Schulte Roth&Zabel

# Alert

## CFTC Proposes to Discontinue Widely-Used Registration Exemptions

*Private Fund General Partners and Managers May Be Required to Register as Commodity Pool Operators*

### March 10, 2011

**Executive Summary**

Eight years ago, the Commodity Futures Trading Commission ("CFTC") adopted two exemptions under the Commodity Exchange Act, as amended ("CEA") (Rules 4.13(a)(3) and 4.13(a)(4) the "4.13 Rules")) that proved to be an efficient way for private investment fund managers to trade commodity interests without registering with the CFTC. On Jan. 26, 2011, the CFTC proposed revoking both exemptions. The repeal of these two exemptions is likely to affect many managers. The CFTC is soliciting public comments that are due by April 12, 2011. The Proposed Rules on CPOs and CTAs: Amendments to Compliance Obligations can be accessed at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-2437a.pdf.

If the proposed rules are adopted, the managers of many private investment funds may still be exempt from registration as commodity trading advisors ("CTAs")[1] because the CEA provides an exemption if they are, or will be, registered with the Securities and Exchange Commission ("SEC") and they advise funds that primarily trade securities as opposed to commodity interests. However, the proposed rules will require registration of the manager (or its affiliated entities) as a commodity pool operator ("CPO")[2] for each pooled vehicle it operates. Any private investment fund will be considered a commodity pool unless that fund does not engage in buying or selling any commodity interests (*e.g.*, the purchase or sale of a single futures contract or entering into a swap). This change will have the effect of subjecting the CPOs to registration with and reporting to the CFTC, and examination by the National Futures Association ("NFA"), which is the self-regulatory organization for CFTC regulated entities, even though their affiliated entities are exempt from registration as CTAs. We are uncertain why the CFTC has proposed this regulatory change, which is not required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), since under current CFTC rules somewhat parallel exemptions are available (see below) for both CTAs and CPOs.

The CFTC has requested comment as to whether to include a grandfather-type clause (to effectively provide exemptions from CPO registration, as well as CTA registration, for existing fund managers who rely on Rule 4.13) or provide a *de minimis* exception (to allow an exemption from CPO registration for private investment

[1] A CTA is an individual or entity that advises others (for profit) on buying and selling commodity interests. In the context of private investment funds, the investment manager of a fund is generally considered its CTA.

[2] A CPO is an individual or an entity that operates a commodity pool and solicits funds for that commodity pool. In the context of private investment funds, the general partner or managing member of a fund formed as a limited partnership or limited liability company, respectively, is considered the entity's CPO. In certain instances, the investment manager of a company may be considered the CPO of that entity.

fund managers to trade commodity interests as a small part of their overall investment program in securities). Other technical changes to the CEA, one of which would affect mutual fund managers, have also been proposed and are discussed below.

**Expanded Definition of Commodity Interests and Commodity Pool Would Capture More Managers**

In light of this proposed rescission of the 4.13 Rules, it is important to recall that the scope of the term "commodity interests" was recently broadened under the Dodd-Frank Act to include swaps[3] as well as commodity futures, commodity options, security futures products, foreign currencies and certain leverage transactions.[4] The definition of "commodity pool" will be broadened as well.[5] Because of these broader defined terms, additional managers will likely need to register with the CFTC and NFA than would be the case if the 4.13 Rules were revoked and the defined terms had remained more narrow. In the above-mentioned proposing Release, the CFTC estimates that more than 77,000 CPOs will now have to register.

**Rescinding CFTC Rules 4.13(a)(3), 4.13(a)(4) and 4.14(a)(8)(i)(D)**

Since enacted by the CFTC in 2003, numerous private fund managers have relied on exemptions 4.13(a)(3) and 4.13(a)(4) in connection with advising 3(c)(1) and 3(c)(7) private funds, respectively.

CFTC Rule 4.13(a)(3) provides an exemption from CPO registration for CPOs of private funds that are (a) offered to "accredited investors"[6] and (b) meet a *de minimis* test by ensuring that its commodity interest exposure at all times does not exceed either (i) 5 percent of the liquidation value of the fund (measured by including the fund's initial margin and premiums to establish the commodity interest positions) or (ii) 100 percent of the fund portfolio's liquidation value (measured by including the net notional value of the fund's commodity interest positions), and in each case taking into consideration unrealized profits and losses on any of those positions.

