Changes to Commodity Laws: What Private Equity Firms Need to Know

You may have read recently about the changes to the commodity laws resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and new Commodity Futures Trading Commission (the "CFTC") rules. This alert examines how those changes will affect private equity firms.

Why Should Private Equity Firms Care About the Recent Changes to Commodity Laws?

Prior to the Dodd-Frank Act, "commodity interests" included futures contracts, options on futures contracts, and options on commodities. As a result, most private equity firms did not need to concern themselves with commodity laws. However, the Dodd-Frank Act added the term "swap" to the existing list of commodity interests, which is a broadly defined concept that includes most over-the-counter derivatives contracts.

Entering into a single commodity interest contract, or having the authority to do so, can subject a private equity sponsor to regulation under the commodity laws (i.e., the Commodity Exchange Act and rules promulgated by the CFTC).

What Commodity Interest Contracts Are "Swaps" that Can Subject a Private Equity Fund to Regulation Under the Commodity Exchange Act?

The "swaps" most likely to be used by private equity funds are foreign exchange forwards, interest rate swaps, and total return swaps on broad-based securities indices. The CFTC's full "swap" definition covers many types of over-the-counter derivatives, including, very generally, commodity swaps, interest rate swaps, currency swaps, credit default swaps on broad-based indices, foreign currency options, commodity options, cross currency swaps, forward rate agreements, options to enter into swaps, swaps on broad-based security indices, and swaps on two or more loans. "Security-based swaps" (i.e., derivatives based on a single security or a narrow-based group or index of securities) are excluded from the term "swap" for these purposes.

All foreign exchange forwards and swaps are "swaps" under the CFTC's definition. However, under the Dodd-Frank Act, the Department of the Treasury (the "Treasury Department") was given the power to exempt certain foreign exchange contracts from the definition of "swap" and has proposed excluding "deliverable" foreign exchange forwards and swaps. It is unclear if (and when) the Treasury Department will promulgate final guidance.

Why Does It Matter If a Private Equity Fund Uses One of These Commodity Interests?

If a private equity fund trades even one commodity interest contract or holds itself out as being able to do so, the sponsor of the fund (typically, the general partner) will be deemed a commodity pool operator ("CPO"), and the adviser to the fund will be deemed a commodity trading advisor ("CTA").

Absent an exemption[1], any CPO or CTA must register as such and become a member of the National Futures Association ("NFA"). In general, if there is no exemption, registration would be required by

[1] Even if exempt from registration, CPOs and CTAs will still be subject to advertising and anti-fraud rules, as well as rules applicable to participants in the commodity interest markets, such as position and accountability limits, large trader reports, restrictions on market manipulation, and restrictions against U.S. persons trading certain products.

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December 31, 2012.[2] Registered CPOs and CTAs are subject to a number of ongoing requirements under the Commodity Exchange Act and the rules thereunder (see below).

How Does My Firm Qualify for a CPO Registration Exemption?

Private equity fund sponsors that are CPOs may be eligible to claim an exemption from registration under Rule 4.13(a)(3), which exempts operators of funds that trade only a *de minimis* level of commodity interests, are only marketed to "accredited investors" (as defined for purposes of Regulation D under the Securities Act) and certain employees, and are not marketed as vehicles for trading in commodity interests. To satisfy the Rule 4.13(a)(3) *de minimis* exemption, a fund must at all times meet one of the following tests with respect to its commodity interest positions:

i. Its aggregate initial margin, premiums and required minimum security deposit required to establish commodity interest positions, determined at the time the most recent position is established, do not exceed 5% of the liquidation value[3] of the fund's portfolio, after taking into account unrealized profits and unrealized losses on any such positions; or

ii. The aggregate net notional value[4] of such positions, determined at the time the most recent position is established, does not exceed 100% of the liquidation value of the fund's portfolio, after taking into account unrealized profits and unrealized losses on any such positions.

Because certain deal structures may necessitate first entering into a commodity interest position, thus causing a fund to initially fail the *de minimis* trading thresholds even though the commodity interest exposure may fall to levels that satisfy these thresholds upon completion of the deal, the CFTC has acknowledged that CPOs should be afforded a "reasonable time"[5] to comply with Rule 4.13(a)(3).

We would anticipate that meeting this test will be straightforward for most private equity funds, as most derivatives will be used for hedging purposes (and, therefore, will have a notional value that is less than the liquidation value of the fund).[6] For example, if a fund's first portfolio company was outside the US, and the purchase price was 100 euro, the fund could enter into a currency forward with a notional value of 100 euro and still be in compliance with the test. Note that (i) the fund would be unable to enter into a currency forward with a notional value of 150 euro to account for potential growth of the portfolio company's value in the future, and (ii) the test will be easier to meet later in the life of the fund, as the denominator for each prong of the test (liquidation value of the fund's portfolio) will increase as additional portfolio investments

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[2] Please note that a filing with the CFTC may be necessary to extend this registration deadline from October 12, 2012 to December 31, 2012.

