

CFTC Significantly Limits the Exemption from Commodity Pool Operator Registration for Registered Investment Advisers and Rescinds the Registration Exemptions for Private Fund Managers and Trading Advisers

On February 9, 2012, the Commodity Futures Trading Commission (the "**CFTC**") issued a final rule (the "**Final Rule**") to remove the exemptions that permitted many registered investment advisers and private investment fund managers to avoid the need to register as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**") in the United States. The **Final Rule** imposes extensive reporting requirements on certain registered CPOs and CTAs.

The CFTC generally requires registration as a CTA of any person who, for compensation or profit, engages in the business of advising others on the trading, or advisability of trading, U.S. futures, commodity options and, upon the finalization of relevant rule, swaps (other than security-based swaps and exempt foreign exchange swaps) ("**Regulated Commodity Interests**"), unless advice given is solely incidental to certain business activities or is non-customized. The CFTC also requires registration as a CPO of any person who solicits, accepts or receives funds or property on behalf of an investment vehicle trading in Regulated Commodity Interests (typically subject to the CFTC regulation as a "commodity pool") for the purpose of investing in Regulated Commodity Interests.

Rules 4.5, 4.13(a)(4) and 4.14(a)(i)(8)(D) previously allowed many fund managers to trade Regulated Commodity Interests for privately offered funds and investment

Key issues

- Registration exemptions for many public and private fund managers have been removed
- Many US and non-US fund managers investing US investors' money in swaps and commodity trades will be required to CFTC registration and reporting
- Key individuals will be required to pass Series 3 examinations
- Financial reporting subject to US GAAP

companies registered under the Investment Company Act ("**RICs**"), without registering with the CFTC as CPOs or CTAs.

The Final Rule significantly curtails the CPO registration exclusion under Rule 4.5 and rescinds the CPO and CTA registration exemptions under Rules 4.13(a)(4) and 4.14(a)(i)(8)(D). As a result, investment managers of RICs and private funds that invest even a minimal amount of assets in Regulated Commodity Interests, which are likely to be required to register with the CFTC as CPOs or CTAs and to become members of the National Futures Association (the "**NFA**"). A summary of CPO registration requirements applicable to private fund managers under the Final Rules is set out in the table at the end of this briefing. An exemption from CTA registration requirement would typically be available to any entity that provides advice related to Regulated Commodity Interests to a CPO that is exempt from CPO registration requirement.

In an effort to mitigate the additional regulatory burden imposed on investment advisers of RICs which are already regulated by Securities Exchange Commission (the "**SEC**"), the CFTC also harmonizing the CFTC's existing disclosure and reporting requirements for CPOs and CTAs with the SEC's equivalent regulations (the "**Harmonization Proposal**").

Restrictions on Investments in Regulated Commodity Interests for RICs Relying on Rule 4.5 CPO Exclusion

CFTC Rule 4.5 currently excludes RICs that manage other RIC funds from the definition of a CPO, regardless of the amount or type of the Regulated Commodity Interests investments held by the RIC as long as the RIC fund is not publicly marketed as a "commodity pool". The Final Rule restricts the exclusion to RICs for which (i) the aggregate initial margin and premiums required in connection with its Regulated Commodity Interests investments held for non-*bona fide* hedging purposes ("**Non-Hedging Investments**") does not exceed 5% of portfolio's liquidation value and (ii) the aggregate net "notional value" of Non-Hedging Investments does not exceed 100% of portfolio's liquidation value. Any Regulated Commodity Interests held for *bona fide* hedging purposes are excluded from calculation of the foregoing thresholds.

- Bona Fide Hedging - Bona fide hedging transactions are limited to transactions entered into to hedge the potential changes in the value of assets owned or liabilities incurred (or anticipated to be owned or incurred) by the fund. In the adopting release, the CFTC expressly declined to exclude risk management transactions from the trading thresholds applicable to Non-Hedging Investments because their market risk is not "offset by exposure to physical markets."
- Notional Value Calculation - For the purposes of calculating its notional value, a RIC may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and swaps cleared on the same designated clearing organization where appropriate.
- No exemption for entities not "primarily engaged" in Regulated Commodity Interests trading. - Unlike the existing exemption from CTA registration (discussed below), the CFTC has expressly declined to adopt a limited exemption from CPO registration for SEC-registered entities that are not "primarily engaged" in trading Regulated Commodity Interests.

