K&L GATES

Legal Insight

www.klgates.com

July 17, 2012

Practice Groups:

Investment Management

Hedge Funds and Venture Funds

CFTC Extends Compliance Date Regarding Rescission of CPO/CTA Registration Exemptions, but Not for Swaps

By Lawrence B. Patent and Cary J. Meer

Introduction

The Commodity Futures Trading Commission ("CFTC") Division of Swap Dealer and Intermediary Oversight ("DSIO") issued a letter¹ dated July 13, 2012 that extends until the end of this year the time during which persons operating or advising commodity pools may continue to rely upon a rescinded exemption and the prior exclusion from registration under the Commodity Exchange Act ("CEA") that were recently rescinded and modified by the CFTC. This no-action relief applies to operators of both registered investment companies ("RICs") and private funds and was requested by the Managed Funds Association, the Investment Adviser Association, the Alternative Investment Management Association and the Investment Company Institute.

When the CFTC rescinded this exemption for operators of private funds (and rescinded the related exemption for advisers to private funds) and modified the exclusion relied on by operators of RICs from registration as a commodity pool operator ("CPO") or commodity trading advisor ("CTA") (under Regulations 4.5, 4.13(a)(4) and 4.14(a)(8)), it permitted CPOs and CTAs that filed exemption/exclusion notices in accordance with these regulations prior to the effective date of the rescission/modification, April 24, 2012, to continue to operate under the prior exemption/exclusion through December 31, 2012. For commodity pools created on or after April 24, 2012, however, the rescinded exemption and unmodified exclusion could no longer be claimed by operators or advisors thereof. The DSIO no-action relief essentially extends the effective date of the exemption rescission and the modification of the exclusion for pools launched after the issuance of the letter (July 13, 2012) until December 31, 2012. In the same letter, DSIO declined to grant additional time beyond December 31, 2012, by which date swaps must be included in the computation used to determine whether the operators of commodity pools may rely upon the amended standards for exclusion under Regulation 4.5 and the provisions of Regulation 4.13(a)(3) (which was not rescinded as had been proposed).²

No-Action Relief

The no-action relief granted to the operators of and advisors to private funds and registered investment companies ("RICs") under the Investment Company Act of 1940 ("1940 Act") applies to the operator or advisor of any such fund or RIC. As is customary for CFTC staff no-action letters, the relief is prospective, *i.e.*, it covers pools launched after the letter's issuance and expires on December 31,

¹ To view the Staff Letter 12-03, please click here.

² The trading limits set forth in those regulations restrict aggregate initial margin and premiums to 5% of the pool's net asset value or, in the alternative, restrict the aggregate notional value of commodity interest positions to 100% of the pool's net asset value. Under Regulation 4.5, unlimited *bona fide* hedging is also permitted. The calculations are made whenever a new position is to be entered into.

2012.³ The conditions applicable to the relief for private funds are essentially the same as those contained in the rescinded Regulation 4.13(a)(4),⁴ and the relief for RICs simply requires that the RIC be registered under the 1940 Act.

Like the rescinded exemption and modified exclusion, this relief is not self-executing, but instead of filing a claim of exemption with the National Futures Association ("NFA"), the claim for no-action relief must be filed with DSIO using the email address dsionoaction@cftc.gov. The claim must be filed prior to the date upon which the CPO or CTA first engages in activity that would otherwise require registration and contain (a) the name, main business address, and main business telephone number of the CPO or CTA; (b) the capacity (i.e., CPO, CTA, or both) and, where applicable, the name of the pool(s), for which the claim is being filed; and (c) be electronically signed by the CPO or CTA. The claim will be effective upon filing so long as it is materially complete. CPOs and CTAs should maintain records of their filings because the letter does not indicate whether these filings will be readily accessible, as is the case for exemption/exclusion claims that may be reviewed on the NFA website

Persons claiming no-action relief as CTAs should note some differences from the conditions applicable under the registration exemption provisions: (1) there is no indication in the letter that the CTA must be registered as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act") or with an applicable state securities regulator, exempt from such registration, or excluded from the definition of the term pursuant to Section 202(a)(2) or (11) of the Advisers Act; (2) CPOs making trading decisions for the pools that they operate must also claim the relief as a CTA; and (3) CTAs may claim relief in connection with pools operated in accordance with CFTC Regulation 4.13(a)(1) or (2), which generally exempt the operators of small pools from CPO registration, in addition to pools operated in accordance with Regulations 4.5, 4.13(a)(3) or the rescinded 4.13(a)(4).

The second difference noted above means that, if the same person operates and advises the type of pool for which no-action relief is available, the person must indicate that it is claiming *both* CPO and CTA relief. By regulation, the CFTC provides that a registered CPO, or a person exempt from CPO registration, that solely advises pools for which it is so registered or exempt is also exempt from CTA registration, and those exemptions are self-executing. However, because the person claiming the CPO no-action relief will be neither registered nor qualified for an exemption from registration, DSIO is requiring that the person claim no-action relief as a CTA also if it solely advises the pools that it operates.

Swaps

Unfortunately, the DSIO has not provided additional relief with respect to swaps. The trade associations that requested relief also sought an extension of time in which a CPO may claim exemption under Regulation 4.13(a)(3) and the amended Regulation 4.5 without including swaps in

³ The letter is silent regarding commodity pools launched on or after April 24, 2012, but prior to its issuance.

