

February 16, 2012

Practice Groups:**Investment
Management****Hedge Funds and
Venture Funds**

CFTC Rescinds Widely Used Private Fund Manager Exemption from Commodity Pool Operator Registration, but Retains *De Minimis* Exemption

By Susan I. Gault-Brown, Cary J. Meer, Lawrence B. Patent

Introduction

On February 8, 2012, the Commodity Futures Trading Commission (“CFTC” or “Commission”) issued final regulations that repeal the commodity pool operator (“CPO”) registration exemption widely used by the operators of private funds offered only to highly sophisticated investors (commonly called “qualified purchaser funds” or “Section 3(c)(7) Funds”). That exemption – which was set forth in CFTC Regulation 4.13(a)(4) – placed no limits upon the amount of commodity interest trading by such funds.¹ At the same time, the CFTC voted to retain the CPO registration exemption in Regulation 4.13(a)(3) for operators of private funds that trade only a *de minimis* amount of commodity interests. The *de minimis* exemption is used primarily by operators of private funds offered to investors that meet a standard basically equivalent to that of an “accredited investor” (commonly called “Section 3(c)(1) Funds”).²

The CFTC’s changes will force private fund operators that currently rely on Regulation 4.13(a)(4) (as well as advisors to those funds that currently rely on the exemption from registration as a commodity trading advisor (“CTA”) in CFTC Regulation 4.14(a)(8)) to restrict commodity interest trading to qualify for the *de minimis* exemption or register as CPOs (and as CTAs for advisors to such funds). Those that register as a CPO and/or a CTA likely will be eligible for a less burdensome system of CPO/CTA regulation under Regulation 4.7, which is available to operators of and advisors to private funds offered only to a class of investors similar to those eligible to invest in Section 3(c)(7) Funds.

The compliance date is December 31, 2012 for fund operators and advisors that have claimed the Regulation 4.13(a)(4) or 4.14(a)(8) exemptions prior to the effective date of the amendments (likely in April 2012). However, the compliance date is also the effective date of the amendments for those fund operators and advisors that have not claimed the rescinded exemptions prior to that date. Finally, with respect to private funds that invest in swaps, but not in other commodity interests, the compliance date is the effective date of the yet-to-be adopted “swap” definitions.³

¹ “Commodity interests” include futures contracts, commodity options, retail forex transactions and leverage contracts, and swaps, once the CFTC and Securities and Exchange Commission (“SEC”) adopt regulations further defining the term “swaps.”

² The CFTC also had proposed to rescind the latter exemption last year, but it “concluded that overseeing entities with less than five percent exposure to commodity interests is not the best use of the Commission’s limited resources.”

³ As with other regulations adopted under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) that are dependent upon the definition of the term “swap,” CFTC amendments to Regulations 4.13(a)(3), 4.13(a)(4), and 4.14(a)(8) as applied to “swaps” will not become effective until the effective date of regulations that further define the term “swap.”

Exemption Changes

Rescinded Exemption Under CFTC Regulation 4.13(a)(4)

Rescinded CFTC Regulation 4.13(a)(4) exempts from CPO registration operators of private funds offered only to certain highly sophisticated investors. As is the case for Section 3(c)(7) Funds, the requirements of Regulation 4.13(a)(4) generally require investors to meet the definition of “qualified purchaser” in the Investment Company Act of 1940 (“1940 Act”).⁴ Due to the similarity in investor qualification requirements, Section 3(c)(7) Funds that trade commodity interests typically rely upon the exemption in Regulation 4.13(a)(4). Regulation 4.13(a)(4) does not contain any limit upon the amount of such funds’ trading in commodity interests, ostensibly because the investor qualifications applicable to such funds are higher than the accredited investor standard that generally is applicable to funds operated in accordance with Regulation 4.13(a)(3).

