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CFTC Re-Imposes Limitations on Derivative Activities by Registered Investment Companies

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The Commodity Futures Trading Commission ("CFTC") recently adopted amendments to Rule 4.5 under the Commodity Exchange Act ("CEA") that will greatly narrow that rule's exclusion for operators of registered investment companies ("Registered Funds" or "Funds") from regulation as commodity pool operators ("CPOs").[1] Amended Rule 4.5 will require the operators of Registered Funds to either limit such Funds' use of commodity futures, options, leverage contracts, retail forex contracts, and swaps (together, "commodity interests") or submit to dual regulation by the CFTC and the Securities and Exchange Commission ("SEC"). Registered Funds that currently invest in commodity interests will need to evaluate and make significant changes to their investment and compliance programs before the amendments to Rule 4.5 take effect.

For persons relying on the Rule 4.5 exclusion as of the effective date of the rule amendments, which will generally be 60 days after publication in the *Federal Register* ("Effective Date"), likely in April 2012, the requirement to register under amended Rule 4.5 will be effective on the later of: (i) December 31, 2012; or (ii) within 60 days after the CFTC adopts final rules defining "swap" and establishes margin requirements for such instruments. However, based upon discussions with CFTC staff, any Registered Fund that does not have a Rule 4.5 notice on file prior to the Effective Date will be required to register at that time if it cannot come within the rule's new trading limits.

Concurrent with the adoption of the amended Rule 4.5, the CFTC proposed certain harmonization measures—for advisers to Registered Funds that will be required to register with the CFTC—to address regulatory issues these Funds will face under a dual SEC-CFTC regulatory scheme (the "Harmonization Proposal"). The compliance regime that will apply to dually-registered funds will become effective 60 days after the final rules proposed in the Harmonization Proposal are published in the *Federal Register*.

Current Rule 4.5 Exclusion

Under the CEA and CFTC rules, the registration requirement applies to the CPO, not the commodity pool itself. Rule 4.5 currently provides a blanket exclusion from CPO regulation for operators of Registered Funds. For investment advisers to Registered Funds to qualify for the exclusion under current Rule 4.5, Registered Funds simply disclose in their prospectuses or statements of additional information that they are operated by a person who has claimed an exclusion from the CPO definition. In addition, Rule 4.5 currently requires that persons claiming the exclusion file a one-time notice

[1] The release containing amended Rule 4.5 ("Final Release") was issued February 8, 2012 and is available at this link. The CFTC's release proposing amendments to Rule 4.5 was issued January 26, 2011. *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations*, 76 Fed. Reg. 7975 (Feb. 11, 2011). Our previous alert summarizes the proposal and can be found at this link.

electronically with National Futures Association ("NFA")[2] and submit to "special calls" to determine compliance with the conditions of the exclusion.

Rule 4.5 currently does not place any limitations on the use of commodity interests by Registered Funds, nor does it restrict Registered Funds from marketing themselves as commodity pools.

Amended Rule 4.5 Exclusion

The Final Release significantly narrows the exclusion in Rule 4.5 with respect to Registered Funds by:

- Requiring the operator of a Registered Fund claiming the Rule 4.5 exclusion to limit the Registered Fund's use of commodity interests to certain *bona fide* hedging and *de minimis* activities (the "Restrictions"), namely:
    - Using commodity interests "solely for *bona fide* hedging purposes" ("*Bona Fide* Hedging"); and
    - Limiting any non-*bona fide* hedging positions to those that would satisfy one of two *de minimis* tests, either the 5% Test or the Notional Test (each of which is described below);
- Preventing the operator of a Registered Fund claiming the Rule 4.5 exclusion from marketing the Registered Fund as a commodity pool or as a fund for trading in commodity interests (the "Marketing Restriction"); and
- Requiring the operator of a Registered Fund claiming the Rule 4.5 exclusion to re-affirm its eligibility at the end of each calendar year.

Significantly, the Final Release clarifies that for a Registered Fund, the CPO is the fund's investment adviser, not the Registered Fund's board of directors. The CFTC acknowledged that to require a member or members of a Registered Fund's board of directors or trustees to register would raise operational concerns as well as result in potential greater liability for actions undertaken in the capacity of a director or trustee. Further, having the adviser register as the CPO recognizes the reality that it is the adviser that creates, and attracts investors to invest in, a Registered Fund. It is therefore more appropriate for the adviser to comply with the registration and other regulatory obligations of a CPO.[3]

Restrictions

Bona Fide Hedging

The Final Release reinstates the *Bona Fide* Hedging limitations, which were part of Rule 4.5 until 2003. Operators of Registered Funds that choose to rely on the *Bona Fide* Hedging restriction will have to implement significant compliance controls to determine whether their commodity interest trading positions are used for *bona fide* hedging and, if not, may have to adjust their portfolios to fall within the amended rule.

