

Alerts & Publications

PDF



The Commodity Futures Trading Commission Adopts Final Rule Significantly Limiting Registration Exemptions for Private Funds and Registered Investment Companies Operating Commodity Pools

February 22, 2012

The Commodity Futures Trading Commission (“Commission” or “CFTC”) recently adopted rule changes significantly limiting the registration exemptions available for companies registered under the Investment Company Act of 1940 (“registered investment companies”) and private funds operating or soliciting funds for a commodity pool. Among other things, the amendments (1) rescind the exemption from commodity pool operator (“CPO”) registration for certain private funds; (2) retain the *de minimis* exemption to CPO registration but add swaps trading to the calculation of the threshold for the *de minimis* exemption; and (3) limit the exclusion of registered investment companies from the definition of CPOs previously available. The changes will have a significant impact on the investment strategies and registration practices of many registered investment companies and private funds transacting business in the commodities markets. The adopting release is available [here](#).

Rescission of Exemption from Commodity Pool Operator Registration for Certain Private Funds

Before the CFTC’s adoption of the amendments, private funds operating

commodity pools were exempt from CFTC registration if their investors were “qualified purchasers”[1] as defined under the Investment Company Act of 1940, or “accredited investors,”[2] as defined in Regulation D under the Securities Act of 1933. The amendments rescind the exemption from CFTC registration for such private funds. The rescission of the exemption has broad implications, including for foreign CPOs operating a pool with at least one US investor, which will now be required to register with the CFTC and report the entirety of their derivatives activities even if their activities are already subject to oversight by foreign regulators.[3]

A fund operating a commodity pool that cannot avail itself of another exemption must register with the CFTC by December 31, 2012. Registration involves, among other things, the submission of an application and fees for the fund, and applications, fingerprints and fees for all natural principals and “associated persons,”[4] as well as evidence that each associated person has passed the required proficiency exams.

***De Minimis* Exemption Revised to Account for Swaps Trading**

Although the CFTC initially proposed to rescind its registration exemption for CPO trading only, a *de minimis* level of commodity interests, the CFTC elected to retain the exemption. The CFTC, however, revised the exemption to account for swaps in the *de minimis* threshold calculation, which will make it more difficult for many funds to meet the *de minimis* exemption. Additionally, the CFTC revised its rule to require that funds relying on the *de minimis* exemption reaffirm their exemption annually.

CFTC Registration Required for SEC Registered Investment Companies Acting As Commodity Pool Operators

The CFTC’s amended rule eliminates the broad exclusion of SEC registered investment companies from the definition of CPO. To avoid registration with the CFTC, an SEC registered investment company operating a commodity pool now will have to either (1) limit the aggregate initial margin and premiums required to establish commodity futures, options on commodities, or swap positions on commodities to no more than 5 percent of the liquidation value of the registered company’s portfolio (after accounting for unrealized profits and losses); or (2) limit the aggregate net notional value of commodity futures, options on commodities, or swap positions on commodities to 100 percent of the liquidation value of its portfolio.[5] Additionally, an SEC registered investment company seeking to avoid CFTC registration must not market “participations to the public as, or in, a commodity pool or otherwise as, or in, a vehicle for trading in the commodity futures, commodity options, or swaps markets.” Compliance with these marketing restrictions will be based on an assessment of several factors, including, among other things, whether the fund is explicitly offering a managed futures strategy.

If an SEC registered investment company cannot claim an exclusion from the definition of CPO under these criteria, the investment adviser to the investment company will be required to register as the CPO. Registration

will be required no later than December 31, 2012 or 60 days after the effective date of the rulemaking further defining the term “swap” under this section of the amended rule. The CFTC has proposed the adoption of additional rule amendments intended to “harmonize” compliance obligations under the CFTC rules with those imposed under the Investment Company Act of 1940; entities required to register because they can no longer claim an exclusion from the definition of a CPO will be required to comply with the CFTC’s recordkeeping, reporting and disclosure requirements within 60 days following the effectiveness of a final rule implementing the CFTC’s proposed “harmonization.”

Implications of Amendments for Registration of Commodity Trading Advisers

The rescission of the exemption for private funds and the inclusion of SEC registered investment companies in the definition of CPOs has implications for commodity trading advisers (“CTAs”) that had been exempt from CFTC registration because they only advised private funds or SEC registered investment companies that were not required to register with the CFTC. Such CTAs will now be required to register with the CFTC, if the private funds and SEC registered investment companies they advise can no longer claim an exemption, unless the CTA can find another exemption from registration.

Collection of Information on Forms CPO-PQR and CTA-PR

Together with the amendments described above, the CFTC also imposed a new requirement on CPOs and CTAs to report certain information on Forms CPO-PQR and CTA-PR. The information sought by the CFTC includes, among other things, information regarding the amount of assets under management, use of leverage, and counterparty risk exposure. The CFTC asserts that the information is required in order for the CFTC to “to identify significant risk to the stability of the derivatives market and the financial market as a whole.” Similar to the SEC’s Form PF, the information collected by the CFTC will be used by the Financial Stability Oversight Counsel in its efforts to monitor systemic risk.[6]

The amount of information required and the dates of compliance with the new reporting requirements depend on the amount of assets under management. For firms that must file Form PF, the CFTC’s requirements supplement SEC reporting requirements for dual registrants, and in some cases, dual registrants are permitted to file Form PF with the SEC in lieu of completing certain schedules of Form CPO-PQR.

Seriatim Vote and Commissioner Sommer’s Dissent

In a break from its trend, the CFTC did not hold an open meeting to adopt the rule changes. Consequently, there was no public discussion regarding the adoption of the amendments.

In her published dissenting statement, however, Commissioner Sommers stated that she did not believe the cost-benefit analysis supporting the rule

changes would survive judicial scrutiny, explaining that the benefits articulated within the amendments were likely to be outweighed by the substantial costs to the fund industry.

O'Melveny & Myers LLP is available to advise private funds and registered investment companies to ensure compliance with the CFTC's amended rules. For questions, please contact the attorneys listed above or any other O'Melveny & Myers LLP attorneys with whom you ordinarily work on related matters.

[1] "Qualified purchasers" generally include individuals with investment portfolios of at least US\$5 million and entities with investment portfolios of at least US\$25 million.

[2] "Accredited investors" generally include individuals with a net worth exceeding US\$1 million and entities with total assets exceeding US\$5 million.

[3] The CFTC considered but declined requests to provide an exemption for foreign CPOs and advisers.

[4] "Associated persons" generally include persons who solicit investors and those who supervise such persons.

[5] The amendments exclude certain "bona fide hedging" from these calculations and also do not finalize the definition of swaps under the rule.

[6] The SEC's Form PF requires registered investment advisers to disclose certain financial information regarding the private funds they manage.