Client Alert

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CFTC Eliminates and Narrows Key Exemptions for Commodity Pool Operators and Commodity Trading Advisors

The Commodity Futures Trading Commission (the “CFTC”) recently issued final rule changes:

- narrowing the exclusion from the definition of commodity pool operator (“CPO”) available to mutual funds and other registered investment companies (“RICs”) and their advisers;
- eliminating an exemption from CPO registration available to private fund operators (but keeping another exemption that had also been proposed to be eliminated);
- narrowing and rescinding certain exemptions from commodity trading advisor (“CTA”) registration;
- adding certain risk disclosure statements for CPOs and CTAs with respect to swaps; and
- making certain changes to reporting and certification obligations for entities required to register as CPOs and CTAs and entities relying on exclusions and exemptions from registration.

The final rules are available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf and are awaiting publication in the Federal Register. Most of the rule changes become effective either 60 days following publication in the Federal Register or December 31, 2012 (with certain rules not becoming effective until the CFTC adopts final rules to define “swap”). In a separate release the CFTC proposed relief from several regulatory requirements for CPOs to RICs that will now be required to register with the CFTC in an effort to harmonize rulemaking with federal securities regulation. This “Harmonization Proposal” is available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-3388a.pdf.

Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act makes sweeping changes to the Commodity Exchange Act and to certain securities laws with respect to the regulation of over-the-counter derivatives and commodities. Prior to the Dodd-Frank Act changes, an operator of a US pooled vehicle that traded only over-the-counter derivatives, but not exchange-traded futures contracts or options on futures contracts, generally would not be required to register as a CPO with the CFTC or rely on a registration exemption. Similarly, a person that provided advice to clients on swaps, but not futures, was generally not required to register as a CTA. Among other things, the Dodd-Frank Act amended the Commodity Exchange Act to add the defined terms “swap” and “commodity pool” and to amend the definitions of “commodity pool operator” and “commodity trading advisor”. A “swap” is broadly defined to include most over-the-counter derivatives other than “security-based swaps” regulated by the Securities and Exchange Commission (“SEC”). Accordingly, for this purpose a “swap” is not limited to contracts normally called “swaps” in common industry jargon. In conjunction with this change, the new and amended definitions of “commodity pool,” “commodity pool operator,” and “commodity trading advisor” all include references to “swaps”. As a result, a person that operates a pooled investment vehicle that trades swaps will be required to register a CPO or otherwise need to rely on some exemption from registration, and any person advising such a pooled investment vehicle with respect to swaps will be required to register as a CTA or otherwise

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claim an exemption from registration. The CFTC and SEC are still in the process of further defining the term "swap" with additional rulemaking. For additional information on the definition of "swap", see our related Client Alert at http://www.chapman.com/media/news/media.1013.pdf, and for updated information see our publication "Dodd-Frank: Impact on Asset Management" at http://www.chapman.com/media/news/media.901.pdf.

In January 2011, the CFTC proposed a number of amendments to the CFTC Rules providing exclusions from the definition and exemptions from the registration available to CPOs and CTAs. At the same time, the CFTC proposed changes to certain other rules relating to disclosure and certification obligations of CPOs and CTAs. The CFTC recently issued their final amendments to the rules relating to CPO and CTA compliance along with the Harmonization Proposal to deal with certain inconsistencies between CFTC and SEC regulations applicable to CPOs and CTAs under the new rules.

CFTC Rule 4.5 CPO Exclusion for RICs

The CFTC final rule amendments narrow the CFTC Rule 4.5 exclusion from the definition of CPO for investment companies registered under the Investment Company Act of 1940. CFTC Rule 4.5 currently provides an exclusion from the definition of CPO for persons operating otherwise regulated entities, such as sponsors and advisers of investment companies registered under the Investment Company Act (along with entities such as banks which are not impacted by these Rule 4.5 amendments). Prior to amendments made in 2003, Rule 4.5 required that the use of commodity futures by a qualifying fund for purposes other than bona fide hedging purposes be limited to five percent of the liquidation value of the fund's portfolio and that the fund not be marketed as a commodity pool to the public. The new rule amendments reinstate the pre-2003 requirements with the five percent non-hedging limit and an alternative de minimis test based on aggregate net notional value of commodities. As a result, operators of RICs will no longer be able to rely on Rule 4.5 to avoid registration as a CPO if the investment company invests more than a small amount of its assets for non-hedging purposes in commodities. Under the new rules, RICs relying on Rule 4.5's exclusion from the CPO definition are required to use commodity futures, commodity option contracts, and swaps solely for bona fide hedging purposes or meet a (1) trading restriction and (2) marketing restriction.

