CLIENT UPDATE

CFTC RESPONDS TO FREQUENTLY ASKED QUESTIONS – CPO/CTA: AMENDMENTS TO COMPLIANCE OBLIGATIONS

NEW YORK
Byungkwon Lim
blim@debevoise.com

Gary E. Murphy
gemurphy@debevoise.com

Michael J. Decker
mdecker@debevoise.com

On August 14, 2012, the Division of Swap Dealer and Intermediary Oversight (the "Division") of the Commodity Futures Trading Commission (the "CFTC") issued responses to frequently asked questions regarding the compliance obligations of commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") in light of recent amendments to sections 4.13 and 4.5 of the CFTC Regulations[1] (the "FAQ").[2]

The topics addressed by the FAQ include: (i) CPO registration and delegation; (ii) wholly-owned subsidiary and controlled foreign corporation regulation; (iii) future Form CPO-PQR and Form CTA-PR guidance; (iv) the application of section 4.13(a)(3); (v) directors and trustees of mutual funds; (vi) the definition of bona fide hedging; (vii) trading limits; (viii) associated person registration with regard to mutual funds; (ix) relief under Commission Advisory 18-96; (x) transitioning from an exemption under former section 4.13(a)(4) to the current regulatory regime; and (xi) the application of compliance dates.

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1 Unless otherwise specified, all section and part references herein are to the CFTC Regulations.

2 Available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq_cpocta.pdf

KEY POINTS FOR GENERAL PARTNERS AND INVESTMENT MANAGERS OF PRIVATE FUNDS

Although each topic addressed in the FAQ is discussed in greater detail below, general partners and investment managers of private funds will be interested in the following key points:

- The investment manager of a commodity pool, instead of the general partner or the managing member of the pool, is permitted to register as a CPO for the pool, if certain delegation conditions are satisfied.
- Wholly-owned subsidiaries of a commodity pool trading in derivatives are themselves commodity pools.
- The FAQ states that CPOs claiming exemption under the de minimis test should be given a reasonable time to comply with the required trading thresholds: CFTC staff recognize "that due to certain deal structures, commodity interest positions are necessarily the first position entered into in furtherance of that structure and that following the completion of the deal the level of derivatives exposure will fall below the de minimis threshold."
- The Division clarifies that the "at all times" requirement of the de minimis test is qualified in subsections (A) and (B) of section 4.13(a)(3)(ii) such that the thresholds are "determined at the time the most recent position was established." The CFTC staff believes that the regulation only requires a CPO to be in compliance with such trading thresholds at the time a position is established, and CPOs will not otherwise be required to reconfigure their portfolios to comply with such limits.
- Where a CPO is operating pursuant to a section 4.13(a)(4) exemption and all of the participants meet the qualified eligible person ("QEP") standard, such CPO will not be required to reaffirm that all existing participants in the pool continue to meet the QEP standard for such CPO to claim a section 4.7 exemption for that pool.
- Division staff are working with National Futures Association ("NFA") staff to permit CPOs exempt under former section 4.13(a)(4) to file an exemption under section 4.7 or Commission Advisory 18-96 prior to December 31, 2012, with an effective date of January 1, 2013.
- CPOs of funds of funds may continue to rely on former Appendix A to part 4 until such time as the Commission adopts revised guidance.

THE FAQ

Who Is the Commodity Pool Operator?

The Division notes that under the final rules (including the preamble thereto, the "Final Rules")[3] adopted by the CFTC on February 9, 2012, which amended part 4, controlled foreign corporations ("CFCs") wholly owned by registered investment companies and used for trading commodity interests are properly considered commodity pools. Therefore, under the Final Rules, the use of CFCs for trading in commodity interests by registered investment companies is permitted so long as the CPOs of such CFCs are properly registered with the CFTC, unless any such CPO may claim an exemption or exclusion on its own merits.

