

**CFTC CONSIDERS NEW RULES
ON REGISTRATION EXEMPTION AND
OFFERS NO-ACTION RELIEF**

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On November 13, 2002, the Commodity Futures Trading Commission ("CFTC") published in the Federal Register proposals from the National Futures Association ("NFA") and the Managed Funds Association ("MFA") that it is considering for new exemptions from registration as a commodity pool operator ("CPO") or a commodity trading advisor ("CTA"). Under the current regulations, most operators of private investment funds that trade in any commodities or futures contracts, and most persons who advise such funds, are required to register with the NFA and the CFTC.

The NFA's proposed changes, if adopted, would expand the current CPO exemptions to include operators of commodity pools that commit only a limited amount of assets to establishing their trading positions in commodity futures and commodity option contracts and restrict participation to investors who are "accredited investors" as defined under the rules of the Securities Act of 1933, as amended (the "Securities Act"). The proposal would further exempt from registration as a CTA a person who does not hold itself out as a CTA and advises only pools operated by persons that are exempt under the proposed CPO provision.

The exemption proposed by the MFA covers only CPOs and would apply to operators of pools whose individual investors are all "qualified eligible persons" as defined by Rule 4.7 under the Commodity Exchange Act of 1974, as amended ("CEA"), and whose entity investors are all qualified eligible persons or accredited investors.

The proposals are open for comment until January 13, 2003, after which the CFTC may accept, reject or modify either of them or create an entirely new rule. Pending the adoption of a final rule, the CFTC has provided for no-action relief to eligible CPOs and CTAs that wish to obtain a registration exemption upon the filing of a notice with the NFA and the CFTC. If the CFTC adopts a final rule with requirements different from the no-action relief, the CFTC will provide CPOs and CTAs with sufficient time to comply with such requirements or, in the event

that a CPO or CTA is unable or unwilling to comply, with sufficient time to register with the CFTC or to withdraw a previously filed claim for no-action relief and cease engaging in business as a CPO or CTA.

This memorandum briefly summarizes the existing regulatory framework applicable to CPOs and CTAs and discusses the proposed new exemptions and the availability of no-action relief for currently unregistered CPOs and CTAs.

EXISTING REGULATORY FRAMEWORK

Prior to the proposals described in this memorandum, most private investment funds were completely precluded from trading in commodity futures contracts or options on such contracts for any purpose unless the operator of the fund registered as a CPO with the CFTC and any advisor to the fund registered as a CTA. As a result, many operators of these funds have foregone the use of these instruments rather than subject themselves to the extensive disclosure, reporting and record keeping requirements that registration with the CFTC entails.

Although the staff of the CFTC has in the past been requested to permit these types of funds to trade in commodity futures contracts and options in limited amounts and for limited purposes without the operators and advisors of the funds having to register with the CFTC, the CFTC has, until now, generally refused to grant such relief.

PROPOSED NEW EXEMPTIONS

NFA Proposal

Regarding CPOs

The NFA proposes that a CPO be exempt from registration if:

- for each fund that it operates, the aggregate initial margins and premiums required to establish the trading positions in commodity futures and commodity options not for bona fide hedging purposes¹ will not exceed 5% of the liquidation value of the

¹ Under CFTC Rule 1.3(z)(1), “bona fide hedging transactions” mean transactions or positions in a contract for future delivery on any contract market, or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from:

- portfolio after taking into account unrealized profits and losses and such trading is solely incidental to the fund's other trading activity;
- it does not market investments in the fund to the public as or in a commodity pool;
 - it discloses in writing to each prospective investor the purpose of and limitations on the scope of the fund's trading activities;
 - it limits investors in its funds to accredited investors, as defined in the rules under the Securities Act;²
 - it retains all books and records in connection with its activities as a CPO for a period of five years (keeping them readily accessible for the first two of the five years) and makes them available to inspection by the CFTC and the United States Department of Justice; and
 - it demonstrates compliance with the above requirements upon request by the CFTC.

In addition, a CPO availing itself of this exemption would be required to file with the CFTC and the NFA and provide to prospective investors a written statement that it is not registered with the CFTC as a CPO and that it is therefore not required to furnish investors with disclosure documents, account statements or annual reports required to be furnished by CFTC-registered CPOs.³ The statement must also provide certain information relating to the CPO and

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- (i) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;
 - (ii) The potential change in the value of liabilities which a person owns or anticipates incurring; or
 - (iii) The potential change in the value of services which a person provides, purchases, or anticipates providing or purchasing.