CFTC Rule 4.13(a)(4) provides an exemption from CPO registration for CPOs of private funds that are offered only to sophisticated participants[7] or non-U.S. persons as defined under CFTC rules. Unlike CFTC Rule 4.13(a)(3), such exemption does not include any *de minimis* test with respect to trading in commodity interests.[8]

There is a correlating exemption from CTA registration for CTAs of private funds. Such exemption from registration is CFTC Rule 4.14(a)(8)(i)(D) that is currently available for managers that advise funds whose CPOs rely on Rule 4.13(a)(3) or 4.13(a)(4). Therefore, this exemption from CTA registration is also proposed to be rescinded. The following exemptions from CTA (as opposed to CPO) registration will remain available to qualifying managers of private investment funds:

- An exemption for a manager that is registered with the SEC and does not act as a CTA to a fund that is "primarily" engaged in trading commodity interests (Section 4m(3) of CEA);

- An exemption for a manager that has not furnished commodity trading advice to more than 15 clients and does not hold itself out to the public as a CTA (Section 4m(1) of CEA); and

[3] "Swaps" for purposes of this *Alert* are swaps regulated by the CFTC and do not include "security-based swaps," which are regulated by the SEC.

[4] *Leverage transaction* means, generally, the purchase or sale of any standard, long-term (ten years or longer) contract of a leverage commodity (gold or silver bullions, bulk gold or silver coins or platinum) which contract provides for physical delivery and that an entity to the contract is long or short such commodity on margin or with financing.

[5] This change will take effect automatically on July 16, 2011.

[6] As defined in Rule 501 of Regulation D promulgated under the Securities Act of 1933, as amended.

[7] Suitability criteria for such a pool include a natural person who is a "qualified purchaser" as defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended ("Company Act"), or otherwise a "qualified eligible person" as defined under CFTC Rule 4.7(a)(2) or a non-natural person who is an "accredited investor" or "qualified eligible person" as defined under CFTC Rule 4.7. See footnote 11 below for a further description of "qualified eligible persons."

[8] The CFTC has not proposed revoking Rule 4.13(a)(1) (operating a single fund without compensation but for reimbursement for expenses) or Rule 4.13(a)(2) (fewer than 15 participants in any fund and less than $400,000 in capital in all funds operated), but these exemptions are so narrow as not to provide exemptions for many managers.

- An exemption for a manager that has registered as a CPO and provides advice only to the funds for which it is so registered (Rule 4.14(a)(4)).

Unfortunately, the proposed rules provide no similar exemptions from registration as a CPO.

There is currently no time period identified in the proposed rule to register. The CFTC is soliciting comments regarding the implementation period and whether managers who are currently relying on such exemptions should be grandfathered.

The CFTC also stated in its release that it is considering whether an alternative *de minimis* exemption should be introduced, although the actual exemption provision has not yet been drafted.

**How to Register as a Commodity Pool Operator**
If adopted in its current form, many managers to private funds will be required to register with the CFTC as a CPO and become members of the NFA. Such registration takes approximately two to three months and entails the following:

- Submission of Form 7-R
- Payment of a non-refundable application fee of $200
- Payment of annual membership dues of $750
- Principals[9] and Associated Persons[10] must
    - Complete Form 8-R,
    - Provide fingerprints to the NFA, and
    - Associated Persons must pass the NFA Series 3 exam.[11]
- Submission of applications for each Principal and Associated Person including a fee of $85
- Ongoing requirements for registered CFTC/NFA members including
    - Ethics training,
    - Maintaining and updating disaster recovery plans,
    - Completing annual questionnaires,
    - Providing certain periodic reports and disclosures to investors, and
    - Review by the NFA with respect to potential business with non-NFA members.

[9] The definition of "Principal" generally includes a founder, general partner of a partnership, a director or a 10 percent owner, but may include other individuals and entities.

[10] The definition of "Associated Person" is any individual that solicits orders, customers or customer funds for a CPO or who supervises persons so engaged.

[11] An exception to the obligation to pass the Series 3 exam may be granted upon written request to the Director of Compliance at the NFA if certain criteria are met, including that the CPO limits its activities to a commodity pool that engages principally in securities transactions; commits only a small percentage of its assets as initial margin deposits and premiums for futures and options on futures; and uses futures transactions and options on futures only for hedging or risk management purposes. *See* 9018 – Registration Rule 402: CPOS of Pools Trading Primarily in Securities (Board of Directors, August 1, 1992; revised December 10, 2007).

In addition, there are new reporting obligations for registered CPOs and CTAs that are being proposed with new data collection in the format of a Form PF for investment advisers registered with the SEC, Form PQR for registered CPOs and Form PR for registered CTAs. These will be addressed in a separate SRZ *Alert*.

