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investment management lawflash

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Part I:
Update on CFTC Rules 4.5 and 4.13 for Registered Investment Companies and Hedge Funds

Investment advisers operating registered investment companies and private funds that conduct more than a de minimis *amount of speculative trading in futures, commodity options, and other commodity interests will no longer be exempt from registering with the CFTC as CPOs.*

February 10, 2012

The Commodity Futures Trading Commission (CFTC) announced on February 9 the adoption of final rules that significantly curtail the ability of registered investment companies to claim relief under CFTC Rule 4.5 as well as the rescission of the exemption from commodity pool operator (CPO) registration contained in Rule 4.13(a)(4), which is relied on by a substantial portion of the hedge fund industry. The CFTC did not, as it had proposed, rescind the exemption from CPO registration under Rule 4.13(a)(3) for hedge funds that conduct a *de minimis* amount of trading in futures, commodity options, swaps, and other commodity interests.[1]

The Final Rules will require full CPO registration by investment advisers operating registered investment companies and private funds that conduct more than a *de minimis* amount of speculative trading in futures, commodity options, and other commodity interests. Those investment advisers required to register as CPOs as a result of changes in Rule 4.5 must become registered by the later of December 31, 2012 or 60 days after the effective date of the final rulemaking by the CFTC defining the term "swap." Once an investment adviser is registered as a CPO for a registered investment company, it will not be required to comply with the CFTC's recordkeeping, reporting, and disclosure requirements until 60 days after the adoption of final rules implementing certain proposed exemptions from these requirements for registered investment companies.[2] Investment advisers operating private funds that are currently relying on the Rule 4.13(a)(4) exemption will be required to register as CPOs by December 31, 2012, unless they are able to avail themselves of another exemption.

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1. Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Final Rules (Feb. 8, 2012) available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf (hereinafter, Final Rules). The release announcing the Final Rules may be found on the CFTC's website at http://www.cftc.gov/PressRoom/PressReleases/pr6176-12.

2. The CFTC's Proposed Rules in this regard are discussed in our LawFlash "Part II: Proposal to Harmonize CFTC and SEC Requirements for Registered Investment Companies as Commodity Pools" (Feb. 10, 2012), available at http://www.morganlewis.com/pubs/IM-LF_PartII_ProposalToHarmonizeRequirements_10feb12.pdf .

CFTC Rule 4.5 Exemption

CFTC Rule 4.5 currently provides an exclusion from the definition of CPO for advisers operating entities regulated as registered investment companies, banks, benefit plans, and insurance companies. Prior to August 2003, any of the regulated persons claiming eligibility for the exclusion under Rule 4.5 were required to represent that commodity futures or options contracts entered into by the qualified entity were for bona fide hedging purposes[3] and that the aggregate initial margin and/or premiums for positions that did not meet the bona fide hedging criteria did not exceed 5% of the liquidating value of the qualifying entity's portfolio, after taking into account unrealized profits and losses. The rule further required that participation in the qualifying entity not be marketed as participation in a commodity pool or otherwise as a vehicle for trading commodity futures or options. In August 2003, as part of a larger overhaul of its regulation of CPOs and commodity trading advisors (CTAs), the CFTC eliminated the Rule 4.5 eligibility conditions requiring that the qualified entity limit speculative trading to 5% of the liquidating value of its portfolio and not market itself as a vehicle for exposure to commodity futures or options.[4]

The Final Rules return Rule 4.5 to its pre-2003 requirements for registered investment companies (but not for the other types of regulated entities), with the addition of an alternative definition of *de minimis*. Banks, benefit plans, and insurance companies currently relying on the exemption are unaffected by the changes and may continue to conduct their commodity pool businesses without registration. In a comment letter, however, National Futures Association (NFA) suggested broadening the scope of the coverage to apply the same types of limits on banks and trust companies as the revised rule does on registered investment companies.[5]