Trading Restriction

To qualify for the amended Rule 4.5 exclusion, a RIC must limit its use of commodity futures, commodity option contracts, and swaps. The amended rule 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 tests applicable to non-hedging use of commodities.

- *Five Percent Limit*—One alternative is for a RIC to limit the aggregate initial margin and premiums required to establish non-hedging commodities positions to not more than five percent of the liquidating value of its portfolio after taking into account unrealized profits and losses on any such contract it has entered into. Options that are in the money at the time of purchase may be excluded for purposes of computing this five percent.

- *Net Notional Value Limit*—A second alternative is for a RIC to limit the aggregate net notional value of 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. 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, swaps cleared on the same designated clearing organization may be netted for purposes of this calculation.

The CFTC also noted in its adopting release that it believes RICs use controlled foreign corporations ("CFCs") as a mechanism to invest substantial portions of RICs' portfolios in derivatives and that the use of a CFC may indicate that the RIC is engaging in derivatives trading in excess of the threshold. The CFTC noted that this will be considered as a factor in whether it meets the trading restriction. While the CFTC specifically noted that it does not oppose the continued use of CFCs, it noted that a CFC wholly owned by a RIC and used for trading commodities falls within the definition of commodity pool and that the CFC's operator must consider CPO registration even if the RIC-parent is excluded from the definition of CPO under Rule 4.5.

Marketing Restriction
In addition to the trading restriction described above, a RIC seeking to rely on the Rule 4.5 exclusion may not market itself as a commodity pool or as a vehicle for trading in commodities futures, commodity options, or swap markets. In the adopting release, the CFTC noted that factors indicative of commodity pool marketing include:

- The name of the RIC;
- Whether the RIC's investment objective is tied to a commodity index;
- Whether the RIC makes use of a CFC for derivatives trading;
- Whether the RIC's marketing materials, including its prospectus or disclosure documents, refer to the benefits of derivatives or makes comparisons to a derivatives index;
- Whether in the course of its normal trading activities, the RIC or entity on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;
- Whether the futures/options/swaps transactions engaged in by the RIC or on behalf of the RIC will directly or indirectly be its primary source of gains and losses; and
- Whether the RIC is explicitly offering a managed futures strategy.

The CFTC noted that no factor is dispositive in determining whether a fund is "operating as a de facto commodity pool" but that it would give additional weight as to whether the RIC is explicitly offering a managed futures strategy.

Who is Required to Register as a CPO for a RIC?
There has been some concern over who would be considered to be the CPO of a RIC deemed to be a commodity pool including substantial concern that a RIC's board of trustees or directors would be required to register. In the adopting release, the CFTC noted that mutual fund board members and directors would not be required to register as this would raise operational concerns for the RIC as it would result in the piercing the limitation on liability for actions undertaken in the capacity as a director. The CFTC adopted the recommendations of commenters that the adviser to a fund is the entity that should register as a CPO if registration is required. There is no clarification in the final rule as to how this should impact sub-adviser(s) to a RIC.

Effective Dates
RICs will be required to comply with the new Rule 4.5 registration rules at the later of December 31, 2012, or 60 days after the adoption of rules to define the term "swap" and establishing margin requirements for "swaps". Compliance with CFTC recordkeeping, reporting, and disclosure requirements will be required 60 days following the effectiveness of a final rule implementing the CFTC's harmonization rules (described below). The final rule amendments do not provide for a grandfathering provision for RICs that had previously relied on Rule 4.5 (as had been considered in the original rule proposals).

Harmonization of Compliance Obligations for RICs Required to Register as CPO Proposals

Because many CPOs of RICs will now be required to register with the CFTC, as a result of the narrowing of the Rule 4.5 exclusion, these CPOs will be subject to certain CFTC rules that directly conflict with certain SEC and Financial Industry Regulatory Authority, Inc. ("FINRA") rules applicable to RICs. The CFTC has issued a Harmonization Proposal to address these conflicts. In part, this proposal would extend relief the CFTC has previously adopted for CPOs operating commodity-based exchange traded funds under Rule 4.12(c). The CFTC stated that in its adopting release it believes most CFTC required disclosures can be addressed alongside SEC required information in RIC registration materials. Comments on the harmonization proposal are due to the CFTC by April 24, 2012.