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[2] The NFA is the futures industry self-regulatory organization, which is a counterpart to the Financial Industry Regulatory Authority in the securities industry.

[3] CPOs register under the CEA through the NFA's Online Registration System. The associated persons, *i.e.*, those natural persons who solicit investors or supervise those who do, and the principals of CPOs are subject to extensive background checks. Associated persons also must pass a proficiency examination unless they are eligible for an examination waiver.

With respect to financial commodity interests, such as, for example, futures on broad-based securities indices,[4] "*bona fide* hedging" is defined under CFTC Rule 1.3(z)(1) to constitute commodity interest positions that: (i) "normally represent a substitute for . . . positions to be taken at a later time in a physical marketing channel"; (ii) "are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise"; (iii) arise from the potential change in the value of the Registered Fund's assets or liabilities, or services; (iv) are for the purpose of "offset[ting] price risks incidental to commercial cash or spot operations"; and (v) comply with relevant trading and position limit requirements. In a 1987 interpretive release, the CFTC clarified that this definition should not be interpreted in a restrictive way with respect to balance sheet and other risk-reducing trading strategies, including "portfolio insurance or dynamic asset allocation strategies that provide protection equivalent to a put option for an existing portfolio of securities."[5]

In the Final Release, the CFTC declined to expand the definition of *bona fide* hedging to include risk management as a recognized *bona fide* hedging activity for purposes of Rule 4.5. Rather, the CFTC indicated that *bona fide* hedging does not include risk management positions as they are broadly understood, but rather that positions must be risk-reducing to qualify as hedges. The CFTC expressed concerns that risk management transactions present greater market risk because they are not offset by exposure in the physical markets and that there was no consensus within the industry as to how to appropriately define a risk management transaction. The CFTC previously has provided guidance on distinguishing between risk management positions and risk *reduction* strategies that would qualify as hedging.[6]

Non-Hedging De Minimis Tests

The Final Release also reinstates the 5% trading *de minimis* threshold that was a condition of the Rule 4.5 exclusion before 2003 (the "5% Test") and introduces an alternative *de minimis* trading threshold test based on the net notional value of a Registered Fund's derivatives positions (the "Notional Test").

5% Test

Under the 5% Test, an adviser to a Registered Fund may rely on the Rule 4.5 exclusion as long as the aggregate initial margin and premiums required to establish a Registered Fund's total non-*bona fide* hedging positions with respect to commodity futures, commodity options or swaps does not exceed

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[4] As mandated by Dodd-Frank, *bona fide* hedging for exempt commodities (*i.e.*, energy and metals) and agricultural commodities is defined under the more restrictive provisions of CFTC Rule 151.5, which likely do not apply here as Registered Funds could not qualify as hedgers with respect to such commodities. 76 Fed. Reg. 71625 (Nov. 18, 2011).

[5] *Clarification of Certain Aspects of the Hedging Definition*, 52 Fed. Reg. 27195 (July 20, 1987), *reprinted in* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,713.

[6] The CFTC gave the following example to illustrate this distinction. A fund manager is fully invested in a combination of debt and equity securities. The manager decides to temporarily alter the asset allocation to provide greater exposure to equities as compared to debt. Instead of selling any existing securities, the manager enters into long broad-based stock index futures and shorts Treasury bond or note futures. Although the short Treasury bond or note futures would constitute a hedge against the portfolio's previously purchased Treasury securities, the long stock index futures position would not constitute a hedge of the existing equity securities in the portfolio, because in effect the fund would be "long" equities and "long" a stock index future. However, subject to certain conditions intended to prevent excessive leverage, the stock index futures position could be eligible for classification as a risk management position. *Risk Management Exemptions From Speculative Position Limits Approved Under Commission Reg. 1.61*, 52 Fed. Reg. 34633 (September 14, 1987), *reprinted in* [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,797.

5% of the liquidation value[7] of the Registered Fund's portfolio (taking into account unrealized profits and unrealized losses on any such positions).

Notional Test

As an alternative to the 5% Test, an adviser to a Registered Fund may rely on the Notional Test, which limits the aggregate net "notional value" of the Fund's non-*bona fide* hedging commodity interest positions to 100% of the liquidation value of its portfolio (taking into account unrealized profits and unrealized losses on any such positions).[8] Because the margin levels for broad-based stock index futures and security futures tend to exceed the levels for other commodity interests, thereby making it difficult to satisfy the 5% Test, the Notional Test may be especially useful for a Registered Fund investing in these instruments.

