ALERTS

Recent CFTC Rule Changes That Affect Hedge and Private Equity Fund Managers

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In recent weeks, the U.S. Commodity Futures Trading Commission has issued several final rules and rule proposals that directly affect hedge fund managers that trade in futures contracts (and in other commodity interests) and private equity fund managers with portfolio companies that may, as part of a hedging or raw materials acquisition effort, engage in commodity interest transactions. All fund managers should review these changes to determine if they present limitations on their business or require regulatory relief filings; registered commodity pool operators and commodity trading advisors, of course, should review all of the developments discussed in this *Alert*.

Expanded Position Limits

On Dec. 5, 2016, the CFTC reproposed rules that would, if adopted, expand the scope of the existing federal position limits regime for exchange-traded futures contracts (the "Reproposal").[1]

CFTC rules currently impose position limits for nine futures and commodity options contracts (the "Legacy Contracts"). In 2011, the CFTC adopted rules to expand the position limits regime beyond the Legacy Contracts, but these rules were quickly vacated — on technical grounds — by a federal district court. In 2013, the CFTC again put forth a proposal for expanded position limits and most recently supplemented that proposal in May 2016. No final rule was adopted, however, and the CFTC issued the Reproposal earlier this month based on public comment and related reviews by the CFTC Staff.

The Reproposal, if adopted, would:

- Establish federal limits on speculative positions in 25 core physical commodity futures contracts (the actual numerical limits were set by the CFTC based on statistical analyses of the normal trading levels for futures and other referenced contracts in actual trading);
- Require their economically equivalent "referenced contracts" (i.e., options and swaps) to count towards such limits; and
- Clarify and, in some ways, expand the use of the "bona-fide hedging" position limits exemption.

The Reproposal also requested comments on the possibility of delaying the compliance date of any final rule to Jan. 3, 2018 (which would align CFTC position limits rules with new EU position limits rules scheduled to go into effect on that date).

While the Reproposal could represent an important expansion of the CFTC's direct role in the markets, it will fall to the CFTC commissioners, and especially the new chairman, who are appointed by the new presidential administration to finalize these changes. While it is quite possible that the CFTC will revisit, modify or even abandon the Reproposal, in the interim, all fund managers that trade in the futures markets should review the new position limits to determine whether they, if adopted, would negatively affect their trading and investment program. Of course, any fund manager that seeks to rely on the hedging exemption should also review the changes to that exemption contained in the Reproposal.

Fund managers should also be cognizant of the fact that the U.S. futures exchanges maintain their own position limits on non-Legacy Contracts pursuant to CFTC Rule 150, which are and will remain effective no matter what happens to the Reproposal.

New Aggregation Rules Effective Feb. 14, 2017

On Dec. 5, 2016, the CFTC did finalize rules concerning position limits aggregation, i.e., rules determining which positions and accounts must be aggregated when determining compliance with position limit rules. While all fund managers that trade futures contracts should be aware of the upcoming changes, this change may also affect fund managers that do not trade commodity interests but hold 10-percent or greater ownership interests in portfolio companies that themselves engage in commodity interests transactions (such as private equity fund managers, activist investors and high-conviction hedge fund managers).

Background on the Aggregation Rules Amendment

CFTC Rule 150.4 has traditionally required several categories of related entities to aggregate their Legacy Contract holdings for purposes of calculating compliance with CFTC position limits. In 2012, the CFTC, as part of its overall position limits rulemaking efforts, amended and expanded its aggregation rules,[2] but those new rules were quashed by the International Swaps and Derivatives Association district court case referenced above in the position limits discussion. In 2013[3] and in 2015,[4] the CFTC re-proposed amendments to its aggregation rules and, on Dec. 5, 2016, adopted new final rules on aggregation (the "New Aggregation Rule").[5]

Overall Impact of the New Aggregation Rule

The New Aggregation Rule will have several impacts on the futures markets, including the following:

- A "control" relationship that requires aggregation now will be deemed to exist where there is "substantially similar" trading;
- The introduction of several new aggregation exemptions and the issuance of additional guidance on certain existing exemptions; and
- New aggregation exemption notice requirements.

Because, as discussed above, the new position limits rules were not finalized, the New Aggregation Rule currently only applies to Legacy Contracts (although it would extend to new limits and new instruments if and when adopted). The New Aggregation Rule is, however, likely to be adopted in some form by the various exchanges, which — among other things — could cause the new federal notice requirement to be replicated on the exchange level.[6]

Extension of the Control Concept to "Substantially Identical" Trading

Rule 150.4 has historically required aggregation where a control relationship exists and, in the adopting release for the New Aggregation Rule, the CFTC reiterated its historical position: (i) that a "control" relationship generally will still require aggregation, and (ii) that control can be evidenced by a 10-percent or greater ownership position.