The FAQ clarifies which entity should be required to register as the CPO of a CFC. Generally, where the registered investment company's CPO is making the determination regarding the engagement of CTAs and the allocation of CFC assets, the CPO for the registered investment company should also be the CPO for the CFC. In addition, where the general partner, managing member, or board of directors of a commodity pool is legally permitted to delegate its rights and responsibilities with respect to the operation of a commodity pool, such rights and obligations as CPO may be delegated to another person, provided that (i) such person is qualified to serve as CPO; (ii) such person is registered as a CPO with the CFTC; (iii) such person has assumed such rights and obligations; and (iv) the delegating entity has agreed to remain jointly and severally liable with respect to any violations of the Commodity Exchange Act (the "CEA") in line with prior no-action letters on this issue. In other words, the investment manager of a commodity pool, instead of the general partner or the managing member of the pool, is permitted to register as a CPO for the pool, if the above conditions are satisfied.

Wholly-Owned Subsidiaries

In the Final Rules, the CFTC stated that where a registered investment company forms a wholly-owned subsidiary for purposes of trading commodity interests, such subsidiary is a pool within the meaning of section 1a(10) of the CEA and such subsidiary will be required to have its CPO register with the CFTC unless such CPO can claim an exemption or exclusion on its own merits.

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[3] The Final Rules are detailed in our February 13, 2012 Client Update, "Amendments to CFTC Part 4 Regulations Regarding Commodity Pool Operators and Commodity Trading Advisors," available at: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=e42014f7-c21f-4106-8932-383132e8b16a

In response to a question asking whether a wholly-owned trading subsidiary of a commodity pool should be deemed and regulated as a pool where the parent is operated by a registered CPO, the FAQ affirms the Final Rules and makes clear the staff's position that wholly-owned subsidiaries of a commodity pool trading in derivatives are themselves commodity pools.

The FAQ gives additional guidance with regard to CFCs. For the purpose of part 4, CFCs should be treated as master funds, and will therefore be exempt from providing disclosure documents and financial statements to investors under common control, which is in accordance with sections 4.20 and 4.22. Where CPOs of CFCs are required to register with the CFTC, registration is required by December 31, 2012. While the FAQ addresses these matters only with respect to CFCs, this guidance will also apply with respect to other wholly-owned trading subsidiaries of commodity pools.

Forms CPO-PQR and CTA-PR

According to the FAQ, with regard to guidance concerning Forms CPO-PQR and CTA-PR, because many of the small- and mid-sized CPOs and CTAs who are not required to make their first filing until 2013 have not yet reviewed the forms, CFTC staff will defer releasing guidance until such time as all filers have had time to review and comment. The Division advises that forms filed before the issuance of such guidance may be completed by filers making reasonable assumptions and good faith efforts in executing their compliance obligations, and that compliance with such guidance will not be required immediately upon release.

Section 4.13

CPOs of commodity pools may rely on section 4.13(a)(3) (the "de minimis test") for exemption from registration where (i) the pool's aggregate initial margin and premiums do not exceed 5% of the liquidation value of the pool's portfolio, or (ii) the aggregate net notional value of positions does not exceed 100% of the liquidation value of the pool's portfolio.

CPOs planning to rely on the de minimis test have expressed concern that they will violate the threshold requirements of the de minimis test if they establish a position in commodity interests before putting on their first deal. The FAQ states that CPOs claiming exemption under the de minimis test should be given a reasonable time to comply with the required trading thresholds: CFTC staff recognize "that due to certain deal structures, commodity interest positions are necessarily the first position entered into in furtherance of that structure and that following the completion of the deal the level of derivatives exposure

will fall below the de minimis threshold." The FAQ only refers to the first position. Depending on the structure and administration of a particular commodity pool, the same issue may arise with respect to subsequent positions established by the commodity pool. We understand from CFTC staff that it may be necessary to seek a staff interpretation or no-action relief where a particular commodity pool faces this issue with respect to a series of positions established by such commodity pool. In addition, the FAQ leaves interpretation of a "reasonable time" up to the facts and circumstances, and advises that entities availing themselves of the de minimis exemption will still be subject to special calls to confirm their ability to comply with its terms.

