# CFTC Rescinds and Revises Hedge Fund Registration Exemptions and Adds Reporting Requirements

The Commodity Futures Trading Commission ("CFTC") recently announced final rules rescinding or revising registration exemptions for private funds, and revising the exclusion for registered investment companies. As a result, hedge fund sponsors and advisors will need to determine whether an alternative exemption is available or whether registration is required. Registered investment companies will have to examine the structure and amount of trading in futures, options and swaps, as well as their marketing to determine whether their advisors will have to register. A separate alert relating to registered investment companies is forthcoming.

## Rescission of CFTC Rule 4.13(a)(4)

On February 9, 2012, the CFTC adopted a final rule rescinding the exemption from commodity pool operator registration for private funds whose investors are "qualified purchasers[1]" or entities that are "accredited investors[2]" (Rule 4.13(a)(4)). Private funds currently operating under the Rule 4.13(a)(4) exemption have until December 31, 2012 to comply with CFTC rules without relying on Rule 4.13(a)(4). New funds will not be able to rely on Rule 4.13(a)(4) beyond 60 days from the publication of the final rule in the Federal Register, which is expected shortly.

## Revision of CFTC Rule 4.13(a)(3)

The CFTC determined to maintain the Rule 4.13(a)(3) exemption, which it had also proposed to rescind, for funds which trade only a *de minimis* level of commodity interests and which are not marketed as vehicles for trading in commodity interests. The CFTC did, however, revise the exemption to take into account swaps trading in the *de minimis* threshold calculations. Under the Rule 4.13(a)(3) exemption, a fund must keep its trading below a 5% threshold level[3] or keep the net notional value[4] of its derivatives trading from exceeding 100% of the liquidation value of the fund's portfolio. Private fund operators that have typically relied on Rule 4.13(a)(4) may be able to rely instead on the exemption in Rule 4.13(a)(3). However, doing so may be more difficult than in the past since swaps will now be taken into account. Moreover, it is often particularly difficult for a fund-of-funds to rely on the *de minimis* exemption, since a fund-of-fund's ability to qualify for the exemption depends on the level of commodity interest trading at the underlying fund level. Under the amended rule, fund sponsors claiming relief under Rule 4.13 must now confirm their claim of exemption on an annual basis. The compliance date for revised Rule 4.13(a)(3) is December 31, 2012.

## CFTC Rule 4.7(b)

Funds that cannot meet either of the *de minimis* tests or the marketing restriction of Rule 4.13(a)(3) may be able to qualify for exemptive relief under CFTC Rule 4.7. However, Rule 4.7 is available only ***after*** a fund

[1] "Qualified purchaser," as defined under the *Investment Company Act of 1940*, generally means an individual with an investment portfolio of at least $5 million and an entity with an investment portfolio of at least $25 million.
[2] "Accredited investor" is defined in Regulation D under the *Securities Act of 1933*, and generally means an individual with a net worth exceeding $1 million and an entity with total assets exceeding $5 million.
[3] Generally, this means that the aggregate initial margin, premiums and required minimum security deposit required to establish commodity interest positions does not exceed 5% of the liquidation value of the fund's portfolio, after taking into account unrealized profits and unrealized losses on any such positions.
[4] Generally, this means that the aggregate net notional value of such positions, determined at the time the most recent position is established, does not exceed 100% of the liquidation value of the fund's portfolio, after taking into account unrealized profits and unrealized losses on any such positions.

operator registers as a commodity pool operator and only if all investors are "qualified eligible persons[5]." Once registered, the fund sponsor can claim relief from specific disclosure, recordkeeping and reporting requirements otherwise applicable to registered commodity pool operators. Registration requires submitting to the National Futures Association an application and fees for the firm, and applications, fingerprints and fees for the firm's principals and "associated persons[6]." Associated persons and branch mangers must also submit proof of passage of required proficiency exams.

Registered commodity pool operators that claim exemptive relief under Rule 4.7 are subject to periodic onsite audits by the National Futures Association, must include prescribed disclosures in their offering memoranda and audited financials, must provide monthly or quarterly reports to investors, and must provide annual audited financial reports to investors and the National Futures Association. They must also provide additional quarterly reports to the National Futures Association disclosing the identity of the pool's administrator, carrying brokers, trading managers and custodians and a schedule of investments identifying any investment that exceeds 10% of the fund's net asset value. Quarterly and annual risk reporting is also required beginning in the fourth quarter of 2012 or the first quarter of 2013, depending on the level of assets under management of the commodity pool operator. There are also recordkeeping, advertising and know-your-customer rules. Periodic ethics training is mandatory. Further, written compliance policies and procedures must be adopted and implemented. Finally, there are periodic filings with, and fees to, the National Futures Association.