[3] The CFTC has clarified that the liquidation value of a commodity pool's portfolio includes all cash held by the pool. Although there is no guidance on point, we think it is unlikely that uncalled capital can be included in a fund's "liquidation value." We are seeking clarification from the CFTC on this point.

[4] The CFTC has clarified that, for both cleared and uncleared swaps, the notional value is the amount reported by the reporting counterparty as the notional amount of the swap under Part 45 of the CFTC's regulations. Typically, this amount will be the notional amount listed on the trade confirmation.

[5] CFTC staff have not specifically delineated what constitutes a "reasonable time," as that will be determined based on the specific facts and circumstances.

[6] See "How Do These Rules Apply If an Entity Owned by the Fund (e.g., a Holding Company) or an Alternative Investment Vehicle Enters Into the Commodity Interest Position?" below for complications that may arise if commodity interest trading is done at an entity other than the main fund.

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are made. Also note that funds-of-funds may find it more difficult than other funds to monitor and/or meet the trading tests set forth above, because such funds must look through their portfolio funds in applying the relevant trading thresholds (see below for more information).

How Does My Firm Qualify for a CTA Registration Exemption?

Private equity fund advisers that are CTAs have a number of exemptions available to them, three of which would be most likely to apply to a private equity firm:

i. Rule 4.14(a)(8) exempts a CTA from registration if the CTA's commodity interest trading advice is directed solely to, and for the sole use of, a fund for which a CPO has claimed exemption under Rule 4.13(a)(3), provided that the CTA provides commodity interest trading advice solely incidental to its business of providing securities or investment advice to the commodity pool and is not otherwise holding itself out as a CTA.

ii. CTAs may be exempt from registration under Rule 4.14(a)(10). Rule 4.14(a)(10) exempts CTAs that have not provided commodity trading advice to more than 15 persons[7] during the course of the preceding 12 months, and do not hold themselves out generally to the public as a CTA.

iii. The exemption under Section 4m(3) of the Commodity Exchange Act exempts CTAs that are (i) registered with the SEC as investment advisers, (ii) whose business does not consist primarily[8] of acting as a CTA, and (iii) who do not act as a CTA to any fund engaged primarily in trading commodity interests.

Most private equity fund managers should be exempt under exemption iii above.

If I Qualify for an Exemption, What Else Do I Need To Do?

The exemptions under Rules 4.13(a)(3) and 4.14(a)(8) are not self-executing. All persons seeking registration exemptions under Rules 4.13(a)(3) and 4.14(a)(8) must file a notice of exemption electronically with NFA, and must confirm their claims of exemption on an annual basis following each calendar year end. Also, certain disclosures to investors are required. The Section 4m(3) and Rule 4.14(a)(10) exemptions are self-executing, and no further action is required.

If My Firm Has Never Filed for a CPO and/or CTA Exemption, When Do I Need to File Under Rule 4.13(a)(3) and, If Applicable, Rule 4.14(a)(8)?

Assuming that the filing obligation arises solely because the definition of "commodity interest" was expanded this year to include swaps, those filings and related disclosure must be made by October 12, 2012.

What If I Previously Filed for a CPO Exemption under Rule 4.13(a)(4)?

Rule 4.13(a)(4) is a recently rescinded exemption from CPO registration. Sponsors currently operating under the rescinded Rule 4.13(a)(4) exemption will have until December 31, 2012 to either register as a CPO or

[7] A fund ordinarily is considered one person for this purpose.
[8] A CTA or a commodity pool is considered to be "engaged primarily" in the business of being a CTA or a commodity pool if it is, or holds itself out to the public as being, primarily, or proposes to engage primarily, in the business of advising on commodity interests or owning, investing or trading in commodity interests, respectively.

claim exemption under Rule 4.13(a)(3). The Rule 4.13(a)(4) exemption will expire automatically on December 31, 2012.

How Do These Rules Apply If an Entity Owned by the Fund (e.g., a Holding Company) or an Alternative Investment Vehicle Enters Into Commodity Interest Positions?

The CFTC has recently taken the position that a wholly owned trading subsidiary of a commodity pool operated by a registered CPO is also considered a commodity pool. The CFTC has not explicitly taken the same position with respect to wholly owned holding companies or AIVs of a pool (such as a typical private equity fund) operated by an exempt CPO; however, the logic of the CFTC's position suggests that holding companies and AIVs of private equity funds with the authority to enter into swaps should be tested independently from the main fund for purposes of the Rule 4.13(a)(3) exemption and, if any such vehicle could not qualify for such exemption on a stand-alone basis, the CPO of such vehicle should register as a CPO.

