February 16, 2012

CFTC Tightens Commodity Pool Operator Exemption for Investment Companies

By Anna T. Pinedo

By a vote of 4-1, on February 9, 2012, the Commodity Futures Trading Commission (the "CFTC") amended Rule 4.5 under the Commodity Exchange Act to sharply limit the ability of advisers to registered investment companies that use derivatives from relying on an exclusion from the definition of a commodity pool operator ("CPO").

Reinstatement of the "5 percent threshold." The new rule reinstates the "5 percent threshold test," which the CFTC eliminated in 2003. Generally, the 5 percent threshold test requires registered investment companies that hold certain commodity futures, commodity options contracts, or swaps whose aggregate initial margin and premiums exceed 5 percent of the liquidation value of the fund's portfolio to register as CPOs. The new rules distinguish between use of derivatives for risk management and for bona fide hedging. The new rules count derivatives trades used for the purposes of managing portfolio risk toward the 5 percent limit, but exclude transactions used for "bona fide hedging."

In the case of an option that is in-the-money at the time of purchase, funds may exclude the in-the-money amount in computing the 5 percent threshold.

Alternative net notional test. The CFTC adopted an "alternative net notional test." This test provides that an investment company's aggregate net notional value of the fund's commodity interest positions may not exceed 100 percent of the liquidation value of the fund's portfolio (taking into account unrealized profits). The rule itself states that investment companies must satisfy both the 5 percent threshold and the alternative net notional test. The adopting release, however, implies that funds seeking to rely on the exemption can satisfy either the 5 percent threshold test or the alternative net notional test.

Notional value. The rule defines how funds must calculate "notional value" for each futures position and swap position.

Netting. Funds may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade, and swaps cleared on the same designated clearing organization where appropriate.

Holding out. As a condition for relying on the exclusion from the definition of a CPO, a fund must not hold itself out as a vehicle for trading in the commodity futures, commodity options, or swaps markets. As originally proposed, the rule would have prohibited funds relying on this exemption from marketing themselves as "seeking investment exposure to" futures, related options, or swaps.

Annual notice. Funds relying on Rule 4.5 by filing a notice of exclusion must annually affirm the notice of exemption from registration, withdraw such exemption if their activities no longer require registration, or withdraw such exemption and apply for registration within 30 days of the calendar year end.

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Who will have to register? Advisers to investment companies that qualify as CPOs but do not otherwise qualify for an exclusion from the definition of a CPO or another exemption from registration (including the exclusion set forth in amended Rule 4.5) must register with the CFTC.

Risk disclosure statement for swaps. The CFTC also adopted standardized risk disclosure statements for CPOs that use swaps.

Effect of the new rules. The rules are likely to increase compliance and other costs of investment companies and their investment advisers that are required to register with the CFTC.

Exemption for qualified eligible persons. The CFTC also rescinded the exemption in Rule 4.13(a)(4) for operators of pools that are offered only to individuals and entities that satisfy the qualified eligible person standard in Rule 4.7 or the accredited investor standard under the SEC's Regulation D.

Why did the CFTC adopt these amendments? In proposing the rule amendments, the CFTC expressed concern that certain registered investment companies were offering interests in de facto commodity pools while claiming exclusion from the definition of a CPO pursuant to Rule 4.5 under the Commodity Exchange Act.

The CFTC stated that it "remains concerned that registered investment companies are offering managed futures strategies, either in whole or in part, without Commission oversight and without making the disclosures to both the Commission and investors regarding the pertinent facts associated with the investment in the registered investment company."

The CFTC noted it was focusing on registered investment companies "because it is aware of increased trading activity in the derivatives area by such entities that may not be appropriately addressed in the existing regulatory protections, including risk management and recordkeeping and reporting requirements."

In the CFTC's view, registered investment companies should not engage in such activities without CFTC oversight, and such oversight was necessary to ensure consistent treatment of CPOs regardless of their status with respect to other regulators.

Critics of the CFTC proposal claimed that the rule would provide no tangible benefits to the CFTC or investors, because investment companies that use derivatives are already subject to comprehensive regulation by the SEC. The CFTC rejected these arguments, saying that the rule provides two distinct benefits. First, it will ensure that all entities operating collective investment vehicles participating in the derivatives markets meet minimum standards of fitness and competency. Second, it gives the CFTC jurisdiction to enforce violations of law by funds that participate in the derivatives markets.

The Commission acknowledged that the revisions to Rule 4.5 will increase costs to investment companies, but said that these costs are justified because they will allow it to effectively oversee investment company derivatives trading activities. Concurrently with the rule, the CFTC has proposed to adopt a harmonized compliance regime for registered investment companies whose activities require oversight by the CFTC.

Rescinding of certification relief. The CFTC rescinded the relief contained in Rule 4.7 from the certification requirement

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for financial statements contained in annual reports of commodity pools offered to qualified eligible persons.

Filing requirements. The CFTC adopted rules requiring registered CPOs and CTAs to file their reports electronically with the National Futures Association ("NFA"). The CFTC also addressed filing requirements of CPOs and CTAs dually registered with the SEC.

Regulatory harmonization. In addition to the final rules described above, the CFTC also proposed rules that provide for regulatory harmonization for registered investment companies and their advisors that must register with the CFTC. The proposed rules exempt investment advisers of funds that do not qualify for the Rule 4.5 exclusion from various requirements that would otherwise apply to CPOs, including delivery of disclosure documents and periodic reports.

The exemption would allow funds to include CFTC-required disclosures in fund prospectuses. In the case of funds that have traded commodity interests for more than three years, and at least 75 percent of whose investments originated from persons unaffiliated with their adviser, such funds may disclose only their own performance. But, in the case of funds that have traded commodity interests for less than three years, their advisers would be required to disclose performance of other commodity pools they operate.

The proposed rules would reconcile other conflicting requirements of the SEC and the CFTC.

Dissent. CTFC Commissioner Jill E. Sommers voted against the new rules, saying that the CFTC has "gone far beyond what was needed" to resolve concerns of the National Futures Association, which requested the rulemaking. Commissioner Sommers stated that it was unlikely, in her view, "that the cost-benefit analysis supporting the rules will survive judicial scrutiny if challenged."

Compliance dates. Funds must comply with Rule 4.5 for registration purposes not later than the later of December 31, 2012, or 60 days after the effective date of the final rulemaking that further defines the term "swap," which the CFTC will publish in the Federal Register at a future date. Funds and advisers required to register due to the amendments to Rule 4.5 must comply with the CFTC's recordkeeping, reporting, and disclosure requirements pursuant to part 4 of the CFTC's regulations within 60 days following the effectiveness of a final rule implementing the CFTC's proposed harmonization effort pursuant to the concurrent proposed rulemaking. CPOs claiming exemption under Rule 4.13(a)(4) must comply with the rescission of Rule 4.13(a)(4) by December 31, 2012. CPOs and CTAs must comply with new reporting requirements by September 15, 2012.

> Final rules, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (February 9, 2012), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf;
>
> Proposed rules, Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators (February 9, 2012), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912.pdf;
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> Dissenting Statement of Commissioner Jill E. Sommers, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement020912a.

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