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CFTC Adopts Final Rules Revising CPO and CTA Registration and Reporting Requirements: Significant Impacts for Mutual Funds and Private Investment Funds

BY THE INVESTMENT MANAGEMENT PRACTICE

On February 9, 2012, the U.S. Commodity Futures Trading Commission (the "CFTC") adopted final amendments[1] (the "Release") to its rules relating to commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") that, among others, rescind or modify several CFTC exemptions and exclusions commonly relied upon by registered investment companies ("RICs") and their investment advisers and private investment fund sponsors (the "Amendments") to avoid registration with the CFTC as CPOs. At the same time, the CFTC separately proposed changes[2] to the disclosure and reporting obligations associated with RICs that will no longer qualify for an exclusion from the definition of CPO under the Amendments in order to harmonize the requirements of CPO disclosure with those of the Securities and Exchange Commission (the "SEC") (the "Proposal"). The Amendments will require many investment advisers to both registered and unregistered funds that make substantial use of derivatives to register as CPOs.

The CFTC believes that the Amendments are necessary in order to enable effective oversight of participants in the commodity futures and derivatives markets in light of the recent economic turmoil and are consistent with the spirit of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In general, the CFTC had became concerned that in recent years many RICs and other pooled vehicles using managed futures strategies were avoiding oversight by the CFTC by avoiding registration. The CFTC concluded that trading by pooled investment vehicles of commodity futures, options and swaps in amounts exceeding a certain threshold evidences a significant exposure to the derivatives markets that requires CFTC oversight, regardless of whether such pools are otherwise registered with the SEC or offered to sophisticated investors.

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

CFTC Rule 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 RICs. The CFTC is reinstating trading criteria for RICs that were repealed in 2003 (with some modifications), so that RICs may not be marketed as a vehicle for gaining commodity exposure or engage in more than a de minimis amount of futures and options activity (other than for bona fide hedging purposes) without the investment adviser to the RIC first registering as a CPO with the CFTC.

Requirements of Amended Rule 4.5 Exclusion

As adopted, the amended Rule 4.5 exclusion from CPO registration for RICs requires the following:

- The RIC must represent that, to the extent that its use of commodity futures (including securities futures, broad-based stock index futues and financial futures contracts), options and swaps is not for "bona fide hedging purposes" (importantly, the Amendments do not permit risk management activities to be considered as "bona-fide hedging"):
  - the aggregate initial margin and premiums required to establish any commodity futures, options or swaps[3] will not exceed 5% of the liquidation value of the RIC's portfolio (after taking into account unrealized profits and unrealized losses on any such positions); or
  - the aggregate notional value of such positions, as determined at the time the most recent position was established does not exceed 100% of the liquidation value of the RIC's portfolio (after taking into account unrealized profits and unrealized losses on any such positions); and
- The RIC may not market itself to the public as a commodity pool or otherwise as a vehicle for trading in the commodity futures, options or swaps markets. Importantly, the CFTC did not adopt a requirement that would also have prohibited RICs from marketing themselves as a vehicle that "otherwise seeks investment exposure" to the commodity futures, options or swaps markets.

The Amendments will leave RICs operating with a managed futures strategy unable to utilize the CPO exclusion under Rule 4.5 and will require investment advisers to such RICs to register as CPOs and comply with all relevant CFTC regulations.

Guidance as to the Marketing Restriction of Amended Rule 4.5

In the Release, the CFTC provided a non-exclusive list of activities that it would consider indicative of whether a RIC was marketing itself as a commodity pool or a vehicle for trading in the commodity futures, options or swaps markets, including:

- The name of the fund;
- Whether the fund's primary investment objective is tied to a commodity index;
- Whether the fund makes use of a controlled foreign corporation for its derivatives trading;[4]
- Whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;
- Whether, during the course of its normal trading activities, the fund 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 fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses; and
- Whether the fund is explicitly offering a managed futures strategy.

The Release notes that the mere disclosure to investors that the RIC may engage in derivatives trading incidental to its main investment strategy and the risks associated therewith will not be considered to be a per se violation of the Rule 4.5 marketing restrictions.

