



Fund Managers Alert: CFTC Rescinds Exemptions and Expands its Regulations

April 16, 2012

The U.S. Commodity Futures Trading Commission (“CFTC”) recently announced the adoption of significant amendments to its rules which govern commodity pool operators and commodity trading advisors under the U.S. Commodity Exchange Act. Most significantly, the amendments eliminate the Rule 4.13(a)(4) exemption from registration as a CPO, which has been commonly relied on by the managers of many privately offered funds, including hedge fund and private equity fund sponsors. The elimination of the 4.13(a)(4) exemption, together with the expected adoption of CFTC regulations that will broadly include swaps as instruments that will cause any investment vehicle holding them to be deemed a “commodity pool” subject to CFTC jurisdiction (and the short timeline for compliance with CFTC regulations that is expected to follow the issuance of such regulations) require immediate attention from all fund managers, including hedge fund managers, private equity managers, fund of funds managers and others, irrespective of the structure or strategy of their investment vehicles.

This memorandum briefly summarizes the amendments and discusses requirements to register as a CPO and CTA in accordance with the amended rules.¹

BACKGROUND/RESCISSION OF 4.13(A)(4) EXEMPTION

Unless an exemption from registration is available, operators of investment pools and investment advisers that engage, directly or indirectly, in *any* transactions in futures, commodities, certain types of over the counter foreign exchange transactions and swaps² that are subject to CFTC jurisdiction (such operators, “commodity pool operators” or “CPOs,” such advisors, “commodity trading advisors” or “CTAs,” and such pools, “commodity pools”³) are subject to potential registration requirements as CPOs and CTAs. It should be noted that owning a single instrument that is described in the preceding sentence will make an investment

¹ The full text of the CFTC adopting release is available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-3388a.pdf>.

² Pursuant to the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the CFTC, jointly with the SEC, is expected to issue new rules that define key terms of the U.S. Commodity Exchange Act including “swaps” (and the exclusions from the definition). The forthcoming rules will require a reassessment of whether private funds that do not currently meet the criteria of commodity pools now do so based on the new definition of the term “swaps”. Further, commodity pools that currently meet the *de minimis* exemption (as further described below) will also need to reevaluate whether they continue to do so under the new “swap” definition.

³ It should be noted that, in addition to private investment funds, other entities (such as holding vehicles, alternative investment vehicles and other investment vehicles) may be deemed commodity pools, and their activities should be reviewed in light of the matters discussed in this memorandum.

vehicle a commodity pool as there is no *de minimis* exclusion from the definition (although there is a *de minimis* exemption from registration as a CPO as set forth below). Hence, for example, private equity and real estate funds that enter into interest rate, currency or other swaps to hedge portfolio risks are likely to be deemed “commodity pools” under the new regulations.

Since 2003, operators of commodity pools that relied on the 3(c)(7) exemption from registration under the Investment Company Act of 1940, as amended (the “Investment Company Act”) (i.e., investment vehicles that limited their investors to “qualified purchasers” as defined under the Investment Company Act), and certain other categories of pools, were eligible for an exemption from registration as CPOs pursuant to Rule 4.13(a)(4), an exemption that required a short electronic filing. On February 9, 2012, the CFTC rescinded this exemption such that it can no longer be claimed following April 24, 2012, and can no longer be relied on as of December 31, 2012.

RETENTION OF RULE 4.13(A)(3) “DE MINIMIS” EXEMPTION

Despite its initial proposal to also rescind the “*de minimis*” exemption provided by Rule 4.13(a)(3), the CFTC retained but revised the limited trading “*de minimis*” exemption. A CPO is not required to register with respect to a pool that (i) issues interests that are exempt from registration under the Securities Act of 1933, as amended (the “Securities Act”) and are offered without marketing to the public in the United States⁴ and (ii) also meets *one* of the following two tests:

- 5% Test: the aggregate initial margin and premiums (including the required minimum security deposit for retail forex transactions) required to establish its commodity interest positions (determined at the time the most recent commodity interest position was established) does not exceed 5% of the liquidation value of its portfolio (after taking into account the unrealized profits and losses on such positions); *or*
- 100% Test: the aggregate net notional value of the fund’s commodity interest positions (determined at the time the most recent commodity interest position was established) does not exceed 100% of the liquidation value of its portfolio (after taking into account the unrealized profits and losses on such positions)⁵.