## Revision of CFTC Rule 4.14(a)(8); CFTC Rule 4.7(c)

The rescission of the Rule 4.13(a)(4) exemption also means that investment advisors to private funds will no longer be able to rely on the exemption from commodity trading advisor registration in Rule 4.14(a)(8) for advisors to funds operating under the Rule 4.13(a)(4) exemption. These advisors will need to find another exemption from registration, or register as a commodity trading advisor. If an advisor is able to continue relying on another provision of Rule 4.14(a)(8) (for example, if the fund determines to rely on Rule 4.13(a)(3) instead), it must now confirm its claim of exemption on an annual basis. The compliance date for revised Rule 4.14(a)(8) is December 31, 2012.

Advisors may be able to use registration exemptions under *Commodity Exchange Act* Sections 4m.(1) or 4m.(3). The exemption under Section 4m.(1) covers advisors which have not provided commodity trading advice to more than 15 persons[7] during the course of the preceding 12 months, and do not hold themselves out generally to the public as a commodity trading advisor. The exemption under Section 4m.(3) covers advisors that are registered with the Securities and Exchange Commission (the "SEC") as investment advisors whose business does not consist primarily[8] of acting as a commodity trading advisor and that do not act as a commodity trading advisor to any commodity pool engaged primarily in trading commodity interests.[9]

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[5] "Qualified eligible person" is defined in CFTC Rule 4.7 and generally means accredited investors with at least a $2 million portfolio.

[6] "Associated person" is defined in CFTC Rule 1.3(aa) and generally means persons who solicit investors and those who supervise such persons.

[7] A fund ordinarily is considered as one person for this purpose.

[8] A commodity trading advisor or a commodity pool is considered to be "engaged primarily" in the business of being a commodity trading advisor or a commodity pool if it is, or holds itself out to the public as being, primarily, or proposes to engage primarily, in the business of advising on commodity interests or owning, investing or trading in commodity interests, respectively.

[9] Commodity interests include futures contracts, options thereon, security futures, swaps, leverage contracts, foreign exchange, spot and forward contracts on physical commodities, and any monies held in an account used for trading commodity interests.

If the advisor must register as a commodity trading advisor, and if all of the advisor's clients are qualified eligible persons, the advisor can claim disclosure and recordkeeping relief under Rule 4.7. Commodity trading advisor registration involves essentially the same process as for commodity pool operators. Registered commodity trading advisors that claim exemptive relief under Rule 4.7 are subject to periodic onsite audits by the National Futures Association. Disclosure documents or investment advisory agreements must contain a prescribed legend, representation and consent. Annual risk reporting is also required beginning in the first quarter of 2013. There are also recordkeeping, advertising and know-your-customer rules. Periodic ethics training is mandatory. Further, written compliance policies and procedures must be adopted and implemented. Finally, there are periodic filings with, and fees to, the National Futures Association.

## New CFTC Rule 4.27

Finally, the CFTC adopted new Rule 4.27, which requires commodity pool operators and commodity trading advisors to report certain information to the CFTC on Forms CPO-PQR and CTA-PR, respectively. Reports must include a description of certain information, such as the amount of assets under management, use of leverage, counterparty credit risk exposure, and trading and investment positions. Rule 4.27 becomes effective on July 2, 2012. The compliance dates for reporting are: 60 days after the end of the commodity pool operator's first calendar quarter ending after July 2, 2012 for commodity pool operators having at least $5 billion in assets under management; 60 days after the end of the commodity pool operator's first calendar quarter ending after December 14, 2012 for all other commodity pool operators with assets of $1.5 billion or more; and 90 days after calendar year end 2012 for all other commodity pool operators and for commodity trading advisors. The amount of information to be reported depends on the level of assets under management. The CFTC's new reporting requirements generally supplement SEC reporting requirements for registrants that must file Form PF with the SEC by virtue of their dual registration status, so that filings with the SEC and the CFTC will be required, although only certain portions of the CFTC form must be completed.

If you would like to learn more about the issues raised in this alert, please contact your usual Ropes & Gray advisor.