⁴ These conditions are that (a) interests in the pool are exempt from registration under the Securities Act of 1933 ("Securities Act"), and such interests are offered and sold without marketing to the public in the United States, and (b) the CPO reasonably believes, at the time of investment, that (i) each natural person participant (including such person's self-directed employee benefit plan, if any) is a "qualified eligible person," as that term is defined in CFTC Regulation 4.7(a)(2); and (ii) each non-natural person participant is a "qualified eligible person," as that term is defined in CFTC Regulation 4.7, or an "accredited investor," as that term is defined in Rules 501(a)(1)-(3), (a)(7) and (a)(8) of Regulation D under the Securities Act.

⁵ Regulation 4.14(a)(4) and (a)(5), respectively.

the trading limit calculations set forth therein until ten months after the effective date of final regulations further defining the term "swap" and setting margin for uncleared swaps. However, DSIO denied relief beyond December 31, 2012 for including swaps in those calculations, despite the fact that the CFTC stated, when adopting the amendments to the registration exemptions, that "it is the [CFTC's] intention to establish the compliance date of the inclusion of swaps within the threshold calculation as 60 days after the final rules regarding the definition of 'swap' *and the delineation of the margin requirement for such instruments are effective.*" In light of the CFTC's recent re-opening of the comment period for margin requirements for uncleared swaps through September 14, 2012, it is unlikely that such requirements will be effective prior to December 31, 2012.

DSIO stated that an extension beyond year's end for including swaps is not necessary because (1) CPOs should have the information regarding margin of their pools' current swaps portfolio necessary to calculate whether the pools exceed the trading limits, and (2) the CFTC has indicated that it will not apply its margin requirements for uncleared swaps retroactively. Of course, CPOs must also include within the trading limit calculations margin requirements for cleared swaps, which will be set by a combination of derivatives clearing organizations, designated contract markets, swap execution facilities and futures commission merchants that submit swaps for clearing. Under CEA Section 2(h)(7)(C)(i)(V), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), swaps are generally required to be cleared, and commodity pools may not claim the exemption from clearing that is available to commercial end users.

The CFTC's recent adoption, jointly with the SEC, of final regulations further defining the term "swap" is also significant for those operators and advisors of collective investment vehicles that have not previously been involved with commodity futures or commodity options but that do use swaps as part of their investment strategy. As those regulations make clear, a swap may include such instruments as a total return swap on a broad-based index, a foreign currency option, or a "nondeliverable forward" involving currencies. Particularly with respect to currency instruments, the persons employing such instruments as part of their investment strategy may not have considered themselves involved in commodity interest markets, but Dodd-Frank has changed that. These persons would not have previously had any reason to file exemption notices with respect to CPO and CTA registration because they were not previously trading instruments subject to CFTC jurisdiction. If the nature and extent of trading by these persons of swaps, which are now classified as commodity interests, makes them ineligible to claim exemption from registration under the CFTC's Part 4 regulations, as amended, or under any other statutory or regulatory exemption, or to claim the noaction relief provided by DSIO, these persons are required to register as CPOs and/or CTAs by the effective date of the regulations further defining the term "swap," which is likely to be sometime in October 2012 (60 days following publication in the Federal Register).

Conclusion

The adoption of the final regulations further defining the term "swap" is a linchpin of the new regulatory framework under Dodd-Frank and sets in motion the general effectiveness of several other regulations that have already been adopted but were essentially on hold pending the adoption of the

⁶ The requested ten-month extension would have roughly paralleled the time period between the CFTC's rescission of the registration exemptions and December 31, 2012.

⁷ 77 Fed. Reg. 11252, 11258 (February 24, 2012) (emphasis added).

⁸ 77 Fed. Reg. 41109 (July 12, 2012).

⁹ 76 Fed. Reg. 23732, 23734 (April 28, 2011).

swap definition regulations. With the issuance of DSIO's no-action relief, CPOs and CTAs will be able to launch new pools prior to the end of this year essentially under the structure that existed prior to the rescission and modification of the CPO/CTA exemptions. However, in light of the denial of any further extension of time regarding the inclusion of swaps as commodity interests, all operators and advisors of collective investment vehicles, whether currently exempt from registration, able to claim the no-action relief, or whose only involvement in commodity interests is through swaps, need to proceed expeditiously to review their swap portfolio and anticipated swap investment strategy going forward to determine if they will be able to qualify for an exclusion or exemption from registration based upon the trading limits in the amended Regulation 4.5 and Regulation 4.13(a)(3).

Authors:

Lawrence B. Patent lawrence.patent@klgates.com +1.202.778.9219

Cary J. Meer cary.meer@klgates.com +1.202.778.9107

K&L GATES

Anchorage Austin Beijing Berlin Boston Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg

Hong Kong London Los Angeles Miami Milan Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh

Research Triangle Park San Diego San Francisco São Paulo Seattle Shanghai Singapore Spokane Taipei Tokyo Warsaw Washington, D.C.

K&l Gates includes lawyers practicing out of more than 40 fully integrated offices located in North America, Europe, Asia, South America, and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information about K&l Gates or its locations and registrations, visit www.klgates.com.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2012 K&L Gates LLP. All Rights Reserved.