In the case of registered investment companies, the CFTC noted in the Final Rules release, as it had in the proposed rules, that it was concerned that funds were "offering de facto commodity pools" and should be subject to CFTC oversight to "ensure consistent treatment of CPOs regardless of their status with respect to other regulators."[6] As a result of the adopted changes, a registered investment company will no longer be able to rely on Rule 4.5 to avoid registering the investment adviser as a CPO if the registered investment company invests more than an immaterial amount of its assets in commodity futures, commodity options, and swaps, other than for hedging, or markets itself as providing commodity exposure. In response to requests from commenters, the CFTC confirmed "that the investment adviser for the registered investment company is the entity required to register as the CPO," if registration is required. Prior to the adoption of the Final Rules, there was a lack of clarity around which entity or persons might be considered to be the CPO of a registered investment company that was deemed to be a commodity pool. Many in the industry were concerned that a registered investment company's board of trustees or directors would be required to register. The CFTC recognized that requiring trustees or directors to register as CPOs "would raise operational concerns for the registered investment company as it would result in piercing the limitation on liability for actions undertaken in the capacity as director."[7]

In order to rely on amended Rule 4.5, a registered investment company will have to limit the aggregate initial margin it posts for its speculative commodities-related trading to 5% of the liquidating value of its

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3. Bona fide hedging transactions and positions are defined at CFTC Rule 1.3(z) (17 C.F.R. § 1.3(z)).

4. Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues. 68 Fed. Reg. 47221 (Aug. 8, 2003).

5. *See* Letter from Thomas W. Sexton, III to David A. Stawick Re: Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Apr. 12, 2011) at p. 19.

6. Final Rules at p. 10. *See also* Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations 76 Fed. Reg. 7976, 7984 (Feb. 11, 2011).

7. Final Rules at p. 29.

portfolio, after taking into account unrealized profits and losses. Alternatively, a registered investment company may limit the aggregate net notional value[8] of its speculative commodities-related trading positions to 100% of the liquidation value of its portfolio, after taking into account unrealized profits and losses (excluding the in-the-money amount of an option at the time of purchase). The new exclusion added by the rule allows a registered investment company to enter into derivatives having a net notional value equal to up to 100% of the fund's net asset value (NAV). Although this exclusion does provide additional flexibility over the 5% limitation, it may not be useful to funds investing in commodities through a controlled foreign corporation (CFC)[9] because the rule treats the CFC itself as a fund and would measure notional value based on the NAV of the CFC.[10] In addition, the rule limits the ability of a fund to market itself as a vehicle to provide commodities exposure even if the *de minimis* thresholds are met.

CFTC Rule 4.13(a)(4) and Rule 4.13(a)(3) Exemptions

The CFTC had proposed to rescind the exemptions available to persons that operate pools exempt from registration under the Securities Act of 1933 (Private Funds) under both CFTC Rules 4.13(a)(3) and (4). The Final Rules, however, only rescinded Rule 4.13(a)(4) and retained the exemption under Rule 4.13(a)(3). Accordingly, advisers operating Private Funds (i) that are offered only to sophisticated investors referred to in CFTC Rule 4.7 as qualified eligible persons (QEPs), accredited investors, or knowledgeable employees; and (ii) where either the aggregate initial margin and/or premium attributable to commodity interests (both hedging and speculative) do not exceed 5% of the liquidation value of the pool's portfolio or the net notional amount of the commodity interests held by the pool do not exceed the fund's NAV will continue to be able to claim an exemption from registering an operator as a CPO. The rescission of Rule 4.13(a)(4) means that advisers operating Private Funds will no longer be able to claim exemption from CPO registration for funds that that are offered only to institutional QEPs and natural persons who meet both definitional and portfolio QEP requirements that hold more than a *de minimis* amount of commodity interests. As of December 31, 2012, a Private Fund that currently relies on this exemption will be required to register an operator as a CPO unless it is able to claim another exemption from CPO registration, such as that in CFTC Rule 4.13(a)(3).

