Foreign Exchange Forwards and Swaps Exempt from CFTC Regulation; CFTC Also Grants Relief to Family Offices and Funds-of-Funds

December 4, 2012

On November 16, in an action that was widely anticipated and has significant impact on many private fund managers, the Department of the Treasury issued a Final Determination exempting both foreign exchange forward contracts (FX Forwards) and foreign exchange swaps (FX Swaps) from the definition of "swap" under the Commodity Exchange Act.

As a result, managers of private funds that trade FX Forwards and FX Swaps, but that do not trade other instruments that qualify as commodity interests under Commodity Futures Trading Commission (CFTC) rules, will not be required to either register with the CFTC as a commodity pool operator (CPO) or file for an exemption before the end of 2012.

For this purpose, an FX Forward is a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange, and an FX Swap is a transaction that solely involves an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange, and a reverse exchange of the same two currencies at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange.

Sponsors, managers and general partners of funds that trade commodity interests, or that invest in other funds that trade commodity interests, generally are required to register with the CFTC as a CPO, unless they qualify for an applicable exemption. On October 12, 2012, the definition of "commodity interests" under the Commodity Exchange Act was greatly expanded to include "swaps." Also earlier this year, the CFTC rescinded, effective December 31, 2012, the widely used exemption from registration under CFTC Rule 4.13(a)(4) that exempted, among others, managers of funds operated under Section 3(c)(7) of the Investment Company Act. As a result of these actions, managers of private funds that trade swaps subject to CFTC jurisdiction are required to either register with the CFTC by the end of this year or to qualify and apply for an exemption from CFTC registration for each fund they operate under the de minimis trading exemption under Rule 4.13(a)(3). In order for a fund to qualify for the de minimis exemption under Rule 4.13(a)(3), either (1) the aggregate initial margin and premiums for all commodity interest positions 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 commodity interests positions 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).

As a result of the action by the Treasury Department, fund managers may now exclude FX Forward and FX Swap positions from their calculation of the 5% and 100% limits under Rule 4.13(a)(3).

CFTC Exempts Family Offices and Grants Extension to Funds-of-Funds

On November 30, the CFTC issued no-action letters providing relief to family offices and fund-of-funds managers.

The family office no-action letter provides that a family office that is exempt from registration with the SEC under the SEC's family office rule, Rule 202(a)(11)(G)-1, is also exempt from registration with the CFTC as a CPO. However, the family office must file a notice of exemption by email with the CFTC.

The fund-of-funds letter provides that a manager or sponsor of a fund-of-funds can obtain temporary relief from CFTC registration (or the need to claim an exemption from registration) until the later of June 30, 2013, or six months after the effective date of revised guidance issued by the CFTC (or the compliance date, if later). However, in order to be eligible for the relief, a fund-of-funds manager must "not know and could not have reasonably known that each fund-of-funds' indirect exposure to commodity interests" exceeds the levels permitted under CFTC Rule 4.13(a)(3), either calculated directly, or through the use of the guidelines in Appendix A under the rule. Appendix A, which is no longer available on the CFTC's web site and is to be replaced by new guidance, provides a series of examples as to how Rule 4.13(a)(3) is intended to apply to funds-of-funds. We hope that the CFTC will issue some clarification as to the intended scope of the relief granted. In order to take advantage of this relief, a fund-of-funds manager must file a notice by email with the CFTC prior to December 31, 2012.

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Please contact your Proskauer relationship lawyer or any of the lawyers listed on this alert if you have any questions.

Related Professionals

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  Partner
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  Partner
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