As a result of the limitations introduced by the Final Rule, the investment adviser of a RIC will no longer be able to rely on CFTC Rule 4.5 to avoid CPO registration and will be required to register as a CPO if the RIC invests more than an immaterial amount of its assets in Non-Hedging Investments, irrespective of the RIC's investment strategy

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or the investment adviser's registration status with the SEC.

Restrictions on Marketing for RICs Relying on Rule 4.5 CPO Exclusion

The exclusion from registration under the amended Rule 4.5 is only available to investment advisers of RICs not marketed as vehicles for trading in Regulated Commodity Interests. Compliance with the marketing prohibition will be determined based on several factors, including:

- the fund's name,
- whether the fund uses a controlled foreign corporation (a "CFC") for derivatives trading,
- the fund's primary investment objectives and strategies,
- the total level of exposure of the fund to Regulated Commodity Interests, and
- the fund's marketing materials.

Use of Controlled Foreign Corporations by RICs Regulated

Prior to the adoption of the Final Rule, investment advisers of RICs could arrange for exempt commodity investments by using a CFC, in which a RIC was the sole investor to trade in Regulated Commodity Interests. The operator of the CFC was not required to register as a CPO because a RIC was its sole participant. This position has been revised in the Final Rule: a CFC will fall within the definition of a "commodity pool," and an operator of a CFC will be required to register as a CPO unless it has the benefit of another exemption or exclusion.

CPO Registration Exemption for Managers of Funds Privately Offered to QEPs Rescinded

CFTC Rule 4.13(a)(4) presently exempts from CPO registration an operator of a commodity pool which is (i) exempt from registration under the Securities Act of 1933, as amended (the "'33 Act"), and (ii) offered only to institutional sophisticated investors referred to as qualified eligible persons ("QEPs") and natural persons who meet both definitional and portfolio QEP requirements, irrespective of the amount of Regulated Commodity Interests held by the pool.

In the Final Rule, the CFTC rescinded this exemption because of an expressed concern that there are no limits on the amount of Regulated Commodity Interests, making it possible for a CFTC Rule 4.13(a)(4) fund to invest solely in Regulated Commodity Interests without being subject to any CFTC oversight. As a result, investment managers of a large number of private funds offered to U.S. investors will be required to register as CPOs for the first time.

A "De Minimis" CPO Registration Exemption under CFTC Rule 4.13(a)(3) Continues to be Available

The CFTC has not rescinded the exemption from CPO registration that is presently available under Rule 4.13(a)(3). As a result, the exemption from CPO registration would continue to be available to an operator of a fund that (i) is exempt from registration under the '33 Act, (ii) is offered only to QEPs, accredited investors, or knowledgeable employees, and (iii) has the aggregate initial margin and premium attributable to Regulated Commodity Interests that do not exceed 5% of the liquidation value of its

portfolio. The threshold under Rule 4.13(a)(3) includes all types of investments in Regulated Commodity Interests and, unlike Rule 4.5, does not provide for any special exemptions or exclusions for transactions entered into for *bona fide* hedging purposes.

No Foreign Advisor Registration Exemption under the Final Rule

The CFTC expressly declined to adopt a foreign advisor exemption similar to that set forth under the Investment Adviser Act of 1940 as part of the Final Rule despite a concern expressed by a number of commentators that as a result of the rescission of Rule 4.13(a)(4) exemption, most non-U.S. based investment managers that manage a single fund investing in Regulated Commodity Interests with at least one U.S. investor would be required to register with the CFTC. In the summary of the Final Rule, the CFTC stated that it reserves consideration of a foreign advisor exemption until it receives data regarding such firms on Forms CPO-PQR and/or CTA-PR, as further described below.

Funds of Funds Fully Subject to CFTC Regulation.

A fund investing in any unaffiliated fund that engages in Regulated Commodity Interests trading would itself be deemed a commodity pool for purposes of the CFTC regulation, and the manager of such fund would be subject to CPO registration. The manager of the fund of funds would be required to provide the names of the investee funds and the size of the fund of funds' investment in the investee funds.

CTA Exemption for Advisors of Privately Offered Funds under CFTC Rule 4.14(a)(8)(i)(D) Rescinded

The Final Rule also rescinds the current exemption from CTA registration set out under Rule 4.14(a)(8)(i)(D) for advisors to private funds of the same type discussed in relation to the CPO registration requirement. Following the rescission of Rule 4.14(a)(8)(i)(D), an exemption from CTA registration will only be available to a private fund manager that: (1) is registered with the SEC and does not act as a CTA to a fund that "primarily" engages in trading Regulated Commodity Interests; (2) has registered as a CPO and provides advice only to the funds for which it is so registered; or (3) has not furnished trading advice in connection with any Regulated Commodity Interests to more than 15 clients and does not hold itself out to the public as a CTA. For purposes of a CTA registration exemption, a CTA that solicits clients beyond family, friends, and existing business associates may be viewed as holding itself out to the public as a CTA.

