Client Advisory

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All Advisers to Registered Investment Companies Need to Evaluate Their Exposure to CFTC Regulation After Recent Rule Amendment

Summary

On February 9, 2012, the Commodity Futures Trading Commission adopted final amendments to its Part 4 Rules. These rules set out compliance obligations for commodity pool operators (CPOs) and commodity trading advisers (CTAs) and create certain exemptions from CPO and CTA registration. Among other changes, the CFTC revised the CPO registration exemption under Rule 4.5 for registered investment companies (funds).[1] As a result, advisers to all mutual funds, closed-end funds and exchange-traded funds registered under the Investment Company Act of 1940 (1940 Act) must evaluate their funds' portfolios, investment strategies and marketing efforts to determine whether they will be subject to CPO or CTA registration and associated CFTC regulations.[2]

Rule 4.5 Amendment. CFTC Rule 4.5 formerly provided a blanket exemption from CFTC registration for registered funds and their advisers. Amended Rule 4.5 is a step back to the rule as it existed before 2003, with certain modifications. If a registered fund adviser trades more than a *de minimis* amount of futures contracts, options on futures or swaps (Derivatives), or markets a fund as a commodity pool, the adviser will now be required to register as a CPO. Sub-advisers to such a registered fund may also need to register as CTAs. Advisers who claim the Rule 4.5 exemption must file a notice of the claim with the National Futures Association (NFA) and renew it annually thereafter.

CFTC Proposes to Harmonize Disclosure, Reporting and Recordkeeping Requirements with SEC's Requirements. On February 9, the CFTC also issued a release proposing further amendments to its Part 4 Rules to harmonize its disclosure, reporting and recordkeeping rules with the Securities and Exchange Commission's requirements for registered funds.

Compliance Deadline. Compliance with amended Rule 4.5 is required after the *later* of (1) December 31, 2012, or (2) 60 days after the CFTC adopts final rules defining the term "swap." Advisers required to register as CPOs solely by virtue of Rule 4.5 will become subject to the Part 4 disclosure, reporting and recordkeeping requirements within 60 days of the adoption by the CFTC of final rules that implement the proposed CFTC harmonizing initiative.

[1] For a discussion of the other Part 4 amendments, see the Katten Client Advisory CFTC Adopts Significant Changes to CPO and CTA Registration and Compliance Requirements.

[2] The CFTC's adopting release for the final Rule 4.5 amendment (Adopting Release) states that the adviser to a registered investment company, rather than the fund itself, would be the registering entity should fund activities fall outside the exemption provided by Rule 4.5.

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Conditions of the Amended Rule 4.5 CPO Exemption

The amended Rule 4.5 CPO exemption focuses not on a fund adviser's activities but on the activities of the fund that would make it a commodity pool. To claim the CPO exemption, a registered fund adviser must represent that the fund[3] (1) uses Derivatives for *bona fide* hedging purposes; (2) uses non-hedging Derivatives below either of two alternative *de minimis* thresholds; and (3) is not marketed as a commodity pool.

Bona Fide Hedging. Amended Rule 4.5 permits the unlimited use of Derivatives solely for "*bona fide* hedging purposes." The term "*bona fide* hedging" is narrowly construed by the CFTC and does not include strategies that are commonly referred to as "risk management." No transactions or positions are classified as *bona fide* hedging by the CFTC unless (1) their purpose is to offset price risks incidental to commercial cash or spot commodity operations; (2) such positions are established and liquidated in an orderly manner in accordance with sound commercial practices; and (3) they represent a substitute for a physical commodity market transaction. The CFTC has expanded the definition to include futures contracts established to reduce the risks of a swap position. Nevertheless, very few registered funds, if any, can be expected to be invested in Derivatives for "*bona fide* hedging purposes" because they are not typically involved in commercial cash or spot commodities[4] business operations.

De Minimis Alternative Thresholds. Amended Rule 4.5 permits the use of non-hedging Derivatives up to the limits of two alternative *de minimis* thresholds (the De Minimis Thresholds), as follows:

- The aggregate CFTC-required initial margin and option premiums for non-hedging Derivatives does not exceed 5% of the fund's liquidation value (excluding the in-the-money amount of any option that was in-the-money at the time of purchase); or
- The aggregate net notional value of non-hedging Derivatives, determined at the time the most recent position was established, does not exceed 100% of the fund's liquidation value.