How Do I Test Under Rule 4.13(a)(3) If I Manage a Fund-of-Funds?

The CFTC has confirmed that, until it adopts revised guidance, CPOs which operate funds-of-funds should continue to rely on Appendix A to its Part 4 Rules. Appendix A provides guidance regarding the application of the trading limits of Rule 4.13(a)(3) to such CPOs, presuming that the CPO in question can comply with all other requirements for that exemption, and applies Rule 4.13(a)(3) exemption criteria to six sample fact patterns. Unfortunately, this guidance is inadequate for many funds-of-funds, as such funds often do not fit neatly into any of the six sample fact patterns. We understand that the CFTC plans to issue updated fund-of-funds guidance at a later date.

What If I Do Not Qualify for the CPO and CTA Registration Exemptions?

A sponsor of a fund that trades commodity interests but does not qualify for the CPO registration exemption under Rule 4.13(a)(3) will be required to register as a CPO by December 31, 2012. Similarly, if a fund advisor does not qualify for a CTA registration exemption, the fund advisor will be required to register as a CTA.

CPOs and CTAs who are required to register may be entitled to an exemption under CFTC Rule 4.7 from certain disclosure, reporting and recordkeeping requirements otherwise applicable to registered CPOs and CTAs. This exemption can only be claimed for funds or accounts offered and sold solely to qualified eligible persons ("QEPs"). Generally, a sponsor to funds whose interests are offered and sold solely to "qualified purchasers" (as defined for purposes of 3(c)(7) of the Investment Company Act) or "knowledgeable employees" (as defined for purposes of Section 3(c)(5) of the Investment Company Act) will qualify for the Rule 4.7 exemption. A claim for exemption under Rule 4.7, if applicable, should be filed immediately upon registration.

What Are the Steps for Registering as a CPO and CTA?

A sponsor that is required to register as a CPO and an adviser that is required to register as a CTA must complete and file online a Form 7-R. Additionally, sponsors and advisers must pay a registration fee of $200 and will be subject to annual NFA membership dues of $750. A Form 8-R must be completed and filed

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online for each "principal"[9] and each "associated person"[10] of the sponsor and the adviser. Each principal and each associated person must also submit a fingerprint card and pay a fee of $85.

Associated persons also must provide evidence from FINRA of proof of passage of the Series 3 exam within the last two years, unless an exemption applies. An associated person who limits his or her activities to swaps will not be required to take the Series 3 exam. Similarly, associated persons of a CPO that would be exempt from registration under Rule 4.13(a)(3) (the *de minimis* exemption) but for the fund's swap activities will also not be required to take the Series 3 exam. These exemptions from the Series 3 exam are not automatic, and the CPO or CTA will need to make certain filings in order to obtain the necessary approvals or waivers from NFA.

Registered CPOs and CTAs whose activities involve swaps and associated persons of these firms must also be approved by NFA as "Swap Firms" or "Swap APs," respectively.

What Are the Ongoing Requirements for Registered CPOs and CTAs Exempt Under Rule 4.7?

Registered CPOs that are exempt under Rule 4.7 are still subject to certain remaining disclosure, reporting and recordkeeping requirements, including, but not limited to, (i) furnishing investors with a prescribed legend, (ii) sending periodic and annual financial reports to investors and NFA, and (iii) submitting annual and quarterly risk reports to NFA. Registered CTAs exempt under Rule 4.7 are subject to certain remaining disclosure and recordkeeping requirements as well. Further, registered CPOs and CTAs exempt under Rule 4.7 are required to comply with additional rules, including know-your-customer and advertising rules, and rules prohibiting business dealings with anyone who is required to be an NFA member but is not such a member. They are also required to provide periodic ethics training and must implement certain written compliance policies. Registered CPOs and CTAs are subject to periodic on-site audits by NFA.

Are There Any Other Registration Obligations that Might Arise from a Private Equity Fund's Use of Commodity Interests?

Yes. The operator and adviser of a fund or other client that enters into off exchange currency transactions for a fund or other client that is not an "eligible contract participant" may have to register as a "retail forex" CPO or CTA.[11] Funds with more than $10 million in assets generally are "eligible contract participants".

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Please contact your regular Ropes & Gray attorney with any questions or to request additional information.

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[9] In general, a "principal" is a general partner, managing member, director, president, CEO, COO, CCO or CFO, or person in charge of a business unit, division or function subject to CFTC regulation, or a 10% or more owner.

[10] In general, an "associated person" is an individual who solicits clients, or who supervises those who do, or who is in the supervisory chain of command with respect to such persons.

[11] The exemptions noted above for CPO/CTA registration do not apply to a retail forex CPO/CTA.

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