CFTC Rule 4.27 Enhanced Reporting Requirements for RIC CPOs

The Final Rule requires RICs registered as CPOs to file Form CPO-PQR, which requires detailed disclosure of the matters set out in the table below. The CFTC noted that a registered CPO that is also registered as an investment adviser with the SEC will be permitted to report its activities on Form PF in lieu of any other reports required under the amended CFTC Rule 4.27. All financial information in Form CPO-PQR must be presented in accordance with US GAAP.

Form CPO-PQR comprises Schedules A, B and C, and registered CPOs are required to complete only the schedule appropriate to their under management ("**AUM**"). Most of the information on the Schedule A and all information on Schedules B and C of Form CPO-PQR will be filed on confidential basis.

The following is the summary of the reporting requirements in connection with Form CPO-PQR:

CPO Reporting Threshold	Form CPO-PQR Schedule	Filing Frequency	Information Required by the Relevant Schedule
Small-Sized CPO Under \$150 million in AUM	Schedule A	Annually (within 90 days of the end of the calendar year, beginning 2012)	<p>For the CPO:</p> <ul style="list-style-type: none"> • Basic identifying information • AUM and net AUM <p>For each pool:</p> <ul style="list-style-type: none"> • management information (third party administrators, custodians, trading managers, brokers, auditors and marketers); • monthly rates of return, subscriptions and redemptions.
Mid-Sized CPO \$150 million in AUM	Schedule A Schedule B	Annually (within 90 days of the end of the calendar year, beginning 2012)	<p>For each pool:</p> <ul style="list-style-type: none"> • investment strategies (including quantitative techniques and high frequency trading) and percentage of NAV and capital devoted to each strategy; • beneficial ownership of 5 largest investors; • borrowings and investments; • counterparty credit exposure; • trading and clearing mechanisms; and • value of aggregated derivative positions.
Large-Sized CPO \$1.5+ billion in AUM	Schedule A Schedule B Schedule C Alternatively, registered investment adviser required to file Form PF with the SEC may report on Form PF in lieu of Schedules B and C	Quarterly (within 60 days following the end of the relevant quarter, beginning with the first calendar quarter ending after: (i) July 2, 2012 for CPOs with at least \$5 billion in AUM or (ii) December 14, 2012 for CPOs with \$1.5 -5 billion in AUM)	<p>For each pool:</p> <ul style="list-style-type: none"> • geographical breakdown of investments <p>For all pools:</p> <ul style="list-style-type: none"> • turnover of aggregate portfolio of pools <p>For each large pool:</p> <ul style="list-style-type: none"> • pool information; • liquidity of pool's portfolio; • counterparty credit exposure; • risk metrics (including VaR calculations); • borrowing information and financing liquidity; • duration of fixed income assets; and • investor information.

Timing of the Registration Requirements under the Final Rule

Although the Final Rule (other than the amendments to Rule 4.27, which take effect on July 2, 2012) will become effective 60 days after it is published in the Federal Register, a fund manager or a trading advisor presently exempt or excluded from CPO or CTA registration under Rules 4.5, 4.13(a)(4) or 4.14(a)(8)(i)(D) but which no longer qualifies for an exemption following the effectiveness of the Final Rule, will be required to register by the later of December 31, 2012 or 60 days following the adoption of final rules defining the term "swap" and establishing margin requirements for such instruments. Any entities not presently exempt or excluded from registration will be required to register prior to engaging in any regulated activity upon the effectiveness of the Final Rule.

Timing of Reporting Requirements for RICs

The amended CFTC Rule 4.27 becomes effective on July 2, 2012, and will apply to CPOs as set out in the table above. With respect to other reporting and recordkeeping requirements presently applicable to registered CPOs, however, the CFTC has issued the Harmonization Proposal (discussed below), and, as a result, advisers to RICs will not be subject to the CFTC's recordkeeping, reporting and disclosure requirements until 60 days after a final rule implementing the Harmonization Proposal becomes effective.

Harmonization Proposal

In an effort to avoid duplicative disclosure, recordkeeping and reporting requirements under the SEC rules and the newly applicable CFTC rules, the CFTC proposed the following exemptions for advisers of RICs who are also required to register as CPOs:

- disclosure, reporting and recordkeeping relief currently available to CPOs of exchange-traded funds under CFTC Rule 4.12, including relief from the account statement and disclosure documents;
- extended filing period for disclosure document updates and financial reporting to investors;
- amended performance disclosure requirements;
- relief for daily liquidity disclosure;
- the use of a summary prospectus for open-ended RICs; and
- the inclusion of mandatory certification language.