The De Minimis Thresholds must be calculated after taking into account unrealized profits and losses on the non-hedging Derivatives already held by the fund. Notional value is calculated for futures positions, option positions and retail foreign exchange transactions according to specific instructions in the rule. Presumably, the notional amount of a swap is the notional amount contract term, but this is not specified by the CFTC.

The netting of futures positions is allowed for the same commodity across designated contract markets and foreign boards of trade, while the netting of swaps is limited only to those cleared by the same derivatives clearing organization. The net notional value test is intended to make the amended Rule 4.5 exemption available to funds trading in classes of Derivatives that have higher required initial margin costs.

The Adopting Release indicates that the CFTC will promulgate the required margin standards for swap transactions at a future date. Compliance with amended Rule 4.5 is conditioned on such rulemaking as well as the adoption of final rules defining "swap."[5]

Marketing Restriction. As a final amended Rule 4.5 condition, an adviser must conclude that the fund has not been, and will not be, marketed "as a commodity pool or as a vehicle for trading in the commodity futures, commodity options, or swaps markets" (the Marketing Restriction).[6] The Adopting Release presents certain factors, none of which are dispositive, that are indicative of marketing a registered fund as a vehicle for investing in Derivatives markets:

- Whether the name of the fund implies such marketing;
- Whether the fund's primary investment objective is tied to a commodity index;
- Whether the fund uses a controlled foreign corporation (CFC) for its Derivatives trading;

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[3] These representations will apply separately to each registered fund advised by the adviser.

[4] "Commodity" would for this purpose include anything that underlies a futures contract, such as Treasury notes or the stocks in the S&P 500.

[5] Sixty days after the adoption of final rules regarding the definition of "swap," registered funds will be required to comply with amended Rule 4.5; however, if final rules regarding required margin standards from swap transactions are not yet adopted, swap transactions will be excluded from the calculation of De Minimis Thresholds until such required margin standards are established.

[6] In a change from the Rule 4.5 amendments initially proposed, the CFTC's final amendments removed the clause "(or otherwise seeking investment exposure to)" from the Marketing Restriction to avoid ambiguity.

- Whether the fund's marketing materials, including its prospectus, refer to the benefits of Derivatives in a portfolio or make comparisons to a derivatives index;
- Whether the fund has a net short speculative exposure to any commodity through Derivatives;
- Whether the fund's Derivative transactions will be its primary source of potential gains and losses; and
- Whether the fund is explicitly offering a managed futures strategy.

The Adopting Release indicates that explicitly offering a managed futures strategy would be convincing, if not quite dispositive, evidence of a fund violating the Marketing Restriction. Any determination of compliance with the Marketing Restriction will consider all of the factors.

Filing for the Rule 4.5 Exemption. Advisers claiming the amended Rule 4.5 CPO exemption must file a notice with the CFTC by the compliance date for each fund. For new funds created after the compliance date, advisers claiming the exemption must do so before the inception of the fund. In either case, a notice of reaffirmation of the Rule 4.5 claim must be filed within 60 days of each calendar year-end.

CFCs Used by Registered Funds for Derivatives Transactions

CFCs are offshore entities that are wholly owned by certain registered funds for trading in Derivatives while complying with subchapter M of the Internal Revenue Code. The managers of CFCs previously avoided CPO status because the CFCs were privately offered to accredited entity investors such as a registered fund, or by claiming that the CFC was a subdivision of the fund, not a separate commodity pool. The Adopting Release included Part 4 rule amendments that rescinded the private offering exemption and further stated that CFCs are separate legal entities. Managers of CFCs that cannot claim exemption from CPO registration under the CFCs' own circumstances, separate from that of their registered fund parent company, must register as CPOs of their CFCs.

