

# Client Alert

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## CFTC Publishes Guidance on Expansive New CPO and CTA Regulations

The Commodity Futures Trading Commission (CFTC) has recently published a series of rules, interpretations and no-action letters applicable to commodity pools, commodity pool operators (CPOs) and commodity trading advisors (CTAs) that may affect a large number of private funds, mutual funds and securitization vehicles, among other types of entities. These CFTC regulations eliminate or modify important exemptions and exclusions from registration, increase reporting obligations and add "swaps" to the categories of commodity interests that are relevant for status determinations. As a result, a large number of vehicles that were not commodity pools under prior regulations, including vehicles operated outside the US, could now be classified as commodity pools, and the advisors to and operators of such vehicles should re-evaluate whether they need to register as CPOs or CTAs, take action to claim exemption or fulfill additional regulatory obligations.<sup>1</sup>

Historically, the definition of "commodity pool operator" in the Commodity Exchange Act (the CEA) focused on operators of collective investment vehicles that traded in commodity futures on registered exchanges. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) expanded the definition of "commodity pool operator" and added a new definition of "commodity pool," with the overall effect of including within the CPO regulations the operators of vehicles "trading" not only in commodity futures, but also security futures products and swaps. In addition, in the preamble to its final rule that imposes new compliance obligations in relation to commodity pools (the CPO-CTA Rule)<sup>2</sup>, the CFTC stated that pool ownership of a single swap could trigger a registration requirement.<sup>3</sup> Informal discussions with the Staff suggest a very expansive view of the term "commodity pool," even where there is no ongoing swaps activity. Moreover, all swaps that are still in existence on the applicable compliance dates — not just new swaps going forward — must be considered in determining whether a CPO or CTA must register as such.

Among other things, the CPO-CTA Rule:

- Eliminated the exemption under Rule 4.13(a)(4) for private funds offered only to "qualified eligible persons" (QEPs) as defined in CFTC Rule 4.7, and certain institutional "accredited investors." Because "qualified eligible persons" includes non-United States persons,<sup>4</sup> the elimination of the Rule 4.13(a)(4) exemption also significantly expands the extraterritorial reach of the regulations; and

"The CPO-CTA Q&A attempts to clarify many of the issues that have been raised [in relation to several new expansive regulations], but many questions remain."

- Modified the previous exclusion under Rule 4.5 for registered investment companies by requiring that companies comply with certain trading restrictions in order to rely on the exclusion and by eliminating key exemptions for CPOs in connection with controlled foreign corporations owned by registered investment companies.

Partially in response to concerns over these regulations, the CFTC provided limited no-action relief on July 10, 2012 with respect to some of the obligations applicable to CPOs and CTAs (the July 10 Letter).<sup>5</sup> Among other things, for example, this no-action letter provided that the CFTC's staff would not recommend that any enforcement actions be brought against persons operating or advising commodity pools that were launched *after* the date of the July 10 Letter and which would have qualified for exemptions that were rescinded or modified by the CPO-CTA Rule. One issue that neither the CPO-CTA Rule nor the July 10 Letter directly addressed was whether funds that were previously not considered to be commodity pools (because they only engaged in swaps) would be granted any temporary relief from the new regulatory requirements — including the potential requirement to register a person or entity as a CPO and/or CTA.

On August 14, 2012, the CFTC responded to many of the lingering questions regarding the regulations applicable to CPOs and CTAs and the timing of registration requirements by way of a further publication (the CPO-CTA Q&A).<sup>6</sup> The CPO-CTA Q&A, and our discussion of it that follows, are rather technical and refer to a number of exclusions and exemptions that may be unfamiliar to our clients who have not previously engaged in activity subject to the CEA. Please contact any of the attorneys who contributed to this *Client Alert* directly for further guidance on these matters.

## **Discussion of Specific Topics Addressed in the CPO-CTA Q&A**

### **1. Compliance Dates and Transitions**

As discussed above, CPO and CTA regulations did not previously apply to the operators of and advisors to funds that engaged in swaps so long as the funds did not engage in certain types of derivatives instruments like futures and options. However, the Dodd-Frank Act extended the CFTC's jurisdiction to pools entering also into swaps. The timing of the inclusion of swaps in the CPO and CTA regulations is tied to the effective date of the so-called "Product Definitions Release" further defining "swaps," which was jointly promulgated by the CFTC and the Securities and Exchange Commission (the SEC) and takes effect on October 12, 2012. Timing is also affected by the effective dates of the rule changes in the CPO-CTA Rule, the expiration of temporary relief from the effectiveness of certain provisions of the Dodd-Frank Act previously granted by the CFTC and the July 10 Letter described above. As a result of the interplay of these various documents, there has been ongoing confusion as to the effective date of the registration requirement, especially for CPOs and CTAs becoming subject to the requirement for existing funds that hold swap positions. The CPO-CTA Q&A, however, clarifies that operators of and advisors to funds that engage in swaps will not have to consider swaps in the evaluation of the funds' status as commodity pools (and thus will not have to register as a result of such swaps) until December 31, 2012.<sup>7</sup>

