AMENDMENTS TO CFTC PART 4 REGULATIONS REGARDING COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS

February 13, 2012

To Our Clients and Friends:

On February 9, 2012, the Commodity Futures Trading Commission (the "CFTC") adopted final rules (the "Final Rules") amending part 4 of the Regulations under the Commodity Exchange Act (the "CEA") regarding commodity pool operators ("CPOs") and commodity trading advisors ("CTAs").[1]

The Final Rules: (i) repeal the exemption from registration of CPOs provided in section[2] 4.13(a)(4); (ii) modify the criteria for registered investment companies claiming relief under section 4.5; (iii) rescind relief from the certification requirement for annual reports provided to operators of certain pools offered only to qualified eligible persons ("QEPs")[3] pursuant to section 4.7(b)(3); (iv) incorporate the revised definition promulgated by the Securities and Exchange Commission (the "SEC") of "accredited investor" under section 4.7; (v) require the annual filing of notices claiming relief under sections 4.5, 4.13 and 4.14; (vi) require the filing with the National Futures Association (the "NFA") of Forms CPO-PQR and CTA-PR pursuant to section 4.27; and (vii) require the inclusion of new risk disclosure requirements for CPOs and CTAs regarding swap transactions under sections 4.24 and 4.34.

REPEAL OF EXEMPTION UNDER SECTION 4.13(a)(4)

Section 1a(10) of the CEA, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), defines a commodity pool to be any investment trust,

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[1] *The full text of the CFTC's release and rules can be found at http://www.cftc.gov/PressRoom/PressReleases/pr6176-12*

[2] *Unless otherwise indicated, all section references are to the Regulations.*

[3] *QEP is defined under section 4.7(a)(2), and includes, but is not limited to, a "qualified purchaser" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 and a non-U.S. person.*

syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including futures and swaps (as defined in section 1a(47) of the CEA).[4]

A sponsor or operator of a commodity pool (such as the general partner of a private fund) is required to register with the CFTC as a CPO, and an investment advisor to a commodity pool is required to register with the CFTC as a CTA unless, in either case, an exemption is available under the CEA or the Regulations. The Final Rules repeal the exemption from registration of CPOs provided in section 4.13(a)(4), which CPOs of private funds have frequently relied on.

Prior to the Final Rules, section 4.13(a)(4) was typically available in the case of private funds that rely on section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") for exemption from registration under the Investment Company Act. Section 4.13(a)(4) generally provides for exemption from CPO registration if the interests in the commodity pool are exempt from registration under the Securities Act of 1933 (the "Securities Act") and the operator reasonably believes that the participants in the commodity pool are QEPs. In its release of the Final Rules (the "Release"), the CFTC noted that there are no limits on the amount of commodity interest trading in which pools operating under the exemption provided in section 4.13(a)(4) can engage, which necessitates CFTC supervision to ensure adequate customer protection and market oversight.

Pursuant to the Final Rules, CPOs that currently rely on section 4.13(a)(4) will be required to register with the CFTC and will be subject to various disclosure, reporting and recordkeeping requirements, unless they are eligible for exemption, including the one provided in section 4.13(a)(3). However, registered CPOs may continue to rely on section 4.7 (as amended pursuant to the Final Rules) for partial relief from certain disclosure and periodic reporting requirements, if the commodity pool is offered only to QEPs.

CPOs currently claiming an exemption under 4.13(a)(4) are required to comply with the rescission of section 4.13(a)(4) by December 31, 2012, but, compliance for all other CPOs that are not currently relying on section 4.13(a)(4) will be required beginning on the 60th day following the date of publication of the Final Rules in the Federal Register. As the characteristics of a pool determine whether or not its operator must register as CPO, the operator of a commodity pool that will be formed and launched after such 60th day will have to

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[4] *The CFTC has not yet adopted final rules on the definition of a "swap," but the effective date of the rescission of section 4.13(a)(4) will be the 60th day following the publication of the Final Rules in the Federal Register, as described below.*

register as CPO, unless it is exempt under the Regulations, even if such operator is an existing entity prior to such 60th day.