Under the New Aggregation Rule, however, the CFTC now will also require aggregation on the basis of "substantially identical" trading. Under the rule, a person (the "aggregating person") will now need to aggregate with its own commodity interest positions all commodity interest positions:

- Held by another person but that are *deemed to be controlled* by the aggregating person (e.g., where the aggregating person makes trading decisions for another person);
- Held by another person acting pursuant to an *express or implied agreement* with the aggregating person;
- Held in an account (other than a fund) in which the aggregating person has a *10-percent or greater* ownership interest;
- Held by a fund: (i) in which the aggregating person is *a 25-percent or larger investor*, and (ii) that is managed by a commodity pool operator that is exempt from registration pursuant to CFTC Rule 4.13; and
- That another person directly or indirectly (e.g., through an investment in a fund operated by an unaffiliated commodity pool operator) holds *within a trading strategy that is "substantially identical"* to a trading strategy overseen by the aggregating person.

In addition, the New Aggregation Rule expressly provides that the "substantially identical trading" provision will override the various aggregation exemptions discussed below.

<u>New Aggregation Exemptions and Notice Requirements</u>

Following the adoption of the New Aggregation Rule, there are five CFTC aggregation exemptions available to fund managers.[7] Three of these predated and were preserved by the New Aggregation Rule, i.e., (i) the "independent account controller" exemption (which would still require some aggregation during the "spot month"),[8] (ii) the "fund investor" exemption,[9] and (iii) the "insider" fund investor exemption,[10] while these two are new:

- The owned-entity exemption, and
- The information sharing exemption.

Under the New Aggregation Rule, to claim any of these exemptions (other than the "fund investor" exemption) a manager is required to make a filing with the CFTC. This is a departure from prior practice and one that all fund managers should consider as soon as possible.

Managers should also note that a CFTC filing is not necessarily sufficient for an exemption at the futures exchange level and that a filing with or approval from each applicable exchange may be required.

The new "owned-entity exemption" is available for a 10-percent or greater owner of a subsidiary, so long as certain physical and informational barriers are in place between the subsidiary and the parent. The CFTC also provided a new exemption from aggregation (the "information sharing exemption ") in situations where there is an inference of control, but the parties involved can reasonably assert (in a memorandum of law provided to the CFTC) that: (i) sharing such information would create a "reasonable risk" of a violation of law, and (ii) there is no actual sharing of futures trading or position information.

<u>Independent Account Controller Exemption</u>

The CFTC independent account controller exemption (the "IAC") permits a firm to disaggregate trading units within the same firm from each other, provided that certain conditions are met and that the firm continues to aggregate during the spot month. This CFTC exemption is relevant to Legacy Contracts and to non-Legacy Contracts traded on futures exchanges whose own IAC exemption mirrors that of the CFTC.

To claim an IAC exemption, a manager must be able to demonstrate that:

- There are appropriate physical and informational barriers between trading units;[11] and
- Certain definitional requirements must be met: i.e., the firm seeking the exemption must be an "eligible entity" (e.g., a commodity trading advisor) and each trading unit must have an "independent account controller" (i.e., certain categories of CFTC registrants and their registered associated persons). Nevertheless, the IAC exemption still does not extend to all categories of traders; for example, proprietary

trading firms and non-CFTC registrants may not be able to utilize an IAC. Funds of funds and multi-manager funds should also consider whether it is necessary or even possible to rely on this exemption.

Fund managers relying on IACs will need to make formal notice filings with the CFTC by Feb. 14, 2017 (the "Effective Date"). They will also need to inquire with each of the futures exchanges that they trade on to ascertain what, if any, filings are required to perfect an exchange-level IAC.

While the CFTC did not make any substantive changes to the IAC in the New Aggregation Rule, it did make some technical revisions that expand its application slightly.[12]

Owned-Entity Exemption

The owned-entity exemption may be a useful exemption for some fund managers, especially for fund managers that do not traditionally trade futures. In particular, private equity funds that invest in operating entities that trade or hedge with futures contracts may be able to establish an aggregation exemption under the owned-entity exemption.