Sub-Adviser CTA Registration

Sub-advisers to registered funds that are also commodity pools under amended Rule 4.5 may have to register as CTAs. Such sub-advisers may still avoid CTA registration if their activities are covered by Section 4m(3) of the Commodity Exchange Act. This provision exempts from CTA registration a registered investment adviser whose business does not consist primarily of acting as a CTA, and that does not act as a CTA to any pool engaged primarily in the trading of commodity interests.[7]

CFTC Proposed Harmonization Initiative

Also on February 9, the CFTC proposed amendments to certain CPO disclosure, reporting and recordkeeping rules to harmonize the obligations of funds that otherwise might be subject to duplicative, inconsistent and possibly conflicting SEC requirements under the 1940 Act.[8]

The harmonization initiative proposes to amend Rule 4.12(c) to offer relief to registered fund advisers/CPOs from, among other things:

- The CFTC's disclosure document delivery and investor written acknowledgement requirements if the CPO posts the fund's current disclosure document/prospectus and statement of additional information (SAI) on the CPO's website;
- CFTC periodic financial reporting obligations by permitting the SEC-required 12-month financial statements to substitute for the CFTC-required 9-month financial statements;
- CFTC-required delivery of monthly account reports to fund/pool investors if such account reports are posted on the CPO's website;

[7] The relief available to registered investment advisers under Section 4m(3) of the Commodity Exchange Act is self-executing and persons relying on the exemption are not required to file any notice or make any specified representations to claim the relief.

[8] Eileen Rominger, the Director of the SEC's Division of Investment Management, commented on February 9 at the PLI Investment Management Forum in New York that the SEC was unlikely to revise the requirements of its registered fund registration statement form due to any actions by the CFTC.

- The requirement that records be maintained at the CPO's main office by allowing fund/pool books and records to be maintained with the fund's third-party service providers, as is currently permitted by the SEC;
- The placement of CFTC-required fee disclosures, which vary from those of the SEC, and break-even table and calculation, if they appear after the fund's summary prospectus; and
- The placement of CFTC-required pool and related pool prior performance if they are presented in the fund's SAI.

Impact of Rule Changes

All registered fund advisers should conduct a review of each of their registered fund's portfolios, investment strategies and marketing materials to evaluate their status as CPOs by the compliance deadline. If a fund portfolio's exposure to Derivatives cannot be managed to reduce non-hedging Derivatives to levels below either of the De Minimis Thresholds or if further use of Derivatives as permitted by the fund's stated strategy *could* exceed the De Minimis Thresholds at any time, then the fund's adviser should prepare to register as a CPO.

Advisers that can comply with either of the De Minimis Thresholds where fund marketing materials already comply with the Marketing Restriction should make preparations for filing claims for amended Rule 4.5 exemption and, if necessary, for reconstituting fund Derivative holdings by the compliance deadline. Such advisers and their funds must also revise their compliance manuals to ensure ongoing compliance with amended Rule 4.5 conditions and annual reaffirmation requirements. Failure to file a reaffirmation, according to the Adopting Release, results in the immediate loss of the amended Rule 4.5 exemption.

Advisers who cannot comply with amended Rule 4.5 by the compliance deadline should prepare for CPO registration. In particular, advisers to managed futures mutual funds, inverse and ultra-long exchange-traded funds and other funds using strategies highly dependent upon swaps and futures must evaluate their CPO registration requirements. Certain business decisions must be made, such as deciding which senior executives need to satisfy NFA examination requirements. Once registered, the CPO adviser must meet the disclosure, reporting and recordkeeping requirements of Part 4. Among other things, a registered fund and its adviser/CPO must design and implement written compliance policies and procedures that address the CFTC's and the NFA's regulations.

If a registered fund is considered a commodity pool by virtue of amended Rule 4.5, the fund and its adviser should anticipate that (1) changes to the fund's prospectus and SAI will be required; (2) these changes will be material; and (3) the amended fund registration statement containing these changes will be subject to SEC and NFA review and comment. Moreover, the fund's SEC and NFA filing schedules must be coordinated to prevent a halt in the issuance of new fund shares, which is less of a concern for closed-end funds not presently engaging in an offering but is of paramount importance to mutual funds and exchange-traded funds.

To review the full final rule release of the CFTC, click here.

For the proposed harmonizing release, click here.

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