Notwithstanding the foregoing, no transactions or positions are classified as bona fide hedging unless their purpose is to offset price risks incidental to commercial cash or spot operations and such positions are established and liquidated in an orderly manner in accordance with sound commercial practices and, for transactions or positions on contract markets subject to trading and position limits in effect pursuant to section 4a of the CEA, unless certain other regulatory requirements have been satisfied.

² Accredited investors include: a natural person with an individual net worth (or a joint net worth with a spouse) in excess of \$1 million; a natural person with an individual income (without including any income of the investor's spouse) in excess of \$200,000, or a joint income with a spouse in excess of \$300,000, in each of the two most recent years and who reasonably expects to reach the same income level in the current year; a corporation, trust or partnership not formed for the specific purpose of acquiring interests in the pool, with total assets in excess of \$5 million; and various categories of institutional investors.

³ The statement must read: "THE COMMODITY POOL OPERATOR OF THIS POOL IS NOT REQUIRED TO REGISTER, AND HAS NOT REGISTERED, WITH THE COMMODITY FUTURES TRADING COMMISSION. THEREFORE, UNLIKE A REGISTERED COMMODITY POOL OPERATOR, THIS COMMODITY POOL

describe the exemption pursuant to which the CPO is not registered. The CPO must file an executed copy of the statement with the CFTC and the NFA by the earlier of seven business days after it is first delivered to a prospective investor and the date on which the fund commences trading in commodity interests.

Regarding CTAs

The NFA also proposes to exempt a CTA from registration if:

- it provides commodity interest trading advice only to funds that are exempt from registration pursuant to the proposed CPO exemption described above or are excluded from the definition of CPO under CFTC Rule 4.5;⁴
- its commodity interest trading advice is solely incidental to its business of providing investment advice to funds in instruments that are either exempt or excluded from CFTC regulation;
- its commodity interest trading advice employs only strategies consistent with the proposed CPO exemption (that is, to funds in instruments that are either exempt or excluded from CFTC regulation);
- it does not hold itself out as a CTA; and
- it provides information upon request by the CFTC with respect to its position holdings.

In addition, prior to the date on which the exempted person intends to engage in business as a CTA, it is required to file a notice of exemption with the CFTC and the NFA. A CTA exempt under the provision must file a supplemental notice with the CFTC and the NFA if the person subsequently registers with the CFTC as a CTA.

OPERATOR IS NOT REQUIRED BY THE COMMISSION TO FURNISH A DISCLOSURE DOCUMENT, PERIODIC ACCOUNT STATEMENTS, AND AN ANNUAL REPORT TO PARTICIPANTS IN THE POOL.”

⁴ Under Rule 4.5, registered investment companies, insurance companies, financial depository institutions, and certain benefit plans are excluded from the definition of CPO if they represent in a filing with the CFTC that they will use commodity futures or commodity options solely for bona fide hedging purposes and that the aggregate initial margins and premiums required to establish trading positions in commodity futures and commodity options not for bona fide hedging purposes will not exceed 5% of the liquidation value of the portfolio. In addition, a person excluded from the definition of CPO under Rule 4.5 must represent that it has not and will not market participation to the public as a vehicle for investing in commodity futures or commodity options markets and will disclose in writing to each prospective participant the purpose of and limitations on the scope of its intended trading activities. Finally, there is a duty to notify the CFTC if any of these representations become inaccurate or incomplete.

MFA Proposal

The MFA proposal contains no new provisions regarding CTA registration, but contains an exemption for any CPO that meets all of the following criteria:

- offers and sales of interests in all of its funds are exempt from registration under the Securities Act and are not marketed to the public in the United States;
- it reasonably believes that at the time of investing all of its individual investors (and any self-directed employee benefit plans for such individuals) are qualified eligible persons;⁵
- it reasonably believes that at the time of investment all of its other investors are either accredited investors or qualified eligible persons; and
- the CPO and its principals are not disqualified under the CEA.

In order to take advantage of the exemption, the CPO is required to file a notice of eligibility with the CFTC. Additionally, it would be required to deliver to investors and the CFTC within 180 days after the end of each fiscal year of the fund financial statements of the fund certified by an independent public accountant and prepared in accordance with generally accepted accounting principles.⁶

Effects of Proposals

If adopted, the NFA proposal would permit a fund to trade in commodity interests to a limited degree without the operator of the fund having to register with the CFTC as a CPO as long as all investors in the fund are accredited investors. The proposal would also permit persons to provide commodity interest trading advice to such a fund without having to register as a CTA with the CFTC.