Retained De Minimis Exemption Under CFTC Regulation 4.13(a)(3)

Regulation 4.13(a)(3) exempts from CPO registration those private fund operators – generally a private fund’s general partner or managing member – that operate funds that limit their trading in commodity interests. As with Section 3(c)(1) Funds, the criteria of Regulation 4.13(a)(3) generally require investors to meet the definition of “accredited investor” in Rule 501 of Regulation D.⁵ Due to the similarity in investor qualification requirements, operators of Section 3(c)(1) Funds that trade commodity interests typically rely on the exemption in Regulation 4.13(a)(3).

To qualify for the exemption, the fund’s commodity interest positions must be limited such that either: (i) the aggregate initial margin and premiums required to establish such positions will not exceed 5% of the liquidation value of the fund’s portfolio, after taking into account unrealized profits and losses, or (ii) the aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100% of the liquidation value of the fund’s portfolio, after taking into account unrealized profits and losses.⁶

Fund operators should keep in mind that derivatives that fall within the definition of “security-based swap” are not instruments that would cause a fund to fall within the definition of a commodity pool. As a result, these derivatives need not be included in either of the alternative *de minimis* calculations under Regulation 4.13(a)(3). “Security-based swaps” include swaps on single securities (such as single name credit default swaps) and swaps on narrow-based securities indices (those with nine or fewer component securities and subject to certain weighting requirements).

⁴ In addition to “qualified purchasers,” eligible investors in a Regulation 4.13(a)(4) fund included “knowledgeable employees” (as defined in 1940 Act Rule 3c-5), certain non-natural persons who are either “qualified eligible persons” (“QEPs”) or accredited investors, and “Non-United States persons” as defined in CFTC Regulation 4.7(a).

⁵ In addition to “accredited investors,” eligible investors in the Regulation 4.13(a)(3) fund include “knowledgeable employees” (as defined in 1940 Act Rule 3c-5), the CPO itself and certain employees and affiliates of the CPO, and “Non-United States persons” as defined in Regulation 4.7(a).

⁶ Unlike the amendments to CFTC Regulation 4.5 applicable to registered investment companies (“registered funds”) that were adopted together with the amendments discussed herein, Regulation 4.13(a)(3) makes no separate allowance for *bona fide* hedging transactions, so the 5% margin/100% notional value test applies to all transactions for purposes of the latter regulation. In addition, the CFTC has amended paragraphs (a)(3)(ii)(B)(1) and (2) of Regulation 4.13 (1) to incorporate within the notional value calculation the value of cleared swaps consistent with the terms of Part 45 of the CFTC’s regulations, and (2) to permit the netting of swaps cleared on the same derivatives clearing organization.

Related Commodity Trading Advisor Exemption

Many private fund advisers currently rely on CFTC Regulation 4.14(a)(8)(i)(D), which provides an exemption from CTA registration to persons that provide advice to funds that rely on Regulations 4.13(a)(3) or 4.13(a)(4). Consistent with its rescission of Regulation 4.13(a)(4), the CFTC amended Regulation 4.14(a)(8)(i)(D) to remove the reference to Regulation 4.13(a)(4).

As amended, a private fund adviser may claim this exemption if: (i) it is a registered investment adviser, either with the SEC or one or more states, or is excluded or exempt from such registration, (ii) its commodity interest trading advice is “solely incidental” to its securities advice or other investment advice to Regulation 4.13(a)(3) funds, and (iii) it does not hold itself out as a CTA.⁷ Advisers that no longer qualify to use this exemption because they advise only Regulation 4.13(a)(4) funds will have to either limit commodity interest trading in their funds so as to fall within Regulation 4.13(a)(3), or register as CTAs. Advisers that choose to register likely will be able to rely on relief from certain CTA regulatory requirements, as discussed below.

Implementation Issues

Who is the CPO?