For calculations under the Notional Test, the notional value is determined by asset class. For example, the notional value of futures contracts is derived by multiplying the number of contracts by the size of the contract, in contract units, and then multiplying by the current market price for the contract. The notional value of a cleared swap, however, will be determined consistent with the provisions of Part 45 of the CFTC's rules.[9] The ability to net positions also is determined by asset class, with entities being able to net futures contracts across designated contract markets or foreign boards of trade, but cleared swaps may be netted only if cleared by the same derivatives clearing organization. Although the CFTC did not address the issue specifically, netting probably will not be allowed for uncleared swaps.

Calculating Positions under the Restrictions

The CFTC declined to exclude from the *de minimis* calculations certain positions that commenters specifically requested be so excluded. As a result, the CFTC noted in the Final Release that the following positions must be included in the calculations—derivatives based on broad-based stock indices, positions entered into under passive investment strategies, and financial commodities generally.

In addition, swaps explicitly are included in the 5% Test and the Notional Test calculations. Given that the use of swaps by a Registered Fund—even without investment in other commodity interests—would bring a Registered Fund within the post-Dodd Frank definition of a "commodity pool,"[10] the

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[7] The liquidation value of a fund's portfolio is sometimes also referred to as the net asset value. The 5% calculation thus cannot be based on the full value of stocks or bonds purchased on margin – the liquidation value of the portfolio is net of the amount borrowed. The liquidation value concept was an element of the Rule 4.5 exclusion for over ten years, from the time Rule 4.5 was first amended in 1993 until trading limits were removed in 2003. *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator,"* 58 Fed. Reg. 6371 (January 28, 1993), *reprinted in* [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶25,543.

[8] The Notional Test was proposed but not finalized in 2002 and since then has been available to certain entities through no-action relief. The Notional Test is identical to the *de minimis* exemption in CFTC Rule 4.13(a)(3)(ii)(B). A separate alert regarding the CFTC's amendments to Rule 4.13 adopted together with the amendments to Rule 4.5 can be found at this link.

[9] 77 Fed. Reg. 2135 (January 13, 2012).

[10] New CEA Section 1a(10) defines "commodity pool" as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any—

(i) commodity for future delivery, security futures product, or swap;

(ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i) [of the CEA];

(iii) commodity option authorized under section 4c [of the CEA]; or

(iv) leverage transaction authorized under section 19 [of the CEA]."

CFTC states in the Final Release that the exemption of swaps from the calculations would have had the undesirable effect of requiring all Registered Funds that use swaps to register.

The CFTC did not identify instruments that would be excluded from the calculations, but presumably derivatives over which the SEC has jurisdiction—specifically security-based swaps (such as single stock CDS)—should be excluded, but security futures would not be excluded.

Marketing Restriction

Even if a Registered Fund satisfies the Restrictions described above, its adviser must still comply with the amended rule's Marketing Restriction. The Marketing Restriction prohibits a Registered Fund whose adviser has not registered as a CPO from marketing the Registered Fund as a fund for trading in commodity interests or as a commodity pool. Responding to concerns raised by the industry that the Marketing Restriction was too vague, the Final Release lists a series of factors that, on a case-by-case basis and with no single factor being conclusive, should be considered when evaluating whether a Registered Fund satisfies the Marketing Restriction. These factors are:

- Fund name;
- Primary investment objectives tied to a commodity index;
- Use of a controlled foreign corporation for derivatives trading;
- References to the benefits of derivatives or comparisons to a derivatives index in a prospectus or other marketing materials;
- Net short speculative exposures to a commodity, directly or indirectly, in the course of normal trading activities;
- Commodity interests as a primary source of gains and losses; and
- Explicitly offering a managed futures strategy. This factor will be given the most weight in determining whether a Registered Fund is a *de facto* commodity pool.

The CFTC agreed to remove language included in the rule proposal suggesting that any prospectus disclosure about possible investments in commodity interests would have violated the Marketing Restriction.[11]

Use of Controlled Foreign Corporations

Currently, most "managed futures" or "commodity strategy" Registered Funds invest in commodity interests through wholly-owned offshore subsidiaries (Controlled Foreign Corporations, or "CFCs"), rather than directly investing in commodity interests, in order to ensure that the Funds qualify for pass-through tax treatment under Subchapter M of the Internal Revenue Code. The CFTC's proposal would have required that any positions in commodity interests for non-*bona fide* hedging purposes be held "by a qualifying entity only." In effect, this would have prohibited a Registered Fund from investing in many commodity interests due to the adverse tax consequences associated with a Registered Fund investing directly in commodities. In the Final Release, the CFTC removed this

The CFTC is further authorized to include within or exclude from this definition any investment trust, syndicate, or similar form of enterprise.

