

CFTC Proposes Amendments to Compliance Obligations of CPOs and CTAs

BY THE INVESTMENT MANAGEMENT PRACTICE

On January 26, 2011, the U.S. Commodity Futures Trading Commission (the "CFTC") proposed amendments to the compliance obligations of commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") that, among others, would rescind or modify several CFTC registration exemptions and exclusions commonly relied upon by private investment fund sponsors (the "Amendments"). The CFTC separately proposed the Amendments shortly after the announcement of its joint proposal with the U.S. Securities and Exchange Commission (the "SEC") to adopt Form PF as mandated by certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").¹ The CFTC believes that the Amendments are necessary in order to oversee participants in the commodity futures and derivatives markets effectively in light of the recent economic turmoil and are consistent with the spirit of the Dodd-Frank Act.

Repeal of Certain Exemptions under CFTC Regulation 4.13

Currently, CFTC Regulation 4.13(a)(3) provides an exemption from CPO registration for operators of commodity pools that have limited futures activity, and CFTC Regulation 4.13(a)(4) exempts from CPO registration operators of commodity pools that restrict participation to certain sophisticated investors, if, in each case, certain conditions are satisfied. Many sponsors of private investment funds rely on one these exemptions. The Amendments, if adopted, would rescind these exemptions. As a result, unless other exemptions are available, sponsors of private investment funds currently relying on the exemptions provided under CFTC Regulations 4.13(a)(3) and (4) will be required to register as CPOs with the CFTC and become members of the National Futures Association (the "NFA"). They also would become subject to certain reporting requirements. Advisers to such private funds may, as a consequence, be required to register as CTAs with the CFTC as well. The CFTC proposed the repeal of these exemptions because the Dodd-Frank Act requires investment advisers to private investment funds be registered with the SEC, and the CFTC believed that the operators of commodity pools that are similar to private investment funds should be subject to similar regulatory obligations.

Reinstatement of Trading Criteria for Registered Investment Companies Claiming Exclusion under CFTC Regulation 4.5

CFTC Regulation 4.5 provides an exclusion from the definition of CPO for various types of entities that are otherwise regulated persons in connection with their operation of specified trading vehicles, including registered investment companies (*e.g.*, mutual funds). In proposing the Amendments, the CFTC intended to reinstate, for registered investment companies, trading criteria that were repealed in 2003 so that companies could neither be marketed as vehicles for gaining commodity exposure nor engage in more than a de minimis amount of futures and options activity (other than for bona fide

hedging purposes) without first registering as CPOs with the CFTC. This could also have the consequence of requiring advisers to such registered investment companies to register as CTAs with the CFTC. The CFTC sought to reinstate the pre-2003 operating criteria as a result of concerns over the practice by certain registered investment companies of offering de facto commodity pool interests without the oversight of the CFTC, in reliance on the exclusion contained in CFTC Regulation 4.5.

Other Changes

The Amendments contain other changes to the compliance obligations of CTOs and CTAs, including the (i) elimination of the exemption under CFTC Regulation 4.7 that allows an exempt commodity pool not to include certified financial statements in its annual report; (ii) modification of the “qualified eligible participants” qualification criteria under CFTC Regulation 4.7 to incorporate the SEC’s “accredited investor” standard by reference rather than by direct inclusion of its terms (which would eliminate the need for further amendment to CFTC Regulation 4.7 in the event of any revisions to the “accredited investor” standard by the SEC as envisioned by the Dodd-Frank Act); (iii) requirement of annual confirmation of their qualifications by all persons claiming exemptive or exclusionary relief under CFTC Regulations 4.5, 4.13 and 4.14; and (iv) inclusion of a description of certain risks specific to swap transactions in the risk disclosure statement that CPOs and CTAs are required to include in their disclosure documents.

The rule proposals for the Amendments have not yet been published. The [Fact Sheet](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/iar_factsheet.pdf) and the [Q&A](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/iar_qa.pdf) regarding the Amendments prepared by the CFTC are available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/iar_factsheet.pdf and http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/iar_qa.pdf.



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¹ See our recent Client Alert on this topic at http://www.paulhastings.com/assets/publications/1818.pdf?wt.mc_ID=1818.pdf.