Commodity Futures Trading Commission Adopts Final Rules Limiting Exclusion from Registration for Registered Investment Companies

On February 9, 2012, the Commodity Futures Trading Commission (the "CFTC") adopted amendments to Rule 4.5 under the Commodity Exchange Act, limiting the availability of the exclusion from the definition of commodity pool operator ("CPO") relied upon by many registered investment companies. The CFTC also proposed new rules to harmonize compliance obligations for entities required to register with both the Securities and Exchange Commission (the "SEC") and the CFTC.

A registered investment company using commodity futures, options on commodities or commodity futures, or swaps is considered a CPO, triggering an obligation to register with the CFTC, unless the investment company satisfies the exclusion set forth in Rule 4.5. Before the recent amendments, Rule 4.5 provided an exclusion from the definition of CPO to registered investment companies, regardless of the level of derivatives use. In response to the increasing use of futures by registered investment companies, in June 2010, the National Futures Association (the "NFA") petitioned the CFTC to revise Rule 4.5 with respect to registered investment companies. The CFTC solicited public comment on the NFA's petition for rulemaking (for further information on the proposed rules, please see our January 28, 2011 Alert) in a process that culminated in the recent rule amendments.

As further discussed below, the CFTC has not yet defined "swaps." Registered investment companies that invest in commodity futures, options on commodities or commodity futures, or swaps must comply with amended Rule 4.5 for registration purposes by December 31, 2012 or, if later, the 60th day after the CFTC has provided a final definition of "swaps."

At the same time as the CFTC adopted the amendments to Rule 4.5, it also adopted changes to other CPO exemptions, including Rules 4.13(a)(3) and 4.13(a)(4), which will significantly affect the regulatory landscape for managers of private funds. Those changes are not discussed below, but are addressed in detail in a companion Alert, which is available here.

A summary of the amendments to Rule 4.5 appears below. The CFTC's release addressing the amendments may be found here.

Trading Thresholds

The trading threshold test adopted by the CFTC provides that a registered investment company can claim an exclusion from the definition of CPO under amended Rule 4.5 only if it meets at least one of the following two tests:

1. The aggregate initial margin and premiums required to establish commodity futures, options thereon or on commodities, or swap positions do not exceed five percent of the liquidation value of the registered investment company's portfolio, after taking into account unrealized profits and unrealized losses. A registered investment company may, however, use commodity futures, options thereon or on commodities, or swaps solely for "bona fide hedging purposes" (as defined in Rule 1.3(z)(1) and Rule 151.5) without counting them towards the threshold.[1] Additionally, in

[1] The definition of "bona fide hedging" is technical and does not necessarily include all transactions that may commonly be considered to be "hedging."

the case of an option that is in-the-money at the time of the option's purchase, the in-the-money amount may be excluded in calculating the value of such contracts for purposes of the five percent threshold.

2. The aggregate net notional value of commodity futures, options thereon or on commodities, or swap positions not used solely for "bona fide hedging purposes," determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the registered investment company's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. Amended Rule 4.5 sets forth the requirements for the calculation of "notional value" and provides that a registered investment company may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and swaps cleared on the same designated clearing organization where appropriate.

A commodity futures contract includes most futures contracts (e.g., commodity futures include not just futures on agricultural commodities but also futures on financial instruments and indices), and swaps, although the rule defining "swaps" is not yet finalized, are expected to include most over-the-counter derivatives on assets other than a single security (e.g., swaps are expected to generally include interest rate swaps and broad-based security index options). Thus, for purposes of the percentage thresholds described in the Rule 4.5 tests, only swaps and other instruments subject to CFTC jurisdiction are counted in the numerator.

Marketing Restriction

A registered investment company claiming exclusion under amended Rule 4.5 may not be, and may not have been, "marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options, or swaps markets." The adopting release lists the following factors which the CFTC stated it would consider in making the determination whether a registered investment company complies with the marketing restriction:

- The name of the fund;
- Whether the fund's primary investment objective is tied to a commodity index;
- Whether the fund makes use of a commodity subsidiary for its derivatives trading;
- Whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;
- Whether, during the course of its normal trading activities, the fund or entity on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;
- Whether the futures/options/swap 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 while no single factor is dispositive, it will give more weight to the final factor in the list above when determining whether a registered investment company is operating as a *de facto* commodity pool; however, if a registered investment company offers a strategy with several indicia of a managed futures strategy, yet avoids explicitly describing the strategy as such in its offering materials, the registered investment company may still be found to violate the marketing restriction.

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Commodity Subsidiaries

The CFTC also stated that commodity subsidiaries used for trading in commodity interests by registered investment companies will be required to have their CPOs register with the CFTC unless they may claim an exemption or exclusion on their own merits. The CFTC explained that it believes that each separate legally cognizable entity must be assessed separately, and a commodity subsidiary should not be entitled to claim exclusion simply because its parent company is a registered investment company that may be entitled to exclusion under Rule 4.5. Further, the CFTC believes that commodity subsidiaries that are wholly owned by registered investment companies and used for trading commodity interests are properly considered commodity pools. As discussed in more detail in our companion Alert, the CFTC rescinded the exemption from CPO registration in Rule 4.13(a)(4) previously relied upon by some commodity subsidiaries; consequently, the CPOs of such commodity subsidiaries will likely need to register unless they can fit under another exemption from registration.