**Narrowing CFTC Rule 4.7 — This Exemption Applies to Registered CPOs and CTAs**

CFTC Rule 4.7 provides registered CPOs and CTAs relief from certain disclosure, recordkeeping and reporting requirements. In order for a CPO to claim this partial exemption with respect to a pool (*i.e.*, private investment fund) it operates, each investor of such pool must be a "qualified eligible person."[12] Rule 4.7 would no longer permit CPOs to provide *uncertified* annual audited financials to the NFA and its investors. Accordingly, all annual audited financials provided to the NFA and investors would need to be certified. For many private fund managers that are registered with the SEC, this narrowing of Rule 4.7 should not be an added burden because these managers already provide certified audited financials to their investors to comply with the custody requirements of the Investment Advisers Act of 1940, as amended.[13]

CPOs of private funds that rely upon Rule 4.7 must adhere to certain CFTC and NFA reporting requirements. Quarterly statements must be prepared and sent to underlying investors within 30 days after the end of each reporting period indicating the fund's net asset value and any change in net asset value from the end of the previous reporting period. In addition, each CPO must file quarterly reports to the NFA within 45 days after the end of each quarterly reporting period which generally contain the following information: (a) the identity of the fund's service providers; (b) a statement of changes in net asset value for the quarterly reporting period; (c) monthly performance for the three months comprising the quarterly reporting period; and (d) a schedule of investments identifying any investment that exceeds 10% of the fund's net asset value at the end of the quarterly reporting period.[14] In addition, annual reports must be prepared and sent to investors and the NFA generally within 90 days after the end of a fund's fiscal year. Proposed Form PQR, as mentioned above, will subject CPOs to additional periodic reporting.

**Narrowing CFTC Rule 4.5 — This Exemption Applies to Mutual Fund Managers, Insurance Companies, Banks and Pension Plan Trustees**

CFTC Rule 4.5 provides an exclusion from the definition of the term CPO (and thus from registration) for certain persons that are subject to another regulatory scheme (*e.g.*, registered investment companies, insurance companies, banks and certain trustees of pension plans) that operate a "qualifying entity" under Rule 4.5. Prior to 2003, Rule 4.5 required that an entity entitled to this exemption file a notice of eligibility that contained a representation that the use of commodity interests for non bona fide hedging purposes was less than 5 percent of the liquidation value of the qualifying entity's portfolio and that the entity would not market the portfolio as a commodity pool to the public. The proposed CFTC rule reinstates the pre-2003 operating restrictions. Therefore, the proposal would require that an entity using commodity interests for bona fide hedging not enter into more than 5 percent of its qualifying entity's liquidation value. In addition, it would require that the entity preclude marketing such entity as a commodity pool, regardless of the amount of commodity interests to which it has exposure. The CFTC is soliciting comments on whether the 5 percent threshold should include swaps or whether it should be limited to futures and options. If the threshold includes swaps, many entities that might otherwise be entitled to the Rule 4.5 exemption may no longer be able to rely on this exemption.

**Additional Changes**

If an entity is a CPO or a CTA and is not entitled to rely upon an exemption or Rule 4.7's limited disclosure obligation, the CFTC is proposing additional disclosure language for investors. In particular, under Rules 4.24(b) and 4.34(b), CPOs and CTAs have certain mandatory Risk Disclosure Statements. These Risk Disclosure Statements would be amended under the proposed rules to include swaps.

---

[12] "Qualified purchasers" are considered qualified eligible persons, which means that managers of funds comprised entirely of qualified purchases that register as CPOs will find Rule 4.7 helpful in reducing their disclosure, record keeping and reporting requirements. "Accredited investors" who own securities and other investments of at least $2 million are also considered qualified eligible persons.

[13] In addition, the CFTC is proposing that Rule 4.7 be amended to incorporate the SEC's accredited investor standard by reference rather than include the actual terms. This is to ensure that if the SEC were to modify the definition of an accredited investor, such amendment would be automatically incorporated into Rule 4.7.

[14] *See* NFA Rule 2-46.

The CFTC is also proposing that any exempted CPO or CTA under Rules 4.5, 4.13 or 4.14 will be required to confirm their notice of exemption or exclusion on an annual basis. Currently, a notice of exemption or exclusion needs to be filed only once.

*Authored by Ida Wurczinger Draim, Daniel F. Hunter, Craig Stein and Kristin Boggiano.*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

---


**New York**
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

**Washington, DC**
Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

**London**
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

**www.srz.com**


**U.S. Treasury Circular 230 Notice:** Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties.