into account unrealized profits and unrealized losses on commodity interest positions.

Currently, registered investment companies are excluded altogether from the CPO definition under CFTC Rule 4.5. The CFTC proposal would require registered investment companies to register as CPOs, unless futures and options are used only for bona fide hedging purposes, or aggregate initial margin and premiums will not exceed 5% of the liquidation value of the fund’s portfolio, **and**, in each case, the fund is not marketed as a vehicle for trading in the futures or options markets. Presumably, relief from certain CFTC rules will be needed for registered investment companies to be able to comply with CPO rules in light of conflicting requirements under the *Investment Company Act of 1940*, pertaining primarily to disclosure document delivery and disclosures of past performance and trading managers, their strategies, and their fees.

Finally, advisers to private funds and mutual funds that are not registered with the CFTC as CTAs should re-examine whether the registration exemptions on which they rely will remain available to them if the proposed rescission of the 4.13(a)(3) and (a)(4) exemptions and the narrowing of the Rule 4.5 exclusion are adopted. Certain CTA exemptions depend on the CPO of the applicable fund being exempt from CPO registration or excluded from the definition of a CPO.

We will continue to follow these rule proposals. If you have any questions on CPO and CTA matters, please contact the Ropes & Gray attorneys with whom you usually work.