The FAQ includes the following additional guidance with regard to section 4.13:

- As of December 31, 2012, swaps must be included in the calculation of "commodity interest" exposure under the de minimis test, including then-existing swaps and all swaps entered into going forward.
- Section 4.13(a)(3) includes all QEPs as eligible investors, particularly non-U.S. persons, just as former section 4.13(a)(4) had done. For the sake of clarity, a typographical amendment will be made to section 4.13(a)(3).
- CPOs that have their current exemption under section 4.13(a)(4) withdrawn on January 1, 2013 do not need to file a 2012 annual report. CPOs coming into registration will be required to file their first annual report for fiscal year 2013.

The FAQ also includes the following registration guidance for CPOs:

- Entities that claimed relief under section 4.13(a)(4) before April 24, 2012 are required to register or claim an exemption by December 31, 2012.
- CPOs that claimed exemption in 2003 under a section 4.13 no-action relief then available will, if they wish to remain exempt from registration, be required to re-file their exemption to designate that such exempt pools are operating pursuant to section 4.13(a)(3) specifically, if applicable.
- The FAQ also refers to a notice of no-action relief issued by the Division on July 10, 2012 (the "No-Action Letter"),[4] which provided for limited temporary relief from registration for CPOs and CTAs that would have been exempt or excluded from registration but for the recent amendments under the Final Rules. Such no-action relief is available to pools launched after the date of the No-Action Letter. The Division

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[4] See our July 16, 2012 Client Update, "CFTC Grants No-Action Relief Extending Compliance Date for CPO and CTA Registration," available at: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=67822928-7a4b-4807-80a6-04089cbd403c

provided the no-action relief to such CPOs or CTAs for failure to register as such until December 31, 2012, subject to certain requirements, including filing a notice claiming the benefit of such no-action relief with the Division.

Directors/Trustees

The Division advises in the FAQ that, where a mutual fund does not qualify for exclusion under section 4.5, such mutual fund's board of directors remains subject to prohibitions under the CEA applicable to all market participants even though such board of directors is not required to register.

Bona Fide Hedging

Under the Final Rules, a mutual fund relying on the exclusion in section 4.5 is subject to trading limits with respect to commodity interests used other than for solely bona fide hedging purposes. The applicable definition of bona fide hedging transaction under section 1.3(z) or 151.5 is rather restrictive, and the CFTC explained that it determined not to provide for a more expansive definition of hedging transaction, such as risk management transactions. The FAQ clarifies the CFTC's position, stating that equitization of cash and risk management are not properly included as bona fide hedging transactions for purposes of section 4.5.

Trading Limits

Under section 4.13(a)(3), the threshold requirements of the de minimis test must be complied with "at all times." Under a conservative reading of this requirement, many CPOs feared that they may be forced to quickly exit positions at unfavorable times to maintain compliance with the de minimis test trading thresholds.

In the FAQ, the Division clarifies that the "at all times" requirement of the de minimis test is qualified in subsections (A) and (B) of section 4.13(a)(3)(ii) such that the thresholds are "determined at the time the most recent position was established." The CFTC staff believes that the regulation only requires a CPO to be in compliance with such trading thresholds at the time a position is established, and CPOs will not otherwise be required to reconfigure their portfolios to comply with such limits. This means a pool will not have to unwind its positions when its liquidation value decreases due to redemptions by investors in the pool, fluctuations in the value of the commodity interest position, or fluctuations in the liquidation value of the pool. This is a departure from past interpretations of the de minimis test, and will make compliance a lot easier.