Disclosure Document Acknowledgement Requirement
CFTC regulations require each CPO to deliver a disclosure document containing certain specified information to prospective participants and to obtain a signed and dated acknowledgement of receipt prior to admitting such participants. The CFTC is proposing to allow RICs to meet this requirement by posting documents to the CPO's website.

Prior Performance Presentation
In certain circumstances, CFTC regulations require CPOs to disclose in disclosure documents the prior performance of pools and accounts other than the commodity pool being offered which disclosure may be in direct conflict with certain SEC provisions. The CFTC has proposed to

require that any performance that CPOs are required to present under CFTC rules may be presented in a RIC's Statement of Additional Information. The CFTC noted in the rule proposal that they have conducted preliminary discussions on this issue with SEC staff.

Cautionary Statement Legend
The CFTC has proposed to combine its cautionary statement requirement with the prospectus legend required by Securities Act of 1933 Rule 481(b)(1) to appear on a RIC's prospectus cover page so that such legend could either read:

- The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or this pool or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense; or

- The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or this pool or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Disclosure of Break-Even Point, Fees and Expenses
CFTC regulations require CPO disclosure documents to include a "break-even point" which provides a specific calculation as to the trading profit that a pool must realize in the first year for an investor to recoup its initial investment. The CFTC has indicated that it believes the inclusion of the break-even point in the RIC's prospectus is necessary despite the RIC prospectus already showing expense ratios. The CFTC is proposing that any fees and expenses required to be included in the fee table in the RIC prospectus under SEC rules be disclosed along with the presentation of the break-even point and other fee/expense information. Pursuant to the requirement that such disclosure be included in the "forepart" of the disclosure document, the CFTC is proposing to clarify that for an open-end fund this shall include the part of the prospectus immediately following all disclosures required by Form N-1/A to be included in the summary prospectus but did not identify what specifically constitutes the "forepart" of a closed-end fund prospectus.

Timing of Mandatory Updates of Disclosure Documents
The CFTC has proposed that disclosure documents be dated no more than 12 months to make updating requirements more consistent with federal securities laws. Currently, the CFTC requires that such disclosure documents be dated no more than nine months prior to the date of use.

Books and Records
The CFTC also proposes to extend relief which would allow CPOs maintain books and records at the RIC's administrator, distributor, custodian, or bank or registered broker or dealer acting in a similar capacity rather than at the CPO's main business office (as required under current CFTC regulations).

Filing of Amendments
The CFTC proposals allow for CPOs of "pools that provide for daily liquidity" (e.g. commodity ETFs) to post disclosure documents on their websites at the same time as they are filed for review with the NFA.

Timing and Certification of Periodic Reports
SEC rules generally require that only annual and semi-annual reports (i.e. not monthly reports) are required to be provided to RIC investors whereas CFTC rules require CPOs to provide monthly reports. The CFTC expressly declined to alter this requirement in the Harmonization Proposal but instead is proposing to allow RICs to satisfy the delivery requirement by posting the statements to its website so long as RIC disclosure documents clearly indicate such documents will be available on the CPO's website. The CFTC also has noted in its discussion that it would accept the SEC's certification required of RICs as to accuracy and completeness as meeting the CFTC rules so long as such certification is part of the filed form N-CSR.

CFTC Rule 4.13 Exemptions

Operators of private funds that trade futures have traditionally relied on CFTC Rule 4.13(a)(3) (generally available to certain private funds that limit their trading of futures) and CFTC Rule 4.13(a)(4) (generally available to operators of certain private funds that were offered only to sophisticated investors) for exemptions from CPO registration. The final CFTC rule changes eliminates the Rule 4.13(a)(4) exemption. As a result, operators of private funds which previously relied on Rule 4.13(a)(4) and which are unable to rely on Rule 4.13(a)(3) (i.e. that hold more than a de minimis amount of commodity interests) will be required to register as CPOs absent some other exemption. Investment advisers that currently operate under an exemption from CTA registration based on the fact that they provide advice only to pools that are

exempt under Rule 4.13(a)(4) will also be required to register as CTA absent some other exemption.