Aggregation Exemption Filings

The CFTC confirmed that the owner of an entity that files an exemption (i.e., the "higher-tier" entity) will be able to rely on the aggregation exemption filing of that entity without having to make its own filing and without needing to be mentioned in the filing. For example, if a fund makes a notice filing to rely on the owned-entity exemption with respect to the fund's acquisition of an entity, an investor in the fund that is required to aggregate the positions of that fund (i.e., a 25-percent investor in a Rule 4.13 fund), will not need to make a separate filing to disaggregate the positions of that entity. The CFTC also clarified that "sister affiliates" under common control generally are not required to aggregate.[13]

CFTC Form 40 Changes

In November 2013, the CFTC finalized rules that made significant changes to many of its "large trader" reporting forms. While these rules made changes to several CFTC forms, buy-side firms are primarily affected by changes to the Form 40. The Form 40 is only required to be filed upon request by the CFTC; when a trader crosses certain reportable thresholds (which may differ contract by contract), the CFTC may choose to send a Form 40 request to the trader. Historically, such thresholds were only in place for futures contracts and were only quantity thresholds. The Form 40 has added "volume" thresholds and is now also applicable to swaps. These changes have already been in effect for a while. The most significant aspect of the November 2013 rule only went into effect in November; the Form 40: (i) has now been modified to require additional information, (ii) must be filed electronically, and (iii) requires a filer to update the form should information change after filing.

While a Form 40 is only required upon request, traders should be prepared in advance to file the new form; once the CFTC sends a request, a filing will need to be made by the deadline requested by the CFTC. Potential filers should also be prepared to answer many of the new questions relating to ownership structure (i.e., parent companies and subsidiaries), accounts controlled by the trader, as well as the names of specific individuals that have authority to trade or authority to oversee traders. The new questions with respect to ownership structure also align with the CFTC rules concerning aggregation of accounts for purposes of position limits (as discussed in "New Aggregation Rules Effective Feb. 14, 2017" above); these are questions that were historically not asked by the CFTC. Thus, traders who are not familiar with the CFTC requirements concerning which accounts to aggregate should refocus on this requirement before being required to file to ensure that the correct calculations are being done. To the extent possible, traders should also try to familiarize themselves with the CFTC portal so that they are prepared for the electronic filing.

Registered Commodity Pool Operator Reporting Requirements

"Long" First Fiscal Year Financial Statement Relief

On Nov. 21, 2016 the CFTC issued final rules[14] allowing registered CPOs to defer the annual financial statement filing requirement for a new fund to the end of the first full calendar year of operation (the "Final Rule"). Historically, fund managers have been able to obtain relief allowing for up to an 18-month extended first fiscal year, generally with no restriction on the size of the fund. The November relief allows funds, without the need for an individual request, to utilize an extended first fiscal year so long as:

- The extended fiscal year is no longer than 16 months (i.e., the fund launches no earlier than Sept. 1);

- During the stub year (i.e., the first one to four months), the fund receives investments from "non-insiders" of no more than $3 million from no more than 15 investors; and

- The CPO receives unanimous consent to an extended fiscal year from all non-insider investors in the form of a separate waiver signature page that contains specific language provided by the CFTC.Fund managers looking to rely on the Final Rule should be aware of the specific consent requirements of the Final Rule so that an additional signature page that complies with the Final Rule can be included with fund subscription documents.

While this relief may be utilized by certain managers, the new restrictions of this rule that were historically not required by CFTC staff, particularly, the $3 million restriction, will severely limit the usefulness of this new rule. Furthermore, extended fiscal year relief has primarily been utilized by non-U.S.-based managers that are not SEC-registered investment advisers. Fund managers that are also registered with the Securities and Exchange Commission and that seek to comply with the "audit exception" under the Custody Rule will need to consider whether this relief is compatible with the fund manager's Custody Rule compliance.

In addition, in the event that a fund relying on this relief does not complete its first fiscal year, the CPO will nonetheless be required to file final audited financials with the NFA.

CPO-PQR Changes

Parallel Managed Accounts (February 2017)

CPOs should also be aware of changes to the CPO-PQR going into effect for the fourth quarter 2016 filing (due in February or March 2017). As a general rule, managed accounts are not reported on the CPO-PQR; they are only reported by registered CTAs in the Form CTA-PR. In November 2015, the CFTC provided additional guidance regarding when "parallel managed accounts" nonetheless need to be reported on CPO-PQR as part of its parallel fund.[15] At that time, CFTC staff provided temporary relief from the requirement,[16] but that relief has expired; a CPO's next filing will require it to aggregate any parallel managed accounts and consider it part of the parallel fund. While the requirement is not applicable for "relationship" questions (i.e., pool custodians, brokers), it is required for most of the rest of the form.

CPOs should be considering whether they are impacted, particularly since the CFTC's approach with parallel managed accounts differs from the SEC's Form PF approach. First, the CFTC does not make a distinction between dependent parallel managed accounts and other managed accounts; all parallel managed accounts are affected. Second, the Form PF only requires counting managed accounts for purposes of the threshold asset under management questions to determine how much of the Form PF must be completed. Conversely, the CFTC requires parallel managed accounts to be considered for all (non-relationship) questions, not just the threshold asset under management questions. Thus, a CPO will be required to answer the CPO-PQR questions as if the pool is the size of the assets of the pool and the managed account(s) combined. This may be somewhat difficult for fund managers, particularly in situations where there is a different administrator for the fund and any parallel managed accounts.