In amending its exemptive regulations, the CFTC did not explicitly address which entity should register as the CPO of a private fund. However, the CFTC indicated that the investment adviser may be the logical entity to register as the CPO of a private fund, noting that “[F]oreign advisors to pools that meet the criteria of § 4.13(a)(3) will be able to continue to operate pursuant to that exemption, if previously claimed, or file notice of claim of exemption under § 4.13(a)(3).” The CFTC made this explicit in its changes to Regulation 4.5 – the exemptive regulation for registered investment companies – stating that “the investment adviser is the most logical entity to serve as the [registered fund’s] CPO.” This is logical because the reality is that the adviser is the driving force behind, and attraction for investors to invest in, the fund, and it is therefore more appropriate for the adviser to comply with the registration and other regulatory obligations of a CPO than for the fund’s directors to do so.⁸ In its discussion of the changes to the exemption in Regulation 4.5, which is the exemption advisers to registered funds rely on, the CFTC also stated that to require a member or members of a fund’s board of directors or trustees to register would raise operational concerns as it would result in piercing the limitation on liability for actions undertaken in the capacity of a director or trustee. Although the CFTC was silent on this issue with respect to private funds, our understanding is that the CFTC staff would be willing to consider providing similar relief for directors of private funds.

Foreign Advisers

The CFTC did not adopt a foreign adviser exemption similar to that set forth in Section 202(a)(11) of the Investment Advisers Act of 1940 (“Advisers Act”), notwithstanding requests for a foreign adviser exemption from several commenters, based on what the CFTC perceived as a lack of data with respect to foreign entities. The CFTC stated that “[d]ue to the exemptions previously adopted by the Commission, and the resulting lack of information regarding the activities of CPOs claiming relief

⁷ An adviser claiming an exemption under Regulation 4.14(a)(8) must file a notice electronically with the National Futures Association (“NFA”) to claim the exemption, maintain certain records for five years, and submit to CFTC special calls to demonstrate eligibility for and compliance with the criteria for exemption.

⁸ These obligations are described more fully in our previous Alert published when the proposals were issued available [here](#).

thereunder, the Commission does not yet have a comprehensive view of the positions taken and interests held by currently exempt entities.” As a result, nearly all non-U.S. based CPOs operating a pool that relies on Regulation 4.13(a)(4) with at least one U.S. investor will be required to register with the CFTC or reduce commodity interest trading to fall within the *de minimis* exemption. Although it refused to provide an exemption at this time, the CFTC did indicate that it may consider a foreign adviser exemption after it receives data from such firms on Forms CPO-PQR and CTA-PR under its newly adopted reporting regime.

Family Offices

The CFTC declined to adopt a family office exemption akin to the exemption adopted by the SEC under the Advisers Act,⁹ citing the same lack of data about such entities as it cited for foreign advisers.¹⁰ Although it refused to provide a family office exemption at this time, the CFTC directed its staff “to look into the possibility of adopting a family office exemption in the future.” The CFTC further noted that family offices may continue to request interpretative relief from the registration and compliance obligations applicable to CPOs on an *ad hoc* basis and to rely on interpretative letters already issued to the extent permissible under the CFTC’s regulations.¹¹

Managers of Funds of Funds

The CFTC declined to retain Regulation 4.13(a)(4) exemptive relief specifically in the fund of funds context (*i.e.*, with respect to managers of funds that do not directly invest in commodity interests, but invest in other funds that directly invest in commodity interests). Here again, the CFTC cited its lack of data regarding the activities of previously exempt entities and, therefore, stated that it has no basis to determine whether to adopt a fund of funds manager exemption. The CFTC did note, however, that its staff will consider requests for exemptive relief for managers of funds of funds on a case-by-case basis.

Further, the CFTC revised Appendix A to Part 4 of its regulations so that it now contains a template of newly adopted Form CPO-PQR. Appendix A previously provided guidance on the application of Regulation 4.13(a)(3) in the fund of funds context. The CFTC staff indicated informally that this guidance is being reviewed and likely will be revised and republished as a new Appendix D to Part 4. Therefore, managers of funds of funds that had been relying upon Regulation 4.13(a)(4) should review the various situations described in the former Appendix A regarding whether they may qualify for exemption under Regulation 4.13(a)(3), at least until specific guidance is provided in this area.

Regulatory Relief From Certain CPO and CTA Requirements

Operators of private funds that were relying upon the exemption from registration in Regulation 4.13(a)(4) whose funds cannot meet the trading limits of Regulation 4.13(a)(3) will have to register as

⁹ See Rule 202(a)(11)(G)-1 under the Advisers Act.