In addition, the Staff stated that funds transitioning from an exemption under 4.13(a)(4) to 4.13(a)(3) must submit a request to withdraw the 4.13(a)(4) exemption with

the National Futures Association, file a new exemption under Regulation 4.13(a)(3) and provide notice to all participants of this change. Staff also provided guidance on transitioning to the more limited exemption provided by Rule 4.7, and indicated that this rule is available to entities that did not comply with some of its provisions at the time of pool formation since they were in compliance with other provisions of Part 4 of the CFTC's rules. All such transitions need to be accomplished by December 31, 2012.

## 2. Reliance on Regulation 4.13(a)(3)

Rule 4.13(a)(3), also referred to as the "private fund *de minimis* exemption," exempts persons who are operators of funds for which: (i) interests in the pool are exempt from registration under the Securities Act of 1933 (the Securities Act); (ii) the pool engages in a limited amount of trading in commodity interests (e.g., futures, swaps and options); (iii) participation in the pool is limited to certain types of qualified investors and (iv) the pool is not marketed as a vehicle for trading in commodity interests.<sup>8</sup> There are two tests for "limited trading": (i) the "5 percent test" that compares the amount of margin, premiums and minimum security deposits used to establish the positions in commodity interests to the fund's liquidation value and (ii) the "alternative net notional" test, which looks at whether the net notional value of the commodity interest positions, measured at the time the most recent position is put on, is more than 100 percent of the fund's liquidation value. Many market participants were unclear how to apply the private fund *de minimis* exemption to the operators of funds engaging in swaps. While the CPO-CTA Q&A does not address all of these questions, it did clarify the following:

- The operator of a fund that enters into a swap prior to putting on its first deal (e.g., in order to hedge interest rate or foreign exchange risks associated with an upcoming deal or loan) will have a "reasonable time" to comply with the trading thresholds. Therefore, such an operator may still qualify for the 4.13(a)(3) exemption even though it technically would temporarily exceed the trading thresholds. The determination of a "reasonable time" will be a facts-and-circumstances test.
- The CFTC plans to amend Rule 4.13(a)(3) to correct an error in which a cross-reference to deleted Rule 4.13(a)(4) remained in the rule. The Staff confirmed explicitly that all QEPs, and in particular non-US persons, will continue to be eligible investors under Rule 4.13(a)(3).
- The compliance date for entities that claimed relief under Rule 4.13(a)(4)<sup>9</sup> prior to April 24, 2012, will be December 31, 2012. Any such entity will need to register or transition to and claim an exemption under Regulation 4.13(a)(3) by such date. Similarly, an entity that previously claimed an exemption under 4.13(a)(4) and that operates a pool launched after April 24, 2012 can rely on 4.13(a)(4) until December 31, 2012 in accordance with the July 10 Letter (although that entity must file certain notifications with the CFTC before doing so). Entities relying on previous no-action relief that allowed them to claim an exemption without specifying the particular provision on which they relied must re-file to maintain that exemption.
- CPOs do not need to file a 2012 annual report for pools that have their exemption under Regulation 4.13(a)(4) withdrawn on January 1, 2013.

### **3. Trading Limits**

The CPO-CTA Q&A addresses various issues regarding the tests for limited trading set forth in Regulations 4.5 and 4.13(a)(3). In particular:

- The Staff reiterated that compliance with the trading limits is measured at the time the fund enters into its most recent position, and that therefore the fund would not be required to exit the position for the CPO to maintain the exemption if the test was not met at a later time (for instance due to a reduction in liquidation value of the fund).
- The Staff further clarified that the liquidation value of a pool's portfolio does include cash positions, and that commodity options with the same underlying can be netted across designated contract markets and foreign boards of trade. This may be useful for funds engaged in cross-market purchases.
- The Staff stated that, under Rule 4.5, *bona fide* hedging does *not* include equitization of cash or risk management.
- Finally, the CFTC stated that funds-of-funds could continue to rely on an appendix to the CFTC's regulations that was rescinded by the CPO-CTA Rule. That appendix provided certain safe harbors for such funds in terms of satisfying the limited trading requirements of Rule 4.13(a)(3). These funds may continue to rely on that safe harbor until the CFTC issues revised guidance on the subject.