In the Final Rules, the CFTC chose not to repeal section 4.13(a)(3) (the "de minimis test"), as it indicated to do pursuant to the proposed rules published on January 26, 2011. Under section 4.13(a)(3), a CPO of a commodity pool that meets certain requirements[5] will not be required to register if:

- the commodity pool's aggregate initial margin, premiums and required minimum security deposit for retail forex transactions required to establish commodity interests, determined at the time the most recent position in commodity interest is established, do not exceed five percent of the liquidation value of the commodity pool's portfolio (after taking into account unrealized profits and losses on any positions); or
- the commodity pool's aggregate net notional value attributable to commodity interests, determined at the time the most recent position in commodity interest is established, does not exceed 100 percent of the liquidation value of the pool's portfolio (after taking into account unrealized profits and losses on any such positions).

In the Release, the CFTC noted that the inclusion of the net notional amount test in section 4.13(a)(3) provides CPOs with a less restrictive means of qualifying for the exemption set forth in section 4.13(a)(3). The CFTC also noted in the Release that it was declining to increase the trading threshold in spite of the fact that swaps are now included in calculating the threshold. However, the Final Rules permit, in applying the net notional amount test, a CPO to net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and, if appropriate, net swaps cleared by the same derivatives clearing organization. In addition, under the Final Rules, section 4.13(a)(3)(ii)(B)(1) provides that "notional value" is calculated (i) for each futures position, by multiplying the number of contracts by the size of the contract, in contract units, by the current market price per unit;

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[5] *In addition to complying with the thresholds set forth herein, in order to claim relief under section 4.13(a)(3): (i) interests in the pool must be exempt from registration under the Securities Act; (ii) the pool may not be marketed to the public in the United States; (iii) the pool may not be marketed as, or a vehicle for, trading in the commodity futures or commodity options markets and (iv) all investors in the pool must be an "accredited investor" (as defined in Rule 501(a) of the rules promulgated under the Securities Act) (or a trust that is not an accredited investor but that was formed by an accredited investor for the benefit of a family member), a "knowledgeable employee" (as defined in Rule 3c5 of the rules under the Investment Company Act) or a "QEP."*

(ii) for each option position, by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units, by the strike price per unit; (iii) for each retail forex transaction, by calculating the value in U.S. Dollars of such transaction, at the time the transaction was established, excluding the value in U.S. Dollars of offsetting long and short transactions and (iv) for any cleared swap, by the value as determined consistent with the terms of part 45 of the Regulations.

While the Regulations are silent, presumably the notional amounts of uncleared swaps must be taken into account but without getting the benefit of netting available for cleared swaps. Reference to part 45 with respect to the determination of a swap notional amount indicates that a CPO should use the same notional amount for this purpose as the one reported to the relevant swap data repository. However, there are a number of technical issues that need to be addressed in determining a swap notional amount for this purpose. For example, it is not clear how to determine the notional amount of a cross-commodity swap expressed in the quantity of two similar commodities with payments based on index prices (such as a swap on WTI crude oil against Brent crude oil settling on the final settlement price of NYMEX WTI crude oil futures against that of ICE Brent crude oil futures or a swap on wheat against corn settling on the final settlement price of MGX wheat futures against that of CBOT corn futures). It is also unclear how to determine the notional amount of a mixed swap settling on index prices (such as a swap on the COMEX settlement price of gold against the value of a narrow-based index of stock).

In the Release, the CFTC declined to provide specific relief to family offices, foreign advisors or funds of funds. Such entities may continue to rely on section 4.13(a)(3) to the extent applicable. In addition, family offices and fund of funds may continue to write in on a firm-by-firm basis to request interpretive relief from the CFTC's registration and compliance obligations. The CFTC noted that after it collects a sufficient amount of data on those entities based on Forms CPO-PQR and CTA-PR, it may exempt certain of them from registration requirements in a future rulemaking.

As a result of the repeal of section 4.13(a)(4), only those CTAs that advise pools where the operators claim an exemption under section 4.13(a)(3) may rely on section 4.14(a)(8)(i)(D) for exemption from registration as a CTA. For those CTAs that advise pools where the CPOs are required to register with the CFTC, such CTA may rely on alternative exemptions for relief from CTA registration, including section 4m(1) or 4m(3) of the CEA and sections 4.14(a)(8) and 4.14(a)(10).