CPO Registration for RICs

Further to comments received by the CFTC following the proposing release, the Release states that the investment adviser to a RIC is the appropriate entity to register as a CPO in the event that a RIC is unable to utilize the exclusion under Rule 4.5.[5]

CFTC / SEC Disclosure Harmonization Proposal

In the Release, the CFTC recognized the disclosure conflict between CFTC and SEC regulations that will face RICs whose investment advisers are required to also register as CPOs. As a result, the CFTC also issued the Proposal to elicit comments from the industry regarding how such conflicts should be harmonized. The Proposal presents several suggestions regarding how CFTC and SEC rules might be harmonized, including making an effective registration statement under the Securities Act of 1933, as amended, ("Registration Statement") to satisfy the various commodity pool delivery and acknowledgment requirements and provide a means to include additional CFTC-centric information in a Registration Statement. The CFTC is also proposing to amend the timing requirements for disclosure documents to align them with the SEC requirements. The comment period for the Proposal will close 60 days from publication of the Proposal in the Federal Register.

Repeal and Modification of Certain Exemptions under CFTC Rule 4.13 Used by Private Investment Funds

The CFTC has rescinded the exemption from CPO registration under Rule 4.13(a)(4) commonly relied upon by certain private fund advisers, but retained the de minimis exemption under Rule 4.13(a)(3). 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 Rule 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.

With respect to Rule 4.13(a)(3), the CFTC determined that overseeing entities with less than 5% exposure to commodity interests is not the best use of the CFTC's limited resources, and therefore opted to retain the exemption with a modification to include swaps in the threshold calculation once the CFTC has finalized its further definition of "swap." With respect to Rule 4.13(a)(4), the Amendments completely rescinded the exemption. In the Release, the CFTC noted that it considered, but declined to extend, any special relief at this time to certain entities that commonly rely on the Rule 4.13(a)(4) exemption, including funds of funds, family offices, and foreign advisers.[6] Private fund advisers relying on Rule 4.13(a)(4) to avoid CPO registration before the Effective Amendment Date (defined below) and that have filed the requisite notice with the National Futures Association as of that date will have until December 31, 2012 to identify another exemption or, alternatively, register with the CFTC as CPOs. Such advisers should also consider whether their change in CPO status will affect any exemptions or exclusions on which they may rely for purposes of avoiding registration as a CTA.

Revisions to Rule 4.7

The CFTC also revised the CPO exemption available under Rule 4.7 to require that CPOs utilizing that exemption are required to comply with the financial statement certification requirements under Rule 4.22(c) in their pools' annual reports, meaning that the annual report must be prepared in accordance

with generally accepted accounting principles consistently applied and audited by an independent public accountant.

Annual Reaffirmation of CPO and CTA Exemptions

The Amendments have added a requirement to the CPO/CTA registration exclusions and exemptions under Rules 4.5, 4.13(a)(3), and 4.14(a)(8) which require CPOs and CTAs utilizing those rules to file an annual notice reaffirming their claims of exemption or exclusion from registration.

Form CPO-PQR and CTA-PR

As part of its increased oversight of commodity pools and their sponsors and advisers, the CFTC has implemented a new commodity pool reporting system for registered CPOs and CTAs by adopting Form CPO-PQR and CTA-PR, and making its filing required for certain CPOs and CTAs[7] pursuant to Rule 4.27.

Form CPO-PQR

Form CPO-PQR is comprised of three schedules (A, B, and C) and must be filed by every CPO that is registered or required to register with the CFTC (including CPOs utilizing the compliance exemption available under Rule 4.7, but not those relying on the exemption from registration under Rule 4.13(a)(4)), although Schedules B and C only need to be filed by CPOs that manage a certain level of commodity pool assets. Form CPO-PQR is required to be filed by Large CPOs[8] within 60 days of the end of each calendar quarter and all other CPOs must file within 90 days of the end of each calendar year. For CPOs registered as investment advisers with the SEC, the new forms are intended to supplement the SEC's reporting requirements on the recently adopted Form PF[9] and such dual-registrants will be exempt from certain information requirements on Schedules B and C of the form.

Schedule A requires basic information regarding the CPO's assets under management and information regarding each commodity pool it manages, including its jurisdiction of organization, service providers (administrators, custodians, brokers, auditors, third-party marketers, and portfolio managers), information regarding investment in other commodity pools[10] and financial data about each pool (*e.g.*, assets under management, subscriptions/redemptions, monthly rates of return, net asset value in relation to prior high water marks, and redemption restrictions on investors). Schedule B, which must be filed by Mid-Sized CPOs[11] and Large CPOs, requires additional information regarding the pools managed by such CPOs, including investment strategy and concentrations, borrowings, counterparty exposure, use of derivatives and a summary schedule of investments. Schedule C, which is only required to be filed by Large CPOs, requires information concerning any commodity pools that exceed $500 million in net asset value (including the net assets of any parallel pool structures[12]) as of the last day of any reporting period, including portfolio liquidity information, counterparty credit exposure, risk metrics, borrowings, use of derivatives, redemption restrictions and side pockets, and duration of fixed income assets.

