

INVESTMENT MANAGEMENT NEWS

CLIENT ALERT:

EXEMPTION FROM CPO/CTA REGISTRATION REQUIREMENTS FOR OPERATORS AND ADVISERS OF CERTAIN POOLS

On November 6, 2002, the Commodity Futures Trading Commission ("CFTC") issued rule proposals that, if adopted as proposed, would make sweeping changes in the commodity pool operator ("CPO") and commodity trading advisor ("CTA") registration requirements for managers of private funds that utilize commodity futures in their investment management strategies.¹ The result would be that many operators and advisers that would be subject to CPO or CTA registration under current rules and interpretations would be exempt.

Under the current regulatory regime, a private fund that invests in commodities futures contracts, including financial futures such as U.S.-traded stock index futures, stock index futures traded outside of the United States and security futures², would be considered a "commodities pool" irrespective of the

amount of commodity interests involved. It is common for private funds that are primarily securities-oriented to use financial futures to hedge securities positions. Operators of commodity pools are required to register with the CFTC as CPOs and advisers to commodity pools are required to register as CTAs if they are located in the United States or if the fund they operate or advise has investors in the United States. Moreover, the Staff of the CFTC (the "Staff") takes the position that holding an interest in a commodity pool is tantamount to holding an interest in the commodity futures contracts held by the commodity pool. Thus, the Staff takes the position that a fund investing in a commodity pool is itself a commodity pool, thus exposing its operators and advisers to the requirement to register as CPOs or CTAs.

It is not surprising therefore that, with the enormous increase in private investment funds over the last few years and with operators and advisers having few exemptions to avail themselves of with respect to the requirement to register either as CPOs or CTAs, the CFTC and the National Futures Association ("NFA") have seen a substantial increase in registrations of CPOs and CTAs, most of which have investment strategies which focus mainly on securities and not commodities trading. In light of the increase in registrations of operators and advisers to funds which are primarily investing in securities rather than commodities, two new rules

¹ Commodity Futures Trading Commission, Advance Notice of Proposed Rulemaking, Commodity Pool Operators and Commodity Trading Advisors; Exemption from Requirement to Register for CPOs of Certain Pools and CTAs Advising Such Pools (Nov. 6, 2002).

² Security futures are futures contracts on individual stocks ("Single Stock Futures") and narrow-based stock indices. Single Stock Futures are standardized agreements between two parties to buy or sell a set number of shares of a particular stock in the future at a price determined today. Futures on narrow-based indices are futures contracts on small groups of stocks that allow an investor to take a position in a concentrated area of the equities market. Trading in security futures was prohibited in the U.S. until the recent passage of the Commodity Futures Modernization Act of 2000.

have been proposed which would allow for relief from the registration requirements for many operators of and advisers to private investment funds. The new rules derive from proposals by the NFA and the Managed Funds Association (“MFA”). This memorandum will discuss briefly the two proposals and the “temporary” no-action relief provided during the rulemaking process.

THE MFA PROPOSAL

The more sweeping of the two proposals is that suggested by the MFA, which would be embodied in a new Rule 4.9. In its current form, the proposed rule would exempt a manager from registration as a CPO, provided that:

- > interests in all pools that it operates are exempt from registration under the Securities Act of 1933, and such interests are offered and sold without marketing to the public in the United States;
- > it reasonably believes that, at the time of investment, all individual investors in all pools that it operates are qualified eligible persons;³
- > it reasonably believes that, at the time of investment, all entity investors in all pools that it operates are (i) accredited investors⁴ or (ii) qualified eligible persons; and
- > neither the CPO nor any of its principals are subject to statutory disqualifications under the Commodity Exchange Act.⁵

³ As defined in CFTC Rule 4.7.

⁴ As defined in Rule 501(a) under the Securities Act of 1933; for example, a bank with total assets in excess of \$5,000,000. See 17 CFR 501.3(i)46.1(o)-7(s) of the Commodity Exchange Act 46.1(n)-0)5d be qu,w(it)993(h)2.3in8 ments-1()6cerntifie byiundpeinhe n(s, odi, i

otherwise be subject to CPO or CTA registration under current rules and interpretations. The no-action relief must be claimed through the filing of a notice with the NFA and the CFTC and a disclosure to prospective and existing participants. Note that this relief is temporary in that it will be superceded by any final action taken by the CFTC as a result of the rulemaking.

To make a claim for such no-action relief from CPO registration, the CPO must represent the following with respect to its pools:

- > participation in the pool is restricted to accredited investors, knowledgeable employees, Non-United States persons,⁶ and certain other persons; and
- > the aggregate notional value⁷ of each pool's commodity interest positions, whether entered into for *bona fide* hedging⁸ purposes or otherwise, does not exceed fifty percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into.

⁶ As defined in CFTC Rule 4.7(a)(1)(iv).

⁷ For this purpose, a CPO should calculate "notional value" for each such futures position by multiplying the size of the futures contract, in contract units, by the current market price per unit, and for each such option position by multiplying the size of the option contract, in contract units, by strike price. The criterion is patterned on the CFTC's recently proposed alternative non-hedge operating criterion for Rule 4.5.

⁸ As defined in CFTC Rule 1.3(z), the CFTC formulated the concept of "bona fide hedging" in terms of hedging physical commodities, such as goods that are manufactured or sold, rather than financial futures. Thus, the CFTC's definition refers to "transactions or positions [that] normally represent a substitute for transactions to be made or positions to be taken at a later time in a *physical marketing channel*, and where they are economically appropriate to the reduction of risks in the conduct and management of a *commercial enterprise...*" (emphasis added).

To make a claim for such no-action relief from CTA registration, the CTA must represent the following with respect to the pools it advises:

- > it claims relief from CPO registration under No-Action Relief and its commodity interest trading advice is directed solely to, and for the sole use of, the pool or pools that it operates; or
- > it is registered as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act") or with the applicable regulatory agency of any state, or it is exempt from such registration, or it is excluded from the definition of the term "investment adviser" under the Advisers Act, provided that it meets certain other criteria.

We will continue to monitor further developments in this area during the comment period on this proposed rule, which closes on January 13, 2003. Please contact either Mark H. Barth, at (212) 696-6059, or Victor L. Zimmermann, Jr., at (203) 388-0849, with any questions regarding this memorandum or the proposed rule.

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