MODIFICATION OF RELIEF CRITERIA UNDER SECTION 4.5

Prior to the Final Rules, section 4.5 provided an exclusion from the definition of a CPO for the operators of certain specified entities, including an investment company registered under the Investment Company Act, without imposing any restrictions on the amount of commodity interest trading or marketing of interests in such registered investment company.

The Final Rules amend section 4.5 as it applies to investment companies registered under the Investment Company Act. First, a registered investment company will be permitted, in seeking a section 4.5 exclusion, to use futures, commodity options and swaps without any restriction solely for bona fide hedging purposes within the meaning and intent of sections 1.3(z) and 151.5. In addition, a registered investment company will be permitted, again in seeking a section 4.5 exclusion, to take positions in futures, commodity options and swaps if such use meets the de minimis test where such positions do not qualify for bona fide hedging treatment under section 1.3(z) or 151.5. The de minimis test for this purpose is the same as the test discussed above under section 4.13(a)(3). In other words, a registered investment company will be eligible for a section 4.5 exclusion so long as its trading in commodity interests for purposes other than bona fide hedging meets the de minimis test.[6] The definition of bona fide hedging transaction under section 1.3(z) or 151.5 is rather restrictive, and the CFTC in the Release stated that it determined not to provide for a more expansive definition of hedging transaction, such as risk management transaction.

In order to claim a section 4.5 exclusion, a registered investment company will be required to file an annual notice of eligibility with the CFTC, which contains representations, among other things, that (i) the use of commodity futures, commodity options and swaps, other than for bona fide hedging purposes, will meet the de minimis test discussed above and (ii) participations in the registered investment company will not be marketed as interests in a commodity pool to the public.[7]

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[6] *The CFTC stated in the Release that it believes that the adoption of an alternative net notional test will provide consistent standards for relief from registration as a CPO for entities whose portfolios contain only a limited amount of derivatives positions and will afford registered investment companies with the additional flexibility in determining eligibility for exclusion.*

[7] *In the Release, the CFTC stated that whether the marketing restriction is complied with will be determined based on all relevant factors, including: the name of the fund; whether the fund's primary investment objective is tied to commodity indexes; whether the fund makes use of a controlled foreign corporation for its derivatives trading; whether the fund's marketing materials refer to the benefits of the use of derivatives in a portfolio or make*

The CFTC noted in the Release that if a section 4.5 exclusion is not available, the investment advisor of a registered investment company, rather than the board of directors for the registered investment company, is the entity required to register as the CPO. In addition, the CFTC stated that where a registered investment company forms a wholly-owned subsidiary (including a controlled foreign corporation as is routinely used in the industry) 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 may claim an exemption or exclusion on its own merits.

Due to the fact that registered investment companies are also regulated by the SEC, the CFTC proposed to amend certain provisions of part 4 in order to harmonize the SEC and CFTC compliance obligations of registered investment companies, as the advisor of such investment companies will be required to register as a CPO as a result of the amendment to section 4.5 under the Final Rules. The comment period for this proposal will end 60 days following the date of its Federal Register publication.

The compliance date for section 4.5 for registration purposes will be the later of (i) December 31, 2012 or (ii) 60 days after the effective date of the final rulemaking defining the term "swap." Entities required to register due to the amendments to section 4.5 will be subject to the CFTC's recordkeeping, reporting and disclosure requirements under part 4 within 60 days following the effectiveness of a final rule implementing the CFTC's proposed rules on the harmonization of compliance obligations of dually registered investment companies.