These exemptions are subject to approved rule, which is open for public comment for 60 days after the Harmonization Proposal is published in the Federal Register.

CPO and CTA Registration Process

Applicants for CPO or CTA registration must submit a Form 7-R for the CPO and the CTA and a Form 8-R for each principal who is a natural person and for each associated person ("**AP**") of the CPO or CTA. An AP is any employee who solicits orders, customers or customer funds on behalf of a CPO or a CTA. The CFTC treats everyone in the "line of supervisory authority" of an AP, regardless of seniority, including the president of the firm, as an AP of a registrant. Each registered CPO and CTA would be required to have at least one AP. The Form 8-R must be submitted with the relevant person's fingerprints and background checks. In addition, each AP of the CPO and the CTA would be required to pass the NCFE Proficiency Examination (Series 3 Exam).

The term "principal" is not defined in the CEA, but is defined by the CFTC regulations and the NFA. Based on NFA guidance, a principal of a CPO or a CTA would be an entity or an individual who is the registrant's general partner, or owner of at least 10% of any class of the registrant's securities or has directly contributed at least 10% or more of the registrant's capital. A natural person would be a principal of a CPO or a CTA depending on the individual's ability to directly or indirectly control the its business activities. Any individual who:

- owns at least 10% of the outstanding shares of any class of a CPO or CTA's stock,
- is entitled to vote at least 10% of any class of a CPO or CTA's voting securities,
- has the power to sell or direct the sale of at least 10% of any class of a CPO or CTA's voting securities,

- has contributed at least 10% of a CPO or CTA's capital, or
- is entitled to receive 10% or more of a CPO or CTA's net profits

would be deemed to exercise control over, and be a principal of, such CPO or CTA. Similarly, individuals who hold specific positions at a CPO or CTA, such as director, president, chief executive officer, chief operating officer and chief financial officer, or who are in charge of the business unit or division that conducts Regulated Commodity Interests activity would be deemed principals, even if that individual cannot control the CPO or CTA's business as a whole.

Summary of CPO Registration Requirements for Fund Managers

Fund's Investment Manager's Jurisdiction	Fund's Jurisdiction and Type ¹	Fund's Investments in Regulated Commodity Interests	CPO Registration Required? ²
U.S.	U.S. RIC	A. 100% for bona fide hedging purposes	No (excluded from CPO definition under CFTC Rule 4.5(c)(iii)(A), (B)).
		B. (i) Aggregate initial margin required in connection with the fund's Regulated Commodity Interests investments for non-bona fide hedging purposes does not exceed 5% of the liquidation value of fund's portfolio; and (ii) Aggregate net "notional value" of the fund's investments in Regulated Commodity Interests for non-bona fide hedging purposes does not exceed 100% of the liquidation value of the fund's portfolio.	
		C. Investments other than as set out in A or B.	
	Non-U.S. Private Fund or U.S. Non-RIC Private Fund	D. Aggregate initial margin required in connection with the fund's Regulated Commodity Interests investments for ANY purpose (including bona fide hedging and risk management) does not exceed 5% of the liquidation value of fund's portfolio.	No (exempt from registration under CFTC Rule 4.13(a)(3)(A)).
		E. Aggregate net "notional value" of the fund's investments in Regulated Commodity Interests for ANY purpose (including bona fide hedging and risk management) does not exceed 100% of the liquidation value of the fund's portfolio.	No (exempt from registration under CFTC Rule 4.13(a)(3)(B)).
		F. Investments other than as set out in D or E above.	Yes.
Non-US	Non-U.S. Private Fund or U.S. Non-RIC Private Fund	Investments as set out in D or E above.	No (exempt from registration under CFTC Rule 4.13(a)(3)).
		Investments other than as set out in D or E above.	Yes.

Clifford Chance has considerable experience in preparing registration submissions and guiding clients through the application and examination process. Please contact your normal Clifford Chance contact or the authors of this briefing for more information.

¹For the purposes of this table, we assume that the fund's interests are solicited or sold to at least one U.S. investor.

²CPO registration requirement determined with respect to each fund managed or operated and not on the aggregated basis. A manager may be required to register as a CPO with respect to one fund and claim an exemption or an exclusion with respect to another fund under its management, depending on that fund's portfolio.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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