

## Commodity-Related Developments Impacting Registered Investment Companies

### Background

In 2012 the Commodity Futures Trading Commission (the “CFTC”) significantly narrowed the CFTC Rule 4.5 exclusion from the definition of commodity pool operator (“CPO”) available to operators of investment companies registered under the Investment Company Act of 1940 (“RICs”). There have recently been several developments related to the Rule 4.5 changes impacting CPOs operating RICs:

- The National Futures Association (“NFA”) issued a notice to members mandating a response from any CPO operating a commodity pool that is a RIC by February 15, 2013.
- The Investment Company Institute (“ICI”), Investment Adviser Association (“IAA”), Managed Funds Association (“MFA”) and Securities Industry and Financial Markets Association (“SIFMA”) submitted a letter requesting that the CFTC grant relief to permit sponsors of RICs to net certain uncleared swaps held by a RIC when applying the net notional test under amended Rule 4.5.
- The ICI and U.S. Chamber of Commerce (the “Chamber”) appealed a federal district court’s decision rejecting the ICI and Chamber’s challenge to the amendments to Rule 4.5.

For additional information on the CFTC’s adoption of the amendments to Rule 4.5 along with information about certain other related CFTC rule changes and proposals, please see our March 2012 Client Alert available [here](#).

### NFA Mandates Response from CPOs Operating RICs

The NFA recently issued a notice to members mandating that every CPO member that operates a commodity pool

that is also a RIC inform the NFA of this fact by February 15, 2013. CPOs are to inform the NFA through their Annual Questionnaires by answering “yes” to the question “Is this pool a Registered Investment Company?” with respect to each such pool that is a RIC. This question appears at the end of each pool’s Annual Questionnaire. The NFA’s notice explains that the NFA is requesting this information in order to identify pools that do not have to comply with certain CFTC requirements and NFA rules until the CFTC adopts final rules governing the compliance framework for RICs subject to the CFTC jurisdiction. While responses to this item are due by February 15, 2013, the remainder of the Annual Questionnaire does not need to be completed by a CPO until the anniversary of its NFA membership. A copy of the NFA’s notice is available [here](#). The Annual Questionnaire can be accessed at the NFA’s website [here](#).

### Relief Requested for RICs to Net Uncleared Swaps when Applying CFTC Rule 4.5

The ICI, IAA, MFA and SIFMA recently submitted a letter requesting that the CFTC grant relief to permit sponsors of RICs to net certain uncleared swaps held by a fund when applying the net notional test in amended Rule 4.5. A copy of the letter is available [here](#).

Amended Rule 4.5 permits a RIC to use commodity futures, commodity option contracts, and swaps in an unlimited amount for “bona fide hedging purposes” (within the meaning and intent of CFTC Rules 1.3(z)(1) and 151.5) and to a limited extent for non-hedging purposes. Amended Rule 4.5 provides two alternative ways to meet the limit on non-hedging use of commodities. One way is for a RIC to limit the aggregate net notional value of its non-hedging commodities positions to not more than 100 percent of the liquidation value of its portfolio, after taking into account unrealized profits and losses on such positions. This computation is determined at the time the most recent position was established. The rule provides that future contracts may be netted with the same underlying commodity across designated contract markets

and foreign boards of trade for purposes of this calculation. Additionally, the rule provides that swaps cleared on the same designated clearing organization may be netted for purposes of this calculation. Amended Rule 4.5 does not explicitly permit the netting of uncleared swaps.

The letter to the CFTC requests that netting of uncleared swaps be permitted where (1) the termination dates of the offsetting swaps are the same and (2) the reference asset or rate for the offsetting swaps are the same. It also asks that, if the notional amounts of the offsetting swaps are not the same, the amount netted be equal to the smaller of the two notional amounts. The letter argues that, in these circumstances, the offsetting swaps serve to reduce the RIC's exposure to commodity interests, which is fully consistent with the purpose of the trading thresholds in Rule 4.5.

The letter to the CFTC also requests that netting of uncleared swaps be permitted when applying the net notional test in connection with the Rule 4.13(a)(3) exemption from CPO registration for certain operators of private funds.

### **ICI and Chamber Appeal Lower Court Decision Rejecting Challenge to CFTC Amendment to Rule 4.5**

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In 2012, the ICI and Chamber filed a legal challenge to the CFTC's amendments to Rule 4.5 charging that the amendments were arbitrary and capricious and that the CFTC violated the Administrative Procedure Act as well as the Commodity Exchange Act. In December 2012, the U.S. District Court for the District of Columbia dismissed the ICI and Chamber's challenge and upheld the CFTC's amendments to Rule 4.5. The ICI and Chamber have appealed the federal district court's decision to the U.S. Court of Appeals for the District of Columbia Circuit and filed a motion for expedited consideration of the appeal.

To discuss any of the topics covered in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at [Chapman.com](http://Chapman.com).

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