The FAQ also includes the following trading limits guidance:

- The "liquidation value of the pool's portfolio," as used in part 4 with regard to the de minimis test and the definition of CPO, includes all cash held by the pool and is not limited to the aggregate liquidation value of the fund's positions.
- Commodity options with the same underlying commodity may be netted across designated contract markets and foreign boards of trade.
- For both cleared swaps and uncleared swaps, the notional amount of a swap is the amount reported by the reporting counterparty as the notional amount of the swap under part 45 (Swap Data Recordkeeping and Reporting Requirements). Note that part 45 does not necessarily provide specific guidance on the determination of the notional amount of every type of swap. For example, there is no specific guidance under part 45 to determine the notional amount in U.S. dollars of a commodity swap whose notional is required to be reported in the quantity of the reference commodity.

AP Registration

To the extent that a registered investment company no longer qualifies for exclusion under section 4.5, it is the CFTC staff's position that a Series 6 FINRA registered limited representative should qualify for the exemption from registration as an associated person under section 3.12(h)(1)(ii) where such Series 6 licensee limits his or her activities to the sale of ownership interests in registered investment companies.

Commission Advisory 18-96

The FAQ states that Commission Advisory 18-96 [5] remains effective and registered CPOs can continue to claim relief pursuant to its terms.

Commission Advisory 18-96, "Offshore Commodity Pools: Relief for Certain Registered CPOs from Rules 4.21, 4.22 and 4.23(a)(10) and (a)(11) and from the Location of Books and Records Requirement of Rule 4.23," provides that (i) a registered CPO who operates an offshore commodity pool may claim relief from certain disclosure, reporting, and recordkeeping requirements by filing notice of a claim for exemption with the Division of Trading and Markets of the CFTC setting forth certain representations that the CPO is registered and that the commodity pool does not have direct organizational, administrative, participant, capital, or marketing ties to the United States, and (ii) a registered CPO whose main business office is within the United States and who operates a

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[5] Available at: http://www.cftc.gov/tm/advisory18-96.htm

commodity pool that has its main business office outside the United States may claim relief from the requirement that a registered CPO maintains the original books and records of its commodity pool at its main business office by filing notice of a claim for exemption that sets forth certain representations that the CPO will maintain original books and records outside the United States in furtherance of Internal Revenue Service requirements for relief from federal income taxation, will maintain duplicate books and records in the United States, and will make available the original books and records to a representative from the CFTC, the United States Department of Justice, or the NFA within 72 hours.

Transitioning

The FAQ responds to a few hypothetical situations regarding registration relief and exemptions:

- The CPO of a pool that was previously exempt under section 4.13(a)(4) will be permitted to claim relief under section 4.7 [6] despite the fact that the interests in the pool were offered and sold, and commodity interests were entered into, before filing the required notice under section 4.7(d) because the interests offered and sold were done so consistent with then-effective provisions of part 4.
- Where a CPO is operating pursuant to a section 4.13(a)(4) exemption and all of the participants meet the QEP standard, such CPO will not be required to reaffirm that all existing participants in the pool continue to meet the QEP standard for such CPO to claim a section 4.7 exemption for that pool. To maintain the section 4.7 exemption going forward, such CPO will, however, be required to ensure that any new participants meet the QEP standard at the time of investment.
- The CFTC does not plan on providing a grace period for exempt CPOs that currently operate a section 4.13(a)(4) exempt pool to pursue a section 4.7 or Commission Advisory 18-96 exemption. Instead, Division staff are working with NFA staff to permit such CPOs to file an exemption under section 4.7 or Commission Advisory 18-96 prior to December 31, 2012, with an effective date of January 1, 2013.
- Where a CTA relied on the exemption from registration in section 4.14(a)(8)(D)[7] based on advice provided to a pool that was exempt under section 4.13(a)(4), such CTA may claim relief under section 4.7(c) despite the fact that it provided advice to the pool prior

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[6] Section 4.7 exempts from certain part 4 requirements (i) CPOs with respect to offerings to QEPs and (ii) CTAs with respect to advising QEPs.

[7] Prior to the Final Rules, section 4.14(a)(8)(D) exempted from CTA registration advisors whose commodity interest advice was directed solely at, for the purposes of this example, CPOs exempt under former section 4.13(a)(4).

to filing the required notice under section 4.7(d), because the advice was provided pursuant to a then-effective exemption from registration.

