Proskauer

CFTC Repeals 4.13(a)(4) Exemption Used by Many Private Fund Managers

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On February 9, 2012, the U.S. Commodity Futures Trading Commission (CFTC) rescinded CFTC Rule 4.13(a)(4), which is the exemption from CFTC registration as a Commodity Pool Operator (CPO) that is commonly used by general partners, managers and sponsors of private funds that trade futures. A private fund currently operating under Rule 4.13(a)(4) can continue to do so until December 31, 2012. As of December 31, 2012, a private fund previously relying on Rule 4.13(a)(4) must qualify for an alternate exemption, such as the exemption under Rule 4.13(a)(3), often called the "de minimis" exemption, or else the "operator" of the fund must register with the CFTC as a CPO. The CFTC also adopted other changes to its rules governing CPOs and Commodity Trading Advisors (CTAs) as discussed below.

Exemptions from CPO Registration

Rule 4.13(a)(4) previously exempted the CPO of a fund from registration with the CFTC if all natural persons investing in the fund are qualified eligible persons (QEPs), as defined in CFTC Rule 4.7(a)(2), and if all non-natural persons investing in the fund are either QEPs or "accredited investors," as defined in Regulation D under the Securities Act of 1933. Since a QEP is defined to include a "qualified purchaser," as defined under the Investment Company Act of 1940, most private funds operated under the exemption under Section 3(c)(7) of the Investment Company Act could automatically qualify for the exemption under Rule 4.13(a)(4). CPOs that are currently relying on Rule 4.13(a)(4) have until December 31, 2012 to claim another exemption, such as under Rule 4.13(a)(3), or to register with the CFTC.

The exemption under Rule 4.13(a)(3) is available for a CPO of a fund that engages in only limited futures trading. For a fund to qualify under the de minimis threshold under Rule 4.13(a)(3), ***either*** (1) the aggregate initial margin for all futures positions and premiums for all options on futures held by the fund must not exceed 5% of the liquidation value of the fund's portfolio ***or*** (2) the aggregate net notional value of all futures positions and options on futures held by the fund must not exceed 100% of the liquidation value of the fund's portfolio (in each case including any unrealized profits and losses on open positions).

Once the CFTC has finalized certain pending rules defining the types of swaps that will be subject to CFTC regulation, fund advisers must include any non-security based swaps and probably many types of so-called "mixed swaps" in the above tests under Rule 4.13(a)(3). The Dodd Frank Act divided regulatory authority over swaps between the Securities and Exchange Commission (SEC) and the CFTC, granting the CFTC primary authority over non-security based swaps and shared authority with the SEC over security based swaps that have a commodity component, or "mixed swaps." A CPO relying on the exemption under Rule 4.13(a)(3) can continue to exclude swaps from the threshold calculation under Rule 4.13(a)(3) until 60 days after the final rules defining swaps become effective. It is unclear at this time when the final rules on swaps will be published.

The rules for netting futures contracts and swaps under Rule 4.13(a)(3) will differ. Futures contracts on a single commodities market or board of trade can be netted with each other, whereas swaps may be netted only if cleared by the same designated clearing organization.

CTA Exemptions Retained

Advisers to many private funds currently rely on an exemption from registration with the CFTC as a CTA under CFTC Rule 4.14(a)(8) or 4.14(a)(10). Neither of these rules was amended. However, the scope of the exemption under CFTC Rule 4.14(a)(8), which exempts a CTA if the CTA only advises certain limited categories of private funds, including funds operated under Rules 4.5 and 4.13, is significantly reduced by the repeal of Rule 4.13(a)(4). Rule 4.14(a)(10), on the other hand, exempts a CTA from registration if the CTA advises less than 15 clients and does not hold itself out to the public as a commodity trading advisor.

Funds of Funds

The CFTC received many comments requesting relief for funds of funds due to the difficulty in applying the de minimis threshold to funds of funds. However, the CFTC but did not grant any new relief. A fund of funds that invests in other funds that trade futures is itself a commodity pool in the eyes of the CFTC. Currently, a fund of funds relying on Rule 4.13(a)(3) must use one of the "look-through" approaches outlined in an appendix to the Rule, which illustrate the application of Rule 4.13(a)(3) in several hypothetical situations. The CFTC noted that "the [CFTC] staff will consider requests for exemptive relief for fund of funds on a case by case basis."

Foreign Advisers and Family Offices

Citing the need to first accumulate more data, the CFTC also decided not to grant any new relief to family offices and non-U.S. advisers. The CFTC directed its staff to "look into the possibility of adopting a family offices exemption in the future."

Annual Notice of Reliance on Exemptions

In a departure from previous practice, the CFTC will now require exempt advisers to make an annual filing to claim an exemption or exclusion from registration as a CPO or CTA. The annual notice requirement will be due within 60 days of the calendar year-end. Failure to file the annual notice in time will result in the exemption or exclusion being deemed withdrawn.

Forms CPO-PQR and CTA-PR

A registered CPO or CTA will be required to report certain information to the CFTC on Form CPO-PQR or CTA-PR, respectively, which are the CFTC equivalents of SEC Form PF. Form CPO-PQR is divided into three Schedules (A, B and C). A CPO may not be required complete all three schedules, depending on the size of the CPO's advisory business and the CPO's SEC reporting obligations if a dual registrant. CPOs with less than $150 million of assets under management will only be required to file Schedule A of Form CPO-PQR annually, with the first filing due within 90 days after December 31, 2012. "Mid-sized CPOs" with between $150 million and $1.5 billion of assets under management will be required to complete both Schedules A and B annually, with the first filing due within 90 days after December 31, 2012. "Large CPOs" managing at least $1.5 billion will be required to complete Schedule C as well. Large CPOs must file Schedule B and Schedule C within 60 days of the end of each calendar quarter, commencing with the quarter ended September 30, 2012 in the case of large CPOs with more than $5 billion in assets under management and commencing with the quarter ended December 31, 2012 for all other large CPOs. SEC registered advisers may file Form PF with the SEC in lieu of completing Schedule B and Schedule C of Form CPO-PQR.

Form CTA-PR must be filed annually within 45 days of the end of the fiscal year.

Additional Amendments Adopted

The CFTC repealed CFTC Rule 4.7(b)(3), thereby requiring pools operated under Rule 4.7 to comply with CFTC Rule 4.22(c) by providing annual financial statements certified by an independent public accountant. The CFTC also modified the criteria established under Rule 4.5 that permit certain registered investment companies to avoid CPO registration. Lastly, the CFTC imposed additional risk disclosure requirements for CPOs and CTAs related to swap transactions.

Please contact your Proskauer relationship attorney or any of the attorneys listed on this alert if you have any questions or would like to discuss the issues raised by the repeal of CFTC Rule 4.13(a(4).

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