

THE
LONG
VIEW

MARC ELOVITZ

explains US regulation of private fund managers, beyond Dodd-Frank



“ONE OF THE MOST CUMBERSOME ASPECTS OF CPO REGISTRATION IS THAT CERTAIN HEDGE FUND MANAGER PRINCIPALS MUST OBTAIN A SERIES 3 LICENCE AND PROVIDE FINGERPRINTS”

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has dominated the discussion of US regulatory requirements. During Q1 2012, thousands of private fund managers that were previously exempt had to register with the SEC or file as Exempt Reporting Advisers. But there are significant developments beyond Dodd-Frank. One major change involves new registration and oversight by the US Commodity Futures Trading Commission (CFTC).

Since 2003, many hedge fund managers have relied on an exemption from registration as a commodity pool operator (CPO) available where only “qualified eligible persons” invested in the fund, a category that includes “qualified purchaser” investors in funds offered pursuant to Section 3(c)(7) of the Investment Company Act. This exemption, under Rule 4.13(a)(4), was rescinded by the CFTC in final rules adopted in February. With the exemption gone, fund managers that trade any “commodity interests” will need to find another exemption, or register with the CFTC.

Many managers are looking to the “de minimus” exemption under Rule 4.13(a)

(3). This exemption, available where only “accredited investors” invest in the fund, restricts trading in commodity interests to 5% of the fund’s liquidation value, measured by including the fund’s initial margin and premiums to establish the commodity interest position. Alternatively, the exemption may be met if the net notional value of the fund’s commodity interests does not exceed 100% of the fund’s liquidation value. To evaluate these thresholds, managers need to know which investments constitute “commodity interests” and are included, and which are excluded. The CFTC has yet to settle on “swap product definition” rules, but in the meantime managers who trade commodity interests are well served by inventorying their portfolios to sort out the instruments they trade.

Managers outside the US may be exempt from CFTC registration in certain circumstances, including with respect to funds organised and operated outside the US with no US investors. Guidance on the CFTC view of its extraterritorial jurisdiction is expected in the next few months.

If no exemption is available, registration is required. One of the most cumbersome

aspects of CPO registration is that certain of the hedge fund manager’s principals and marketing personnel must obtain a Series 3 licence and provide fingerprints. CPOs of funds whose investors are all qualified eligible persons may avail themselves of “registration lite” under Rule 4.7, which minimises some of these burdens.

In addition to the reporting requirements imposed on CPOs, the CFTC added a new set of disclosures similar to the Form PF systemic risk reports mandated by the SEC. Form CPO-PQR will, like Form PF, provide the regulators with data related to systemic risk. The good news: dual SEC/CFTC registered firms will generally only have to complete Form PF.

Private fund managers also have to consider whether they need to register with the CFTC as a commodity trading adviser (CTA). There is still a “fewer than 15 client” exemption from CTA registration, which many managers may be able to rely on, as well as another exemption if the manager is SEC-registered and not “primarily engaged” in trading commodity interests. The “registration lite” relief under Rule 4.7 also may be available.

The implication of these changes is that many private fund managers now not only need to register with the US SEC – they may also need to register with the CFTC.

What’s next? A potential sea-change in hedge fund marketing rules – the JOBS Act, signed into law on 5 April, eliminates the ban on general solicitation and advertising under Reg. D of the Securities Act, provided that all investors are accredited investors. Eagerly anticipated SEC rules implementing the changes are due by 4 July.

MARC E. ELOVITZ is a partner at Schulte Roth & Zabel. BRAD L. CASWELL, special counsel at Schulte Roth & Zabel, co-authored the article.

Schulte Roth & Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London