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A Legal Update from Dechert's Financial Services and Corporate Groups

CFTC Grants CPO Registration No-Action Relief to Business Development Companies

Summary. Under pending regulations of the U.S. Commodity Futures Trading Commission (CFTC) scheduled to take effect on January 1, 2013, business development companies (BDCs) and/or their sponsors or advisers (operators) would be required to register as “commodity pool operators” (CPOs) if BDCs entered into even a single swap agreement to hedge interest rate or currency exposure or for other purposes. At the request of Dechert LLP on behalf of its clients and the industry as a whole,¹ on December 4, 2012 the CFTC Staff issued no-action relief and guidance (Relief) that effectively extends to BDCs and their operators relief comparable to that afforded to mutual funds and other registered investment companies and their operators in Regulation 4.5 under the U.S. Commodity Exchange Act as amended (CEA)². As a result of this action, BDCs and their operators will not be required to register as CPOs with the CFTC if they meet the requirements of the Relief and make an effective claim for the Relief with the CFTC.

Discussion. The CEA and the related regulations of the CFTC require that any person or entity qualifying as a CPO³ register with the CFTC as such unless such person or entity has an applicable exclusion or exemption from registration. A registered CPO must also become a member of the U.S. National Futures Association, the self-regulatory organization for the commodity industry. In August 2012, the CFTC published a joint rulemaking with the U.S. Securities and Exchange Commission (SEC) implementing various provisions of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).⁴ This rulemaking took effect on October 12, 2012. Among other provisions, the Dodd-Frank Act and this rulemaking added certain “swaps” to the range of instruments subject to regulation by the CFTC as “commodity interests”⁵ and broadened the definition of the term “commodity pool” from an investment trust, syndicate, or similar form of enterprise operated for the purpose of trading exchange-traded commodity futures contracts and options to any such vehicle trading any commodity interests, including most swaps.⁶ Under these new rules, unless a commingled investment vehicle were to obtain specific relief from the CFTC, it would fall within the definition of commodity pool upon entering into a commodity interest and it and/or its operator would therefore be required to register as a CPO (unless it otherwise qualifies for an exclusion or exemption from such rules, for which there are currently only limited and unattractive options for BDCs). These rules make no distinction between commodity interests entered into for hedging purposes or for other purposes. This broad definition increased substantially the number and type of entities that will potentially need to register as CPOs, including vehicles that use swap contracts solely as part of their interest rate or currency management strategy.

With the broad scope of these pending new rules, which are scheduled to take effect on January 1, 2013, all entities entering into most swap agreements or other commodity interests must either register as a CPO or have an available exclusion or exemption. Recently amended CFTC Regulation 4.5⁷ excludes from the definition of CPO persons who would otherwise be regulated under the CEA due to their operation of certain commingled investment vehicles that constitute commodity pools, including any “investment company that is registered as such under the Investment Company Act of 1940 [as amended (1940 Act)]” (Registered Fund). In the case of a Registered Fund, this exclusion is available only if (1) the Registered Fund will not be, and has not been, marketed to the public as a commodity pool or otherwise as a vehicle for trading commodity interests (Marketing Test), and (2) with respect to commodity interests entered into by the Registered Fund for purposes other than *bona fide* hedging (as that term is interpreted by the

CFTC),⁸ either (a) the aggregate initial margin, independent amounts, and option premiums required to establish such Registered Fund's commodity interest positions do not exceed 5% of the liquidation value (*i.e.*, net asset value) of the Registered Fund's portfolio (after taking into account unrealized profits and unrealized losses and, in the case of an in-the-money option at the time of purchase, excluding such in-the-money amount) or (b) the aggregate net notional value of such Registered Fund's commodity interest positions does not exceed 100% of the liquidation value of such Registered Fund's portfolio (with the same treatment for unrealized profits and losses) (Trading Tests). A Registered Fund must test compliance with the *de minimis* Trading Tests each time it enters into a commodity interest position. Persons able to take advantage of the exclusion provided by Regulation 4.5 are not required to register with the CFTC, but they must still make a notice filing with the CFTC regarding their reliance on such exclusion.