The CFTC had also originally proposed to eliminate CFTC Rule 4.13(a)(3) which provides an exemption from CPO registration with respect to certain privately-offered funds (such as 3(c)(1) and 3(c)(7) funds) that are offered only to "qualified eligible persons" (as defined under CFTC rules), accredited investors, or knowledgeable employees and that limit the aggregate initial margin and premiums attributable to commodity interests to no more than five percent of the fund's liquidation value. However, the CFTC did not rescind that rule. Accordingly, advisers operating private funds which rely on CFTC Rule 4.13(a)(3) will continue to be able to claim an exemption from registering as a CPO. Advisers relying on an exemption from CTA registration based on the fact that they provide advice only to pools that are exempt under Rule 4.13(a)(3) will also be able to continue to rely on that exemption. The final rule amendments do modify the definition of "notional value" for purposes of the Rule 4.13(a)(3) exemption in a manner consistent with that adopted for Rule 4.5 described above.

Effective Dates

Commodity pool operators currently relying on the Rule 4.13(a)(4) exemption will not be required to register or claim another exemption until December 31, 2012. Operators of private funds not currently claiming the exemption (i.e. new funds) may be required to register as a CPO within 60 days following publication of the final rules in the Federal Register. However, private funds who will fall under the definition of CPO as a result of investments in "swaps" will not be required to register until that term is defined. Advisers relying on an exemption from CTA registration 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 within 60 days of the publication of the new rules in the federal register. The final rule amendments do not provide for a grandfathering provision for pool operators that had previously relied on Rule 4.13(a)(4) (as had been considered in the original rule proposals).

No Exemption for Family Offices and Foreign Advisers

The final amendments do not include a family office exemption from registration as a CPO or CTA (as is contained for investment adviser registration with the SEC under Dodd-Frank), but the CFTC noted in its adopting release that the CFTC is directing its staff to look into adopting such an exemption. In the interim, family offices will need to register or pursue interpretive relief from the CFTC. The adopting release also specifically noted that the final rules do not exempt foreign advisers from registration as CTAs but it is possible the CFTC will consider doing so in the future.

Additional Considerations for CPO and CTAs

Entities that will be required to register as CPOs and/or CTAs will also need to meet a variety of other requirements including, but not limited to:

- Become a member of the CFTC, including completion of an application form for registration with the CFTC for the entity, associated persons, and principals;
- Become members of the National Futures Association (the "NFA") and come into compliance with all NFA rules and bylaws, including becoming subject to periodic examination and audit by the NFA;
- Submit fingerprint cards for FBI background check for all such persons described above;
- Have any such persons so required meet necessary proficiency exams;
- Comply with CFTC disclosure, recordkeeping, and other requirements (absent an applicable exemption such as CFTC Rule 4.7);
- Submit of monthly or quarterly financial reports to investors (as required);
- Submit certified annual financial reports to the CFTC and NFA.

Registered CPOs will also be required to file a Form CPO-PQR or Form PF, and registered CTAs will be required to file a form CTA-PR or Form PF to the CFTC. The entity will be required to file the Form PF if it is a private fund adviser subject to reporting on such form. Registered CPOs with at least $5 billion in assets under management attributable to commodity pools will be required to file Form CPO-PQR within 60 days after September 30, 2012, and quarterly thereafter while other CPOs and CTAs will be required to file such forms within 90 days after the close of each calendar year. However, such filings are not required until such entities are registered with the CFTC.

Annual Notice Requirement with Respect to Exemptions and Exclusions

Under the final rules, all entities claiming exclusions or exemptions from CPO or CTA registration under Rules 4.5, 4.13 or 4.14 will be required to affirm on an annual basis the notice of exemption or exclusion from registration or withdraw such exemption or exclusion and apply for registration within 60 days of the calendar year end with the NFA.

Risk Disclosure Statement for Swaps

The final rule amendments added risk disclosure statements for CPOs and CTAs for swaps which will be required for all new disclosure documents and all updates filed after the final rules become effective.

Modification of Rule 4.7 Exemption from Disclosure and Recordkeeping

Rule 4.7 provides relief from certain disclosure and recordkeeping requirements to CPOs that offer interests in private pools investing in commodities solely to “qualified eligible persons”. Rule 4.7 currently provides that a CPO claiming relief under the rule is not required to provide its pool participants with audited annual financial statements. The final amendments to the rules also rescind this element of the Rule 4.7 exemption but otherwise substantially keeps the Rule 4.7 exemptions. Rule 4.7 was also modified to incorporate by reference the SEC’s definition of “accredited investor” to allow the CFTC’s definition of “qualified eligible person” to be adjusted automatically in the event the SEC’s accredited investor standards are adjusted.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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