[11] The proposal would have prohibited marketing the Registered Fund "as a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures, commodity options, or swaps markets." 76 Fed. Reg. 7976, 7989 (Feb. 12, 2011). The Final Release omits the words "(or otherwise seeking investment exposure to)."

language and expressly stated that "it does not oppose the continued use of CFCs" by Registered Funds. However, the CFTC also stated its belief that CFCs fall within the statutory definition of "commodity pool" and that their operators are subject to regulation as commodity pool operators. Therefore, CFCs' operators will have to register as CPOs unless they can claim another exemption or exclusion. The CFTC also stated that a CFC is not entitled to rely on the Rule 4.5 exclusion simply because its parent company is a Registered Fund.

It is not clear how or whether amended Rule 4.5—particularly the CFTC statement that it does not oppose the continued use of CFCs by Registered Funds—will affect the recent uncertainty surrounding the tax treatment of Registered Funds investing in commodity interests through CFCs. A revenue ruling issued by the Internal Revenue Service ("IRS") in 2006 makes it virtually impossible for a Registered Fund to invest directly in derivative contracts with respect to commodities or a commodity index without jeopardizing its pass-through tax treatment under Subchapter M. Following the issuance of this revenue ruling, the IRS issued more than 50 private letter rulings holding that commodity-related income earned by a Registered Fund through a CFC would not jeopardize the Registered Fund's pass-through tax treatment under Subchapter M. However, the IRS suspended further issuance of these private letter rulings in July 2011 in order to re-evaluate the underlying policies. On November 3 and January 26, 2012, at hearings before the Permanent Subcommittee on Investigations of the Senate Homeland Security and Government Affairs Committee, Senator Carl Levin (D-Mich.) identified the use of commodity-related investments by Registered Funds as a source of commodity speculation and questioned these private letter rulings, focusing in particular on the substance of the CFCs. The IRS, however, has not yet issued adverse guidance on this issue, and Subchapter M specifically treats income from a CFC as qualifying income when the CFC distributes its earnings each year. It is unclear whether the amended Rule 4.5, requiring investment advisers to CFCs to register as CPOs, will lend more "substance" to the CFCs and thus undercut the arguments of critics such as Senator Levin.

Impact on Registered Funds of Hedge Funds

Currently, many registered funds of hedge funds ("FOHF") allocate their investments among many other types of private investment funds, including commodity pools and managed futures funds. Most do so without an ability to monitor the use of commodity interests by the underlying funds. The CFTC takes the position that, if an FOHF invests in another fund and the underlying fund trades commodity interests, the FOHF is a commodity pool based on the commodity interest trading at the underlying fund level and the operator of the top-level fund would need to register as a CPO or avail itself of an exclusion or exemption. Accordingly, under amended Rule 4.5, the investment advisers of many FOHF may have to register as CPOs unless they can claim an exemption on another basis.

Dual CFTC and SEC Registration – Harmonization Proposal

The investment advisers of Registered Funds that hold commodity interest positions but are not able to qualify for the exclusion in amended Rule 4.5 will be subject to regulation by both the SEC and the CFTC. Recognizing that dual regulation would currently be untenable for many Registered Funds due to different, and sometimes conflicting, requirements imposed by the two regulators, the CFTC concurrently proposed a separate rulemaking to "harmonize" the compliance obligations that will apply to operators of Registered Funds subject to the two regimes.[12] The Harmonization Proposal addresses the following areas of proposed harmonization:

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[12] The Harmonization Proposal is available at this link.

- Disclosure document (*i.e.*, prospectus) delivery, form, and content;
- Disclosure document updating requirements;
- Delivery of periodic reports;
- Timing of financial reporting;
- Performance disclosure;
- Break-even point disclosure;
- Required cautionary language and certifications; and
- The location where books and records are maintained.

Comments on the Harmonization Proposal will be due 60 days after it is formally published in the *Federal Register*.

Conclusion

Advisers to Registered Funds that currently invest in commodity interests will need to evaluate their current positions and strategies to determine whether they can continue to rely on Rule 4.5, as amended. If not, such advisers will need to register as CPOs or change their investment programs to allow continued reliance on the rule. In addition to any required changes in their investment programs, those advisers that wish to continue to rely on Rule 4.5 will need to make significant changes to their compliance programs before amended Rule 4.5 takes effect. As advisers review their commodity interest activities, there will undoubtedly be particular questions and issues that arise, and we encourage you to reach out to any of the authors of this alert or your K&L Gates relationship partner for further guidance.

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