### **4. Timing of Further Guidance on Forms CPO-PQR and CTA-PR**

The Staff has decided to defer releasing additional guidance with respect to Forms CPO-PQR and CTA-PR until such time as all filers have had adequate time to review and comment on certain key issues. Due to this delay, the CPO-CTA Q&A states that the Division "would not expect immediate compliance" by the large entity filers until further guidance is issued on the subject. To the extent that an entity must file such Forms prior to the issuance of guidance from the CFTC, the CPO-CTA Q&A states that such entities should make reasonable assumptions consistent with a good faith effort to comply with the filing obligations.

### **5. Directors'/Trustees' Liability**

In the CPO-CTA Rule, the Staff specifically stated that the directors and trustees of mutual funds will not have to register as CPOs if those mutual funds no longer qualify for the exclusion from the definition of commodity pool under Rule 4.5 and the fund's investment adviser registers as the CPO. However, the Staff noted that certain liabilities arising under the CEA would continue to apply to those directors and trustees, including liability arising as a result of violations of the anti-fraud and anti-manipulation provisions.

### **6. Extraterritorial Application**

The CPO-CTA Q&A clarified that Advisory 18-96,<sup>10</sup> which provides registered CPOs with relief from certain books and records requirements in connection with their offshore funds, remains available. In addition, CPOs that formerly relied on Rule 4.13(a)(4) in connection with their offshore funds will have to consider other rules and guidance in evaluating whether they will have to register with the CFTC. In particular, the CFTC very recently revised Rule 3.10 to clarify that CPOs and CTAs located outside the US and acting on behalf of persons located outside the US and its territories do not need to register if they are executing commodity interest transactions (including swaps) bilaterally or pursuant to the rules of an exchange or

swap execution facility, as long as they submit the commodity interests for clearing through a CFTC-registered futures commissions merchant.<sup>11</sup> An exemption under Rule 4.13(a)(3) may also be available for some non-US funds.

## Conclusion

The changes to the requirement for CPO and CTA registration bring many new entities within the scope of the CFTC's rules. The CPO-CTA Q&A attempts to clarify many of the issues that have been raised in this regard, but many questions remain. We will continue to monitor and analyze these developments and provide our clients with periodic updates of noteworthy developments in this area. If you need further information about the regulatory system applicable to CPOs and CTAs, please contact one of the attorneys listed at the bottom of this *Client Alert* or the Latham attorney with whom you normally consult and we will be happy to assist.

### Endnotes

- <sup>1</sup> See Latham & Watkins *Client Alert, Final CFTC Rules Maintain Limited Trading Exemptions But May Require Many More Investment Advisers to Investment Funds to Register as CPOs and CTAs* (March 2, 2012), available [here](#).
- <sup>2</sup> Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. 7976 (Feb. 11, 2011); *corrected by* Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations., 77 Fed. Reg. 17328 (March 26, 2012).
- <sup>3</sup> In the CPO-CTA Rule, in describing the need to include swaps in its formulation of the *de minimis* threshold under its Section 4.13(a)(3) exemption, the CFTC stated that holding a single swap could cause an entity to be a commodity pool:  

If swaps were excluded, any swaps activities undertaken by a CPO would result in that entity being required to register because there would be no *de minimis* exclusion for such activity. As a result, one swap contract would be enough to trigger the registration requirement.

CPO-CTA Rule, 77 Fed. Reg. at 11258.
- <sup>4</sup> While the CFTC recently released guidance on the extraterritorial application of Dodd-Frank provisions and defined the term "U.S. person," the term "non-United States person" here refers to that term as used in existing CFTC Regulation 4.7(a)(iv). These terms differ in certain ways.
- <sup>5</sup> See CFTC Letter 12-03 (July 10, 2012).
- <sup>6</sup> See Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions — CPO/CTA: Amendments to Compliance Obligations (August 14, 2012).
- <sup>7</sup> See CPO-CTA Q&A, p. 6.
- <sup>8</sup> See 17 C.F.R. § 4.13(a)(3).
- <sup>9</sup> Regulation 4.13(a)(4) exempted from registration operators of commodity pools that limit participation in those pools to certain enumerated types of sophisticated investors.
- <sup>10</sup> See CFTC 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 (April 11, 1996).
- <sup>11</sup> See Registration of Intermediaries, RIN 3038-AC96 (not yet published in the Federal Register). Additionally, Section 4(m)(1) of the CEA requires any commodity pool operator that uses the mails or any means or instrumentality of interstate commerce in connection with its business as such commodity pool operator to register as a CPO. See 7 U.S.C. § 6(m)(1).

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