⁴ It should be noted that the recently enacted Jumpstart Our Business Startups (JOBS) Act, once implemented through forthcoming SEC regulations, will eliminate the restriction against general solicitation and general advertising in offerings of securities purchased solely by accredited investors for purposes of the relevant exemptions under the Securities Act and the Investment Company Act. However, to date it is unclear whether the CFTC will maintain this restriction for offerings of interests in commodity pools seeking to rely on the 4.14(a)(3) exemption. Therefore, pending further clarification on this issue, pools relying on this exemption should continue to offer their interests without marketing to the public. For the full text of the JOBS Act, see <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>

⁵ Though there is no official guidance on this point, the CFTC’s usage of the term “portfolio” implies that any unpaid capital commitments would not count as assets when calculating the liquidation value of a portfolio under both the 5% test and 100% test described above. As a result, a private equity or real estate fund establishing a swap position to hedge its portfolio risks in the early stage of its investment period may not meet these tests.

The *de minimis* exemption is claimed by CPOs on a fund-by-fund basis by a short electronic notice filing.

OPTIONS AVAILABLE TO PRIVATE FUND MANAGERS

The new CFTC rules provide the following options for private fund managers advising commodity pools for which they serve as a CPO:

- Rely on the *De Minimis* Exemption. If eligible for the *de minimis* exemption as described above, a CPO must file a notice of claim of exemption with respect to each relying pool.
- Register as a CPO/Claim Rule 4.7 Relief. Registration as a CPO is an involved process and typically takes about six to eight weeks. The CPO must submit Form 7-R and Forms 8-R for its principals and associated persons⁶. The CPO's principals and associated persons must also submit fingerprint cards (for background checks by the FBI, and Interpol in the case of non-U.S. individuals) with the Forms 8-R, and all associated persons must take and pass a proficiency examination (typically the Series 3 or 31). Once registered, the CPO may claim some reporting and recordkeeping relief on a pool by pool basis pursuant to Rule 4.7 if the interests in such pool are offered only to qualified eligible persons.⁷
- Cease trading futures, commodity options, certain foreign exchange contracts regulated by the CFTC and "swaps" as defined in the forthcoming CFTC definition.

The new CFTC rules provide the following options for private fund managers serving as a CTA:

- Section 4m(1) and Rule 4.14(a)(10). CTAs that have no more than 15 clients (with each fund (where advice is provided based on the fund's investment objectives and not the objectives of individual clients) typically counting as one client) during the prior 12 months and do not hold themselves out to the public as CTAs

⁶ Principals are certain senior executive officers of the registrant (i.e., director, president, chief executive officer, chief operating officer or chief financial officer, a general partner of a partnership, a manager of a limited liability company) or a 10% or more beneficial owner of the registrant. An associated person is any person that has contact with investors (or anyone who supervises such persons) of a registrant. It is important to note that the registration requirements apply to any supervisor in the chain-of-command and not only to those who directly supervise investor relations and similar personnel.

⁷ "Qualified Eligible Persons" (or "QEPs") include, among other categories of investors, "qualified purchasers" and "knowledgeable employees" under the Investment Company Act and non-U.S. persons. A registered CPO/CTA relying on this exemption must file an electronic notice to claim the exemption. It should be noted that an amendment to Rule 4.7 makes it necessary for a registered CPO to provide certified financial statements in the commodity pool's annual reports to its pool participants. Additionally, registered CPOs and CTAs, even if relying on Rule 4.7, are subject to the new systemic risk reporting requirements on Forms CPO-PQR and CTA-PR. For more information on Forms CPO-PQR and CTA-PR and the related newly adopted Rule 4.27, please see the CFTC release available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister103111.pdf>

are exempt from registration. For purposes of this self-executing exclusion from the registration requirement, U.S. CTAs must count all clients and non-U.S. CTAs must count only their U.S. clients.

- Section 4m(3). CTAs that are registered with the SEC as investment advisers are exempt from registration as a CTA if their business is not “acting primarily” as a CTA and they do not advise a commodity pool “engaged primarily”⁸ in investing in commodity instruments. This is also a self-executing exclusion from the registration requirement.
- Rule 4.14(a)(8). CTAs that do not hold themselves out at CTAs and provide investment advice to commodity pools where CPOs of all such pools are exempt under the *de minimis* CPO exemption or certain other exemptions are generally eligible for an exemption from registration as CTAs. This exemption requires an electronic notice filing.
- Register as a CTA/Rule 4.7 Relief. Registration as a CTA is very similar to registration as a CPO described above and, similarly to a registered CPO, a registered CTA may claim some reporting and recordkeeping relief pursuant to Rule 4.7 with respect to its clients (including commodity pools) that are QEPs by making an electronic filing claiming the exemption.