¹⁰ Commenters argued that the CFTC should have little regulatory concern about family offices because their clientele is necessarily limited to family members and the family offices do not solicit outside of the family unit.

¹¹ See CFTC Regulation 140.99(a)(3) (“An interpretative letter may be relied upon by persons in addition to the Beneficiary.”). CFTC Interpretative Letter 10-25 is the most recent letter affirming the interpretation that a “family office” is not a commodity pool and is available at the Commission’s [website](#). See also CFTC Interpretative Letter 00-100 [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,420 (November 1, 2000); CFTC Interpretative Letter No. 96-24, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,653 (March 4, 1996); CFTC Interpretative Letter No. 97-29, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,039 (March 21, 1997); CFTC Interpretative Letter No. 95-35, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,376 (November 23, 1994).

CPOs or have the funds exit the commodity interest markets. Similarly, advisers to such funds will have to register as CTAs or discontinue commodity interest advisory services to such funds. These newly registered CPOs and CTAs should be able to qualify for regulatory relief (described below) in accordance with Regulation 4.7(b) and (c), respectively. Those provisions provide relief from certain CPO and CTA regulatory requirements with respect to the preparation of a disclosure document,¹² periodic and annual reporting to investors,¹³ and recordkeeping.¹⁴ CPOs and CTAs to private funds offered solely to “qualified eligible persons” under CFTC Regulation 4.7, a definition that includes individuals who are qualified purchasers as well as certain Non-United States persons, likely will be eligible to rely on Regulation 4.7 relief.

Claiming an Exemption

Regulation 4.7, 4.13 and 4.14 exemptions are claimed by filing a notice electronically with NFA.¹⁵ Previously, such notices were filed on a one-time basis, with CPO exemption notices requiring that the name of the pool be listed and updated as new pools are added, and CTA exemption notices only requiring the name of the CTA. The CFTC has amended these regulations to require an annual re-affirmation of the exemption claims by March 1 (or February 29 in leap years).¹⁶

Timetable

The CFTC did not “grandfather” private funds that currently claim a CPO exemption under Regulation 4.13(a)(4), but it did recognize that firms will need time to comply with the new regulatory framework within the following timeframes.

¹² If an offering memorandum is distributed, it must include all disclosures necessary to make the information contained therein not misleading, and a prescribed legend regarding the regulatory relief must be prominently disclosed on the offering memorandum’s cover page. If there is no offering memorandum, the legend must appear immediately above the signature line on the subscription agreement or other document that an investor must sign.

¹³ Such reports are still required, but the required contents are less extensive than for pools open to all investors. The CFTC also adopted a requirement that annual reports filed under Regulation 4.7 must be certified by an independent public accountant.

¹⁴ The CPO must maintain periodic and annual reports, and all books and records prepared in connection with its CPO activities, including records relating to the qualifications of investors and substantiating any performance representations. These records must be maintained in accordance with the CFTC’s general recordkeeping standards, which include a five-year retention period, during the first two of which the records must be readily accessible, and require that records be open to inspection by any representative of the CFTC, NFA or the U.S. Department of Justice. CFTC regulations currently require that records be kept at the CPO’s main business address. However, the CFTC recently provided regulatory relief to the operators of funds classified as “Commodity ETFs” that includes the ability to maintain books and records with the administrator, distributor or custodian, or a bank or registered broker or dealer acting in a similar capacity with respect to the fund, subject to certain conditions. Regulation 4.12(c)(2)(iii), 76 Fed. Reg. 28641 (May 18, 2011). The CFTC also stated in the preamble of the *Federal Register* release proposing regulatory changes to harmonize the CFTC and SEC frameworks regarding registered funds that it would be willing to extend similar relief to the operators of those funds. Based upon discussions with CFTC staff, they might be willing to consider interpretative relief on this issue.