Full registration as a CPO is a relatively involved process and typically takes from six to eight weeks to complete. Registration involves submission of Form 7-R for the CPO and Form 8-Rs for all natural person Principals and for all Associated Persons (APs), along with fingerprints for such Principals and APs, as well as proof that each AP passed the required proficiency exams (generally the Series 3 or 31). At least one Principal will be required to be registered as an AP. Fully registered CPOs will also be subject to CFTC and NFA regulation. Such regulation includes providing disclosure documents to pool participants that are subject to review by NFA and recordkeeping and periodic and annual reporting requirements, including delivery of audited annual financial statements.

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8. Under the Final Rules, for determining the "net notional value" the registered investment company may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and swaps cleared on the same designated clearing organization.

9. Although in mid-2011 the Internal Revenue Service (IRS) stopped issuing private letter rulings on mutual funds investing in CFCs that invest in commodities and commodity-linked derivatives (and such rulings were the topic of a recent Senate hearing), we expect that mutual funds will continue to invest in commodities and commodity-linked derivatives through appropriately operated and structured CFCs until such time as the IRS issues guidance to the contrary or Congress passes legislation to limit or eliminate such activity.

10. The CFTC made clear that a CFC that is engaging in commodity trading is itself a commodity pool and, accordingly, advisers operating a CFC must register as a CPO unless they qualify for an exemption "on their own merits." Final Rules at p. 31.

Registered CPOs may rely on CFTC Rule 4.7 for relief from certain requirements. Rule 4.7 provides relief from the disclosure, recordkeeping, and reporting requirements for CPOs that offer interests in private pools investing in commodities solely to QEPs. Currently, Rule 4.7 provides that a CPO claiming relief under the rule is not required to provide its pool participants with audited annual financial statements. The Final Rules rescind this relief and require CPOs operating pools pursuant to relief under Rule 4.7 to have the annual financial statements for the pool certified by a public accountant.[11] The rules do not, however, rescind the other types of relief offered under Rule 4.7. Accordingly, a Private Fund that will now be required to register an operator as a CPO due to the rescission of Rule 4.13(a)(4) will be able to claim at least some relief from the disclosure, recordkeeping, and reporting requirements under the CFTC rules.

The rescinding of 4.13(a)(4) also means that a number of investment advisers will be required to register with the CFTC as CTAs. Investment advisers who currently operate under an exemption from CTA registration under CFTC Rule 4.14(a)(8), based on the fact that they provide advice only to pools that are exempt under Rule 4.13(a)(4), will be required to register as CTAs with the CFTC and become NFA members. These advisers will also be subject to the full scope of CFTC and NFA requirements applicable to CTAs.

The changes will impact a wide variety of private funds and other investment managers, such as family offices. Given that the CFTC invoked the Dodd-Frank Wall Street Reform and Consumer Protection Act as part of the basis for its decision to roll back Rules 4.13 and 4.14, it is surprising that the CFTC declined to adopt a carve out for family offices as Congress did in the case of SEC registration.

Annual Notice

Currently, Rules 4.5, 4.13, and 4.14 require persons claiming relief from registration with the CFTC to electronically file with NFA a notice claiming such exemption at inception. The Final Rules require that on an annual basis, in order to retain eligibility for the exemption, persons who are still eligible for relief under Rules 4.5, 4.13, and 4.14 must affirm the accuracy of their original notice of exemption, withdraw the exemption if they cease to conduct activities requiring registration or exemption from registration, or withdraw the exemption and apply for registration.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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11. The Finals Rules also amend Rule 4.7 to incorporate the newly accredited investor standards by reference to the applicable Securities and Exchange Commission (SEC) rule rather than including the terms of the rule, so as to avoid having to amend Rule 4.7 in the event that the SEC later changes the accredited investor standard.

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