It is also worth noting that the different methods of calculating assets under management may result in different levels of reporting on the CPO-PQR from the Form PF. For example, a CPO with a parallel managed account that is not dependent would be required to count such account for CPO-PQR purposes, but not for Form PF. This could result in such a CPO being considered a "large filer" for CPO-PQR, but not for Form PF.

Financial Ratios Reporting for CPO and CTA Entities (August 2017)

Starting with the CPO-PQR and CTA-PR second quarter 2017 filings (due in August 2017), the NFA will, for the first time, require firms to provide certain financial information at the management company level (as opposed to client-level information typically asked for in those forms). Starting with that filing, the NFA will require firms to provide two ratios: (i) current assets/current liabilities as of quarter-end; and (ii) total revenue/total expenses for the prior 12 months. Filers will be able to elect to report the ratios at a parent company level. The NFA also clarified that this does not mean they are imposing any minimum financial ratio requirements; rather, the NFA will use these ratios as part of its regulatory oversight program of CPOs and CTAs.

Use of Alternative Accounting Standards

The CFTC generally requires use of U.S. GAAP for purposes of the audited financial statements and the CPO-PQR, although CFTC Rule 4.22(d)(2) permits the CPO of a pool organized outside the U.S. to use

IFRS. The CFTC has now expanded this rule to codify previous CFTC staff relief and to permit a fund organized outside of the U.S. to use the accounting principles, standards or practices followed in the United Kingdom, Ireland, Luxembourg or Canada.[17] This will also be permitted for CPO-PQR.

The CFTC's approach regarding the use of IFRS has historically differed from the SEC's approach with respect to the custody rule audit requirement; while the SEC relief is based on the location of the fund manager, the CFTC relief is based on the location of the fund. The CFTC's approach can be problematic for a non-U.S. fund manager with a U.S-based fund. For example, a "master-feeder" structure that includes a U.S.-based feeder fund would be unable to utilize IFRS (or any of the other non-U.S. accounting standards now permitted by the CFTC) for the U.S. feeder fund. While we have previously been granted relief for clients to use IFRS for a U.S.-based fund (provided that it included a reconciliation to U.S. GAAP), the Final Rule did not codify this relief. Fund managers wishing to take this approach would continue to be required to request such relief from CFTC staff.

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

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[1] *Position Limits for Derivatives:* Reproposal (Dec. 5, 2016).

[2] *Aggregation, Position Limits for Futures and Swaps*, 77 Fed. Reg. 31767 (May 30, 2012).

[3] *Aggregation of Positions; Proposed Rule*, 78 Fed. Reg. 68946 (Nov. 15, 2013).

[4] *Aggregation of Positions*, 80 Fed. Reg. 58365 (Sept. 29, 2015).

[5] *Aggregation of Positions*, 81 Fed. Reg. 91454 (Dec. 16, 2016).

[6] While the futures exchanges have some flexibility with respect to implementing aggregation rules and exemptions that apply to contracts traded on each respective exchange (that are not Legacy Contracts), they tend to generally track the CFTC rules, with some exceptions, as discussed below.

[7] The CFTC also provides aggregation exemptions not applicable to fund managers, such as exemptions for broker-dealers and futures commission merchants.

[8] The independent account controller exemption permits a firm to disaggregate trading units within the same firm from each other, provided that certain conditions are met.

[9] As a general rule, passive fund investors that are not affiliated with the fund manager are not required to aggregate the positions of the fund, even when above 10 percent, but this exemption is not available where: (i) the investor holds more than 25 percent of a fund for which the CPO relies on a Rule 4.13 exemption from registration, and (ii) where the new "substantially identical" aggregation requirement applies.

[10] This exemption is available where the fund investor is also an "insider" (e.g., a principal or affiliate of the commodity pool operator) but certain physical and informational barriers are erected.

[11] These criteria did not change significantly. A firm that is disaggregating affiliated trading units will need to demonstrate that there are written procedures precluding access to information across trading units, and that each trading unit has a separately developed trading system and is marketed separately.

[12] The CFTC added general partner, managing member or manager of an exempt or excluded CPO to the definition of "Eligible Entity." It also now only requires aggregation during the spot month for physically settled contracts, a change that will only impact the IAC exemptions of futures exchanges that reference the CFTC rules.

[13] However, their parent company may still need to utilize the owned-entity exemption.

[14] *Commodity Pool Operator Financial Reports*, 81 FR 85147 (Nov. 25, 2016).

[15] CFTC Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions Regarding Commission Form CPO-PQR.

[16] CFTC Letter No. 16-22 (Feb. 26, 2016).

[17] *See Commodity Pool Operator Financial Reports* at note 17.

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