⁵ U.S. persons that are qualified eligible persons generally include (i) a “qualified purchaser” under the Investment Company Act of 1940, as amended (as described below), a broker-dealer, a futures commission merchant and certain U.S. banks or thrift institutions, registered investment companies, insurance companies, pension plans and (ii) certain natural persons that meet a minimum portfolio requirement of \$2,000,000 in investments. In addition, non-U.S. persons are generally qualified eligible purchasers.

“Qualified purchasers” are comprised of individuals and certain family investment vehicles with at least \$5 million of “investments” (defined to exclude, for example, real estate used for personal reasons) and entities with at least \$25 million of investments.

⁶ This obligation is less burdensome than those currently applicable to commodity pools exempt under Rule 4.7, which requires distribution of quarterly reports within 30 days of the end of each quarter and annual reports within 90 days of the pool’s fiscal year end (with a copy of such annual report to be filed with the CFTC and the NFA) in addition to other disclosure and record keeping requirements.

If adopted, the MFA proposal would remove the burdens of registration and compliance for the operator of a fund that is privately offered and sold to sophisticated investors. Since hedge funds typically recruit only such investors, this proposal eliminates a significant barrier to entry to hedge funds wishing to trade in commodities and futures. Despite the removal of registration requirements, however, the MFA proposal subjects those persons that take advantage of it to reporting requirements that are absent from the NFA proposal.

NO-ACTION RELIEF

Until a final rule has been adopted, the CFTC will grant no-action relief from registration to qualifying pools, operators and advisors who file notice with the CFTC and NFA and describe the substantive criteria and temporary nature of the relief to their prospective investors and clients. Persons claiming no-action relief will be exempt from CFTC registration requirements but will remain subject to the anti-fraud and other provisions of the CEA and the CFTC rules that apply to all commodity interest market participants.

In order to take advantage of the no-action relief, an eligible CPO or CTA must file a signed notice with the CFTC and NFA stating its name, address and telephone number and whether it is a CPO or a CTA. In the notice, the CPO or CTA must also represent that it is qualified for the no-action relief, will comply with the criteria of such relief and will make the disclosure described below. Any final action taken by the CFTC will supersede the no-action relief, but CPOs and CTAs who have claimed relief will be given time to comply with the new requirements, register with the CFTC or withdraw a previously filed claim for no-action relief and cease engaging in business as a CPO or CTA.

CPO Relief

In order to qualify for no-action relief, a CPO must meet and remain in compliance with the following two criteria:

- participation in the fund is restricted to:
 - accredited investors,
 - “knowledgeable employees” as defined in the Investment Company Act of 1940, as amended,
 - Non-United States persons as defined in the CFTC Rules, and
 - certain other categories of investors; and

- the aggregate notional value⁷ of the pool's commodity interest positions (whether or not entered into for bona fide hedging purposes) does not exceed 50% of the liquidation value of its portfolio, after taking into account unrealized profits and losses.

In addition to the investor suitability and aggregate notional value requirements, a CPO seeking no-action relief must, before commencing commodity trading activity, disclose to all prospective and existing investors in each of its funds that it is unregistered by virtue of a claim for no-action relief and that the aggregate notional value of its commodity interest positions is restricted to 50% of the liquidation value of the fund's portfolio. The disclosure must also describe the temporary nature of the no-action relief and the possibility that the CFTC may adopt a different rule with which the CPO will have to comply or cease its commodity trading activities.⁸

Fund of Funds Relief

The operator of a fund of funds that indirectly trades commodity interests through its portfolio funds will be entitled to claim exemption from registration as a CPO under the no-action relief provisions described above only if the CPO of each of its portfolio funds that trades in commodity interests has also been granted no-action relief based on its meeting the above criteria. If the fund of funds additionally engages in the direct trading of commodity interests, then it can claim no-action relief only if the CPO of each portfolio fund that trades in

⁷ For this purpose, the notional value of each futures position is calculated by multiplying the size of the futures contract, in contract units, by the current market price per unit. The notional value of each option position is calculated by multiplying the size of the option contract, in contract units, by the strike price. The "aggregate notional value" is the sum of the notional values of all futures positions and option positions.

⁸ The statement must read: "PURSUANT TO NO-ACTION RELIEF ISSUED BY THE COMMODITY FUTURES TRADING COMMISSION, [NAME OF CPO] IS NOT REQUIRED TO REGISTER, AND IS NOT REGISTERED, WITH THE COMMISSION AS A CPO. AMONG OTHER THINGS, THE NO-ACTION RELIEF REQUIRES THIS CPO TO FILE A CLAIM OF NO-ACTION RELIEF WITH THE NATIONAL FUTURES ASSOCIATION AND THE COMMISSION. IT ALSO REQUIRES THAT THE AGGREGATE NOTIONAL VALUE OF THIS POOL'S COMMODITY INTEREST POSITIONS DOES NOT EXCEED FIFTY PERCENT OF THE LIQUIDATION VALUE OF THE POOL'S PORTFOLIO.