The Internal Revenue Service (the "IRS") has also been reevaluating the practice of registered investment companies that are regulated investment companies under the Internal Revenue Code of 1986 ("RICs") of obtaining indirect exposure to commodities through, among other things, commodity subsidiaries and, in July 2011, suspended its issuance of private letter rulings to RICs in this area (see our prior Alert for more discussion of the IRS's suspension). The ruling suspension remains in effect as the IRS continues to evaluate its prior rulings and whether to issue industry-wide guidance.

Entity Required to Register as CPO

If a registered investment company cannot claim an exclusion under Rule 4.5, the CFTC clarified in the adopting release that the investment adviser to the investment company is the appropriate entity to register as the CPO (rather than the investment company itself or the board of directors of the investment company).

CTA Registration

Currently, many advisers to registered investment companies rely on Rule 4.14(a)(8) for an exemption from registration as a commodity trading advisor ("CTA"). To satisfy Rule 4.14(a)(8), an adviser must advise solely registered investment companies satisfying Rule 4.5 and certain other "qualifying entities," or certain private and non-U.S. funds. If a registered investment company does not meet the requirements for an exclusion under amended Rule 4.5, then it is not a "qualifying entity" for purposes of Rule 4.14(a)(8), and the adviser to that investment company may no longer be able to rely on Rule 4.14(a)(8) for an exemption from registration. Consequently, such an adviser would need to find another exemption from CTA registration or register as a CTA.

Reporting Requirements – Form CPO-PQR

The CFTC also adopted new Rule 4.27, which requires advisers to registered investment companies that are registered as CPOs to submit reports on Form CPO-PQR. 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 for each registered investment company. The amount of information to be reported depends on the assets under management.

Annual Notice Requirement

Before the recent amendments, registered investment companies claiming an exclusion under Rule 4.5 were required to file only an initial notice of the claim with the NFA and to comply with specific disclosure

requirements. The CFTC's recent amendments require all registered investment companies claiming exclusion under Rule 4.5 to confirm their notice of claim of exclusion on an annual basis, within 60 days following each calendar year-end, by means of a filing with the NFA. A registered investment company claiming exclusion under Rule 4.5 must affirmatively withdraw the claim for exclusion and apply for registration following calendar year-end if it ceases to be eligible for the exclusion during the calendar year.

Compliance Dates

In recognition of the fact that the rule defining the term "swap" has not yet been finalized, the CFTC stated that advisers to registered investment companies that do not satisfy amended Rule 4.5 must register as CPOs no later than the later of December 31, 2012 or 60 days after the effective date of the final rulemaking further defining the term "swap," which the CFTC is currently expected to publish by mid-July 2012. Advisers to registered investment companies that will be required to register due to the amendments to Rule 4.5 will not be subject to the CFTC's recordkeeping, reporting and disclosure requirements until 60 days after the effectiveness of a final rule implementing the CFTC's proposed harmonization effort (discussed below).

Rule 4.27 becomes effective on July 2, 2012. The compliance dates for reporting are 60 days after the end of the CPO's first calendar quarter ending after July 2, 2012 for CPOs with at least $5 billion in assets under management; 60 days after the end of the CPO's first calendar quarter ending after December 14, 2012 for CPOs with assets of $1.5 billion or more; and 90 days after calendar year end 2012 for all other CPOs and for all CTAs.

Proposed Rules to Harmonize Compliance Obligations

Many commenters observed that registered investment companies whose advisers would be subject to registration as CPOs under the revised Rule 4.5 may be subject to duplicative, inconsistent and potentially conflicting disclosure and reporting requirements. To address these concerns, the CFTC is proposing amendments to its regulations.

The proposed amendments address the following areas: (1) the timing and delivery of disclosure documents to prospective participants; (2) the requirement that a sponsor receive a signed acknowledgment of disclosure documents before accepting or receiving funds, securities or other property from a prospective participant; (3) the frequency of required updates for the disclosure documents; (4) the timing of financial reporting to participants; (5) the requirement that a CPO maintain its books and records at its main business office; (6) the required disclosure of fees; (7) the required disclosure of past performance; (8) the inclusion of mandatory certification language; and (9) the SEC-permitted use of a summary prospectus for open-ended registered investment companies. The CFTC's proposals include changing current CFTC rules and providing specific relief from certain rules. Comments will be due on the proposals approximately 60 days after the proposed rules are published in the Federal Register, which is expected shortly. The release proposing the amendments can be found here.

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

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If you would like to learn more about the developments discussed in this alert, please contact the Ropes & Gray attorney with whom you regularly work or any partner in the Ropes & Gray Investment Management group, listed below.

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