For technical reasons under the 1940 Act, BDCs are not Registered Funds. As a result, they do not qualify for the exclusion provided by Regulation 4.5.⁹ Therefore, after December 31, 2012 and absent the Relief, BDCs would not be able to enter into even a single swap agreement (other than a security-based swap) without registering as a CPO.

In our letter dated November 13, 2012, Dechert requested relief and guidance from the CFTC Staff to permit a BDC to utilize the exclusion from the definition of a CPO afforded by Regulation 4.5 for Registered Funds. Our letter noted that the CFTC originally adopted Regulation 4.5 for the purpose of providing relief from regulation as a CPO to "certain otherwise regulated entities,"¹⁰ such as Registered Funds. A BDC, however, is not "an investment company registered as such" under the 1940 Act, as required by the text of Regulation 4.5. Rather, although BDCs are created by, and subject to extensive regulation under, the 1940 Act, they are entities exempt from registration under the 1940 Act and, as a result, Regulation 4.5 does not expressly apply to BDCs.

In response to the Dechert request and on the basis of the existing, comprehensive regulatory structure applicable to BDCs, the CFTC Staff issued the Relief that allows all qualifying BDCs and their operators to claim relief from the CPO registration requirements, provided the BDC satisfies the following requirements:

1. the BDC has elected to be treated as a BDC under Section 54 of the 1940 Act with the SEC and continues to be regulated as such by the SEC; and
2. the BDC satisfies the Marketing Test; and
3. the BDC satisfies at least one of the two Trading Tests.

The Relief is not self-executing. A qualifying BDC must file with the CFTC a claim for the Relief (in proper form via e-mail) prior to December 31, 2012 (for BDCs in operation as of December 1, 2012) and within 30 days after commencement of operations (for BDCs commencing after December 1, 2012), to be effective upon filing.

Footnotes

1. [Letter from M. Holland West and Thomas J. Friedmann, Dechert LLP, to Gary Barnett, Director of the Division of Swap Dealer and Intermediary Oversight, U.S. Commodity Futures Trading Commission \(Nov. 13, 2012\) \(PDF\).](#)

2. [CFTC Letter No. 12-40, No-Action Relief from the Commodity Pool Operator Registration Requirement \(Dec. 4, 2012\) \(PDF\).](#)

3. A CPO is a person engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests. CEA Section 1a(11);

6. Dodd-Frank Act Section 721(a)(5); CEA Section 1a(10); CFTC Regulation 4.10(d).

7. CFTC Regulation 4.5, and particularly (a)(1), (b)(1) and (c)(2)(iii) thereof.

8. CFTC Regulations 1.3(z); 151.5.

9. BDCs are investment companies exempt from registration as investment companies pursuant to an election to be treated as BDCs under Sections 54 through 65 of the 1940 Act.

10. Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term Commodity Pool Operator, 50 Fed. Reg. 15868 (April 23, 1985) (codified at 17 C.F.R. pt 4).

CFTC Regulation 1.3(cc).

4. Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (Aug. 13, 2012) (to be codified at 17 C.F.R. pts 1, 230, 240, and 241).

5. Commodity interests were previously limited to exchange-traded commodity futures contracts, options on futures, and commodity options (among other instruments). The Dodd-Frank Act expanded the definition of commodity interest to include security futures products and certain exchange-traded and over-the-counter derivatives (such as swap, forward, and option contracts), other than swaps (including credit default swaps) referencing single securities or loans or baskets of nine or fewer securities (that is, security-based swaps which are not commodity interests subject to CFTC regulation and are instead regulated by the SEC), forward contracts on non-financial items, and certain limited currency swaps and forwards providing for physical delivery of two currencies. CFTC Regulation 1.3(yy).

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