The FAQ provides procedural guidance where a CPO wishes to avail itself of relief under section 4.7:

- Currently, before a CPO can file an exemption under section 4.7 on behalf of any of the pools that the CPO currently operates, the CPO must apply for registration with the CFTC and NFA membership. This can be accomplished through NFA's online registration system. Once the CPO is pending registration as a CPO and NFA member, the CPO will be able to access NFA's exemption system where the CPO can withdraw the exemption under former section 4.13(a)(4) and file the new exemption under section 4.7. CPOs withdrawing the section 4.13(a)(4) exemption prior to December 31, 2012 may become subject to financial reporting requirements under CFTC and NFA regulations; to prevent this issue, Division staff is working with NFA staff to develop an appropriate mechanism to enable entities to claim relief under section 4.7 and register while deferring the effective date of such registration and exemption until January 1, 2013.

The FAQ also provides procedural guidance where an exempt CPO wishes to transition from being exempt under former section 4.13(a)(4) to being exempt under section 4.13(a)(3):

- The CPO must first submit a written request to the NFA to withdraw the exemption under former section 4.13(a)(4). The NFA will then contact the CPO when the exemption has been withdrawn. After the withdrawal is finalized, the CPO may file the new exemption under section 4.13(a)(3) electronically. Note that such CPOs must provide notice to participants of the change in exemption.

Compliance Dates

According to the FAQ, CPOs of funds of funds may continue to rely on former Appendix A to part 4, "Guidance on the Application of Rule 4.13(a)(3) in the Fund of Funds Context" ("Appendix A"), until such time as the Commission adopts revised guidance. Under the former Appendix A, which was eliminated pursuant to the Final Rules, the 4.13(a)(3) exemption generally extended to funds of funds: (i) where the manager of each underlying fund claimed exemption under the de minimis test or was otherwise a registered CPO that complied with the trading restrictions of the de minimis test; (ii) that directly traded commodity interests in addition to their allocation of assets to underlying funds, so long as the manager treated the assets directly traded as a separate pool and applied the requirements of the exemption to that pool; or (iii) that did not trade commodity interests

directly and had no more than 50% of their assets allocated to underlying funds that traded commodity interests. We understand that the revised guidance for funds of funds, new Appendix D, will be substantially similar to former Appendix A, but that Situation 5 in old Appendix A (summarized in clause (iii) above) will almost certainly not be included.

The FAQ provides additional guidance on the requirement for swaps to be included within the trading threshold under sections 4.13(a)(3) and 4.5:

- Swaps are required to be included within the trading threshold under sections 4.13(a)(3) and 4.5 by December 31, 2012; CFTC staff believes that CPOs will have sufficient time prior to such date to conduct the necessary calculations to determine eligibility under sections 4.13(a)(3) and 4.5 to complete the registration process, if necessary. CFTC staff also believes that it is not necessary to delay compliance with the inclusion of swaps within the threshold until the finalization of the margin requirements for uncleared swaps, and that CPOs should have the necessary information regarding margin payments made for their current swaps portfolio to calculate whether the operated pool exceeds the trading threshold.

Finally, the FAQ provides guidance on compliance dates for registered investment company registration:

- Registered investment companies required to register due to changes in section 4.5 must register by December 31, 2012.
- CPOs of new registered investment companies that are launched after April 24, but before December 31, 2012 must register on January 1, 2013.
- For a sub-advisor of a registered investment company that can no longer rely on section 4.14(a)(8) because the CPO of the registered investment company cannot rely on amended section 4.5, registration for that sub-advisor will be required when the CPO for the registered investment company would be required to register. The CTA's compliance with the Commission's recordkeeping, reporting, and disclosure requirements pursuant to part 4 is not required until 60 days following the effective date of a final rule implementing the Commission's proposed harmonization effort.

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August 17, 2012