YOU SHOULD ALSO KNOW THAT THIS REGISTRATION NO-ACTION RELIEF IS TEMPORARY. IN THE EVENT THE COMMISSION ULTIMATELY ADOPTS A REGISTRATION EXEMPTION RULE THAT DIFFERS FROM THE NO-ACTION RELIEF, [NAME OF CPO] MUST COMPLY WITH THAT RULE TO BE EXEMPT FROM CPO REGISTRATION. IF [NAME OF CPO] DETERMINES NOT TO COMPLY WITH THAT RULE, IT MUST EITHER REGISTER WITH THE COMMISSION OR CEASE HAVING THIS POOL TRADE COMMODITY INTERESTS."

commodity interests has been granted such relief and the portion of the fund used in direct trading meets the aggregate notional value test described above.⁹

CTA Relief

In order to qualify for a no-action relief, a CTA must:

- have also claimed relief from CPO registration under the no-action provisions and its commodity interest advice must be directed solely to, and for the sole use of, a fund or funds that it operates; or
- be registered as an investment adviser under the Investment Advisers Act of 1940, as amended, or with the applicable state securities regulatory agency, be exempt from registration under the Advisers Act or be excluded from the definition of investment adviser under certain provisions of the Advisers Act, provided that:
 - its commodity interest trading advice is directed solely to, and for the sole use of, funds operated by CPOs that claim no-action relief under this provision;
 - its commodity interest trading advice is solely incidental to its business of providing securities advice to each fund;
 - its commodity interest trading advice employs only strategies consistent with the “aggregate notional value” test described above; and
 - it does not otherwise hold itself out as a CTA.

In addition to these requirements, before conducting any business that would otherwise obligate it to register as a CTA, the CTA must disclose to each fund it advises or intends to advise that it is not registered and may provide advice only to funds operated by CPOs that have claimed no-action relief. The disclosure must also describe the temporary nature of the relief and the requirement to comply with any final rule that is issued or cease offering commodity interest trading advice.¹⁰

⁹ A fund of funds operator may also claim relief if it knows that the notional value of all of the fund of fund’s commodity interest positions (i.e., those held outright and those held through investment in portfolio funds) is fifty percent of the fund of funds portfolio’s liquidation value. To be in possession of such information, the operator would need to have direct knowledge of, and immediate access to, the notional value of the commodity interest positions of each portfolio fund. The operator of the fund of funds could have this knowledge and access where, for example, it was the same person as, or an affiliate of, the CPOs of the portfolio funds.

¹⁰ The statement must read: “PURSUANT TO NO-ACTION RELIEF ISSUED BY THE COMMODITY FUTURES TRADING COMMISSION, [NAME OF CTA] IS NOT REQUIRED TO REGISTER, AND IS NOT REGISTERED, WITH THE COMMISSION AS A CTA. AMONG OTHER THINGS, THE NO-ACTION RELIEF REQUIRES THIS CTA TO FILE A CLAIM OF NO-ACTION RELIEF WITH THE NATIONAL FUTURES ASSOCIATION

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If you have any questions concerning the proposed rules or no-action relief, please contact John E. Riley (jriley@stblaw.com), Olga Gutman (ogutman@stblaw.com) or Heath N. Weisberg (hweisberg@stblaw.com) of our firm at (212) 455-2000.

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AND THE COMMISSION. IT ALSO REQUIRES THAT THIS CTA PROVIDE ADVICE SOLELY TO POOLS WHOSE CPOS HAVE FILED A CORRESPONDING CLAIM OF NO-ACTION RELIEF.

YOU SHOULD ALSO KNOW THAT THIS REGISTRATION NO-ACTION RELIEF IS TEMPORARY. IN THE EVENT THE COMMISSION ULTIMATELY ADOPTS A REGISTRATION EXEMPTION RULE THAT DIFFERS FROM THE NO-ACTION RELIEF, [NAME OF CTA] MUST COMPLY WITH THAT RULE TO BE EXEMPT FROM CTA REGISTRATION. IF [NAME OF CTA] DETERMINES NOT TO COMPLY WITH THAT RULE, IT MUST EITHER REGISTER WITH THE COMMISSION OR CEASE PROVIDING COMMODITY INTEREST TRADING ADVICE TO THIS POOL.”