Form CTA-PR

Form CTA-PR must be filed by each CTA that is registered with the CFTC, but only requires basic information, including the CTA's assets under management and the names of each pool it advises.

Compliance Dates

In general, the Amendments will go into effect 60 days following publication of the Release in the Federal Register (the "Effective Amendment Date"), except for the amendments to CFTC Rule 4.27, which will become effective on July 2, 2012.[13]

For investment advisers to RICs which are required to register as CPOs due to the changes to Rule 4.5, compliance with respect to registration will be required not later than the later of December 31, 2012, or 60 days following the effective date of CFTC rulemaking further defining the term "swap." For those RICs registered as CPOs, compliance with the CFTC's recordkeeping, reporting, and disclosure requirements will be required 60 days following the final adoption of the harmonization changes outlined in the Proposal.

CPOs that claim an exemption from registration under Rule 4.13(a)(4) before the Effective Amendment Date will have until December 31, 2012 to identify another exemption or register as CPOs with the CFTC, although compliance for all other CPOs will be required upon the Effective Amendment Date. CPOs relying on 4.13(a)(4) should use the transition period to review their use of futures, options, derivatives and swaps, and consider the best future course of action. For many private fund investment advisers, the exemption under Rule 4.13(a)(4) provided a simple way to avoid CPO registration which did not require the adviser to analyze heavily its anticipated use of commodities. With investment advisers now faced with a choice between the de minimis exemption under Rule 4.13(a)(3), and the more heavily regulated exemption under Rule 4.7 (which, in practice, is better thought of as a registration-lite regime), some advisers may determine that the limitations on commodity activities required by Rule 4.13(a)(3) are palatable. Advisers to funds of funds in particular should consider whether they will be able to obtain the information necessary to rely upon the de minimis exemption under Rule 4.13(a)(3).

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[1] "Commodity Pool Operators and Commodity Trading Advisers: Amendments to Compliance Obligations," available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf. See also *CFTC Proposes Amendments to Compliance Obligations of CPOs and CTAs*, February 4, 2011 (http://www.paulhastings.com/publicationDetail.aspx?PublicationId=1824).

[2] "Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators," available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912.pdf.

[3] Swaps will not be required to be included in the threshold calculation until 60 days following the adoption by the CFTC of final rules regarding the further definition of "swap" and the delineation of the margin requirements for such instruments have become effective.

[4] The Release also noted that the CFTC considers wholly-owned controlled foreign corporations to be separate, legally cognizable entities from the RICs invested in them and therefore separately subject to CFTC regulation as commodity pools, regardless of the CPO status of the parent RIC.

[5] The Release provides that this relief is applicable only to RICs and does not apply to other non-RIC commodity pools organized as corporations.

[6] Investment advisers should note that, at this time, the CFTC opted not to provide standard exemptions for family offices or foreign advisers, although it noted that based on information received on forms CPO-PQR and CTA-PR, it may do so in the future.

[7] According to the Release, affiliated entities are permitted, but not required, to report on a single form with respect to all affiliates and the pools that they advise.

[8] Any CPO that had at least $1.5 billion in aggregated pool assets under management (aggregate AUM of all commodity pools operated by the CPO) as of the close of business on any day during a reporting period.

[9] *See SEC and CFTC Adopt Private Fund Adviser Reporting Form*, November 28, 2011 (http://paulhastings.com/publicationDetail.aspx?PublicationId=2052).

[10] The Release states that the CFTC considers pooled investment vehicles invested in unaffiliated commodity pools to be commodity pools themselves and therefore subject to disclosure on Form CPO-PQR. CPOs will be required to provide basic information about any underlying commodity pools in which their funds may be invested, but the CFTC is otherwise permitting CPOs to disregard the assets of such funds that are invested in other commodity pools or private funds for reporting purposes (although the CFTC notes that such funds must be treated consistently for purposes of the entire form).

[11] Any CPO that had at least $150 million in aggregated pool assets under management (aggregate AUM of all commodity pools operated by the CPO) as of the close of business on any day during a reporting period.

[12] Any structure in which one or more pools pursues substantially the same objective and strategy and invests side by side in substantially the same assets as another pool.

[13] Compliance with the revised Rule 4.27 shall be required by not later than September 15, 2012 for a CPO having at least $5 billion in assets under management, and by not later than December 14, 2012 for all other registered CPOs and all CTAs.