REPEAL OF EXEMPTIVE RELIEF FROM CERTIFICATION REQUIREMENT UNDER SECTION 4.7

Currently, financial statements contained in annual reports distributed to pool participants and filed with the NFA are not required to be certified by an independent auditor under section 4.7(b)(3)(i). However, in the Final Rules, the CFTC extends the requirement for certified financial statements in commodity pool annual reports to commodity pools with participants

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comparisons to a derivatives index; whether, during the course of its normal trading activities, the fund or an entity on its behalf has net short speculative exposure to any commodity through a direct or indirect investment in other derivatives; whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses; and whether the fund is explicitly offering a managed futures strategy. The CFTC noted that the last factor (offering a managed futures strategy) will be given more weight than the other factors.

who are QEPs. The CFTC staff will continue to consider requests for exemption from the audit requirement pursuant to the general exemptive provisions of section 4.12(a).

INCORPORATION OF ACCREDITED INVESTOR DEFINITION UNDER SECTION 4.7

The Final Rules amend sections 4.7(a)(3)(ix) and (a)(3)(x), which contain an outdated definition of "accredited investor" within the definition of "QEP", in order to incorporate the SEC's new definition of "accredited investor" by reference to section 501(a) of the Securities Act.

ANNUAL FILING OF CLAIMS OF EXEMPTION UNDER SECTIONS 4.5, 4.13 AND 4.14

Currently, persons claiming exemptive relief from inclusion in the definition of a CPO or from registration as a CPO or CTA under section 4.5, 4.13 or 4.14 are required to file only a single notice of such claim with the NFA and to comply with a few minor requirements.

The Final Rules require all persons claiming relief under section 4.5, 4.13 or 4.14 to confirm their notice of claim of exemption or exclusion on an annual basis within 30 days[8] of the calendar-year end. Alternatively, a person may withdraw the exemption due to the cessation of activities requiring registration or exemption therefrom, or withdraw such exemption and apply for registration with the NFA within 30 days of the calendar year end. Failure to comply with the annual notice requirement would result in a deemed withdrawal of the exemption or exclusion and could result in an enforcement action.

FORMS CPO-PQR AND CTA-PR

The CFTC has adopted new section 4.27, pursuant to which all CPOs and CTAs registered or required to register with the CFTC will file reports with the NFA on Forms CPO-PQR[9] and CTA-PR,[10] respectively. Large CPOs (those with at least $1.5 billion of aggregated pool assets under management) are required to file Schedules A, B and C of Form CPO-PQR within 60

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[8] *We note that the text of the Final Rule provides for a 30 day period, but the Release states that the CFTC determined to extend the 30 day period to 60 days in response to comments received from the public. We expect that this error will be fixed in the near future by the CFTC.*

[9] *Form CPO-PQR is included in the CFTC's regulations as Appendix A to part 4.*

[10] *Form CTA-PR is included in the CFTC's regulations as Appendix C to part 4.*

days following each quarter-end. Mid-sized CPOs (those with at least $150 million in aggregated pool assets under management) are required to file Schedules A and B within 90 days following the close of the calendar year. In order to eliminate duplicative filings, section 4.27(d) allows CPOs that are also registered as investment advisors with the SEC to satisfy the CFTC's reporting requirements set forth on Schedules B and C of Form CPO-PQR by completing Form PF, which has been jointly promulgated with the SEC. Form CTA-PR must be completed annually by all CTAs.

The effective date of section 4.27 and Forms CPO-PQR and CTA-PR is July 2, 2012. The compliance date for section 4.27 is September 15, 2012 for any CPO having at least $5 billion in assets under management attributable to commodity pools as of the last day of June 30, 2012; therefore, a CPO having at least $5 billion in assets under management as of June 30, 2012 must file its first Form CPO-PQR within 60 days following September 30, 2012. For all other registered CPOs and all CTAs, the compliance date for section 4.27 is December 15, 2012. As a result, most advisors must file their first Form CPO-PQR or CTA-PR based on information as of December 31, 2012.

NEW RISK DISCLOSURE STATEMENT FOR CPOS AND CTAS UNDER SECTIONS 4.24 AND 4.34

Pursuant to the Final Rules, the CFTC has amended the mandatory risk disclosure statements under sections 4.24(b) and 4.34(b) for CPOs and CTAs to describe certain risks specific to swaps transactions. The new disclosure highlights certain potential risks related to swaps, including that swaps may have limited liquidity and accordingly can be hard to value, which may result in limited liquidity for pool participants.

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Please call us if you have any questions.

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