¹⁵ Those entities that can continue to claim exemption from registration under Regulations 4.13 and 4.14 remain subject to the anti-fraud and anti-manipulation provisions applicable to all CPOs and CTAs under the Commodity Exchange Act, advertising restrictions in Regulation 4.41, and the large trader reporting system and position limits applicable to all traders. Parts 15-21 of the CFTC’s regulations govern the large trader reporting system. Position limits are set forth in Part 150 of the CFTC’s regulations, and the CFTC has adopted new Part 151 to include the limits previously covered in Part 150, as well as limits on additional commodities.

¹⁶ In response to NFA’s comment, the CFTC adopted the uniform date for re-affirmation of exemption claims, rather than the proposed anniversary of the original filing, as being more operationally efficient, and also extended the time period within which to make the re-affirmation from the proposed 30 to 60 days.

1. For Regulation 4.13(a)(4) Notices Filed Before the Effective Date. Any firm that has filed a notice of exemption prior to the general effective date of the new regulations – which will be 60 days following publication of the final regulations in the Federal Register (*i.e.*, the general effective date likely will occur sometime in April) (the “Effective Date”) – must by the end of the year, either (1) conform its operations to the conditions of Regulation 4.13(a)(3) and amend its exemption notice to reflect the new basis for exemption, (2) register as a CPO, or (3) cease operating pools that trade in commodity interests.
2. For Regulation 4.13(a)(4) Notices That Were Not Filed Prior to the Effective Date. For operators of any new pools formed after the Effective Date, the firm must be in compliance with the new regulatory scheme upon formation and commencement of operations and will be unable to rely upon rescinded Regulation 4.13(a)(4) with respect to those pools.
3. For CTAs to Regulation 4.13(a)(4) Funds. CTAs that claimed exemption under Regulation 4.14(a)(8) because they advised pools operated in accordance with Regulation 4.13(a)(4) must adhere to the same timetable. Accordingly, CTAs acting as advisors or sub-advisors to pools formed after the Effective Date no longer will be able to rely upon Regulation 4.13(a)(4) as the basis for exemption from CTA registration under Regulation 4.14(a)(8).
4. For Operators of Private Funds with Commodity Interest Investments Limited to Swaps. Operators of private funds that have participated in the commodity interest markets only through swaps have not been required to register as CPOs or to claim any exemption from registration because the pre-Dodd-Frank CPO definition did not include swaps. The compliance date for CPO registration or filing of exemption notices for these funds is the effective date of the yet-to-be adopted further definition of the term “swap,” whether that comes before or after December 31, 2012. On the effective date of the further definition of the term “swap,” operators of such funds will be required to register as CPOs, come within the trading limits and other conditions of Regulation 4.13(a)(3), or exit the swap market.

Conclusion

Private fund operators and advisers that have claimed exemption from CPO and CTA registration on the basis of Regulation 4.13(a)(4) or Regulation 4.14(a)(8) can take advantage of the compliance period to review the commodity interest participation of each fund for which an exemption has been claimed to determine whether the funds are in compliance with, or readily can conform their operations to come within, the criteria for exemption under Regulation 4.13(a)(3). If so, exemption notices should be amended to reflect the new basis for exemption. If not, the operator and adviser of the funds must decide whether to register as a CPO or CTA or wind up the operations of those funds that are not in compliance with Regulation 4.13(a)(3). As clients review their commodity interest activities, there undoubtedly will be particular questions and issues that arise, and we encourage you to reach out to any of the authors of this Alert for further guidance.

Authors:

Susan I. Gault-Brown
susan.gaultbrown@klgates.com
+1.202.778.9083

Cary J. Meer
cary.meer@klgates.com
+1.202.778.9107

Lawrence B. Patent
lawrence.patent@klgates.com
+1.202.778.9219

K&L GATES

Anchorage Austin Beijing Berlin Boston Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg
Hong Kong London Los Angeles Miami Milan Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh
Research Triangle Park San Diego San Francisco São Paulo Seattle Shanghai Singapore Spokane Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of more than 40 fully integrated offices located in North America, Europe, Asia, South America, and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&L Gates or its locations and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2012 K&L Gates LLP. All Rights Reserved.