IMMEDIATE ACTION ITEM TO BE ADDRESSED PRIOR TO APRIL 24, 2012

In light of the expected issuance of the new rules on definition of swaps (see footnote 2 above) and the timing of compliance with such rules (expected to be 60 days following their issuance), private fund managers are advised to consider whether, even if under the current rules the investment vehicles they advise are not commodity pools (*i.e.*, they do not hold any commodities, futures or retail foreign exchange instruments), such pools may become commodity pools after the new swap rules are issued (*e.g.*, if the investment vehicles hold or are likely to hold interest rate or other swaps). If that is the case, then in the absence of a certainty that the relevant commodity pool will meet the *de minimis* exemption, claiming the 4.13(a)(4) exemption prior to April 24, 2012 with respect to such pool is likely to provide its CPO with more time to comply with the revised CFTC rules (*i.e.*, until December 31, 2012 as compared to 60 days following the issuance of the swap rules).

IMPLICATIONS FOR NON-U.S. INVESTMENT MANAGERS

Despite public comments requesting that the CFTC adopt registration exemptions for non-U.S. based advisors and CPOs, the CFTC amendments provided no exemption for non-U.S. based CPOs that operate a pool with even one U.S. investor. Accordingly, the analysis and issues

⁸ It should be noted that the CFTC has not yet provided guidance on what being “engaged primarily” entails but it is not expected that this exemption will be helpful to many private fund managers.

described above, except as expressly stated otherwise, apply to non-U.S. investment managers with funds that include U.S. investors in the same manner as they do to U.S. managers.

IMPLICATIONS FOR FUND OF FUNDS

Fund of funds managers face unique issues with respect to the CFTC rules because they typically do not control or influence investment activities of the underlying vehicles and often have limited information about such activities and because a fund of funds is deemed a commodity pool if any of its underlying funds holds commodity interests. The CFTC did not adopt any additional exemptions for fund of funds CPOs and CTAs. Fund of fund managers are eligible for the *de minimis* exemption and may attempt to rely on it by obtaining a covenant from each investee fund that it will at all times meet the *de minimis* test. However, in light of the two alternative tests for the *de minimis* exemption, unless all investee funds of a particular fund meet the same prong of the test, the fund of funds manager may not be able to rely on the *de minimis* exemption.

Further, in its new rules, the CFTC eliminated Appendix A, which formerly provided limited guidance to fund of funds managers relying on Rule 4.13(a)(3). The Appendix entitled “Guidance on the Application of Rule 4.13(a)(3) in the Fund-of-Funds Context” set forth six hypothetical fact patterns demonstrating when a fund of funds manager could rely on the *de minimis* exemption. The CFTC provided no explanation for removing Appendix A but did state that it may consider an exemption for fund of funds once it receives systemic risk reporting data.

IMPLICATIONS FOR FAMILY OFFICES

The CFTC provided no exemption for family offices. Operators of family offices may rely on previously issued staff “not a pool” interpretive letters or continue to request relief on a case-by-case basis. Family office operators may also rely on the limited trading exemption.

ANNUAL NOTICE FOR CONTINUED EXEMPTION OR EXCLUSION

The new CFTC rules now require that a CPO or CTA file a reaffirmation of a claim of exemption from registration within 60 days of the end of each calendar year following the initial filing. Failure to comply with the new annual filing deadline will be deemed a withdrawal of the exemption.

IMPORTANT DATES

April 24, 2012	New rules generally effective, 4.13(a)(4) no longer available with respect to pools for which the exemption has not been claimed prior to such date.
December 31, 2012	Deadline for CPOs previously relying on the Rule 4.13(a)(4) exemption to register with CFTC or file for an exemption from registration.
60 days after the effective date of the final rules on swaps	Compliance with new rules for pools that become commodity pools in light of the new swap definition – deadline for claiming an exemption or registration for CPOs and CTAs for such pools.
Annually - 60 days after the end of the calendar year in which an exemption was claimed	Reaffirmation of an exemption filing.

CONCLUSIONS

In view of the developments summarized in this memorandum, a fund manager should review all its current funds, including hedge funds, private equity funds, real estate funds, fund of funds and all related vehicles, for which the manager relies (or intends to rely) on the rescinded Rule 4.13(a)(4) exemption to assess whether the manager will be eligible to rely on the *de minimis* exemption described above, or whether a fund is not a commodity pool in which case reliance on these exemptions is not necessary. Once such a review is complete, a number of follow up action items will need to be implemented, including, as appropriate, notice to fund investors of changes in exemptions, initiating the process for registration as a CPO/CTA (if applicable) and updating fund offering documents to reflect these changes. Additionally, as noted above, the new rulemaking on swaps by the CFTC will need to be monitored to make sure the analysis is conducted promptly following the issuance of the swap related rules.

For more information about any of the foregoing, please contact a member of the Firm's Private Funds Group.

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