

CFTC Adopts Final Rules Requiring CPO Registration by Certain Hedge Fund and Private Equity Fund Managers

In final rules (the “**Final Rules**”) recently adopted by the Commodity Futures Trading Commission (the “**CFTC**”),¹ the CFTC has withdrawn an exemption from registration as a commodity pool operator (“**CPO**”) that has been widely relied upon by managers² of hedge funds and private equity funds that engage in futures transactions for hedging and other investment objectives.³ The Final Rules also extend the now expanded CPO registration requirement to fund operators that use swaps, in addition to futures contracts.

As a result of these changes, the managers of funds that engage in more than narrowly prescribed futures and/or swaps activities will need to register with the CFTC as a CPO and become a member of the National Futures Association (the “**NFA**”) by **December 31, 2012**. A fund manager who plans to launch any such fund after **April 24, 2012** will also need to consider whether it must register prior to launching the fund. CPO registration covers all funds operated by a CPO that qualify as commodity pools by virtue of trading activity in futures, swaps and certain other instruments subject to CFTC jurisdiction.

CPO registration will subject the manager and certain employees to detailed CFTC and NFA rules and regulations, such as:

- Client-facing employees and their supervisors must register as “associated persons,” become members of the NFA and pass a proficiency exam;

¹ 77 Fed. Reg. 11,252 (Feb. 24, 2012). This Memorandum highlights only those key elements of the Final Rules relevant to hedge fund and private equity fund managers, in particular the CFTC’s repeal of the exemption in CFTC Rule 4.13(a)(4) for CPOs of private funds that are not restricted in the scope of their futures trading but whose participants are limited to certain sophisticated investors.

² References in this Memorandum to fund “managers” are intended to encompass those persons responsible for the operational management of the relevant fund and who fall within the definition of “commodity pool operator” under Commodity Exchange Act (the “**CEA**”) Section 1a(11), rather than to investment managers (who may, under appropriate circumstances, also function as commodity pool operators). See Note 4 below.

³ CFTC Rule 4.13(a)(4).

- Portfolio-related reports must be made to the CFTC, NFA and investors;
- The manager will be subject to CFTC recordkeeping rules;
- The manager will be subject to NFA supervision requirements, including requirements to implement and maintain compliance procedures, review and supervision of promotional materials and review of e-mails and other communications; and
- The manager and all fund records will be subject to examination by the CFTC and the NFA.

Willful violation of the CPO registration requirement is a felony punishable by a fine of not more than \$1,000,000 or imprisonment for not more than ten years, or both, together with the costs of prosecution. A private right of action may also be available in certain cases, with recovery by the plaintiff generally limited to actual damages.

Who May Be Covered?

- **Managers of Funds that Use CFTC-Regulated Derivatives.** Subject to a limited exemption described below, every manager of a fund that uses CFTC-regulated derivatives (called “commodity interests”) – even if used solely for hedging purposes – will potentially be subject to CPO registration.⁴ While the definition of “commodity pool” technically covers only collective investment vehicles “operated for the purpose of trading commodity interests,” the preamble to the Final Rules suggests that there is no general minimum level of activity triggering regulation, stating that “one swap contract would be enough to trigger the registration requirement.”⁵ This will require managers that do not register as CPOs to then rely on, and qualify for, the specific *de minimis* exemption described below.

⁴ Although technically a CPO is a person who “solicits, accepts or receives...funds” for a commodity pool, the CFTC has stated that a CPO is “any firm or individual that *handles or exercises control over* the funds of persons who invest in commodity pools, regardless of whether the firm or individual is also currently engaged in soliciting, accepting or receiving funds from the pool participants.” CFTC Interpretative Letter No. 75-17, Comm. Fut. L. Rep. (CCH) ¶20,112 (Nov. 4, 1975). In circumstances where more than one entity might plausibly be regarded as the CPO of a pool, the CFTC staff has shown flexibility in permitting the affected parties to designate a single entity, such as the pool’s manager, to be responsible for CPO registration and compliance. The CFTC confirmed this position in the preamble to the Final Rules, noting in the case of a registered investment company that the investment adviser, rather than the company’s directors, is required to register as a CPO. Final Rules at 11,259.

⁵ Final Rules at 11,263. This standard, standing alone, is clearly overbroad. In prior contexts, the CFTC has indicated that a wider range of facts would be relevant to determining whether an entity is a commodity pool, including: (i) the frequency with which it trades commodity interests, (ii) the percentage of its assets committed to such trading, (iii) whether it trades commodity interests to hedge portfolio risks or to speculate, (iv) the nature of its investors and (v) the manner in which it is marketed. *See, e.g.*, 46 Fed. Reg. 26,004, 26,005–06 (May 8, 1981).

- **Investment Managers Affected.** In addition, it should be noted that an investment manager who provides trading advice regarding commodity interests (now including swaps) may also be deemed a commodity trading advisor (“**CTA**”) and be subject to CTA registration with, and regulation by, the CFTC and NFA. Investment advisers registered with the Securities and Exchange Commission formerly relying on CFTC Rule 4.14(a)(8) for an exemption from CTA registration in the context of advice provided to commodity pools whose CPO is (was) exempt under CFTC Rule 4.13(a)(4), will no longer be able to rely on that exemption.⁶
- **Covered Derivatives.** Relevant derivatives for this purpose will include listed futures, listed commodity options and those swaps regulated by the CFTC under the Dodd-Frank Act.⁷ Those include interest rate swaps, commodity swaps, a wide range of foreign exchange products, and credit default and total return swaps on broad-based security indices (*e.g.*, indices of 9 or more securities), but do not include single-name total return or credit default swaps (or swaps on narrow-based indices of issuers/reference entities).
- **Funds of Funds Managers.** The CFTC staff has historically regarded any fund more than 5% of which is invested in a commodity pool to be a commodity pool, even if the fund does not directly invest in any commodity interests itself.⁸ In the Final Rules, the CFTC went even further, suggesting without qualification that “a fund investing in an unaffiliated commodity pool is itself a commodity pool.”⁹

Are Registration Requirements Coordinated with the SEC?

- **No Exemption for SEC-Registered Investment Advisers.** Registration with the SEC as an investment adviser does not provide a basis for an exemption from registration with the CFTC as a CPO (or, except in certain cases, as a CTA).

⁶ However, the Final Rules retained other exemptions from CTA registration, including for a person registered or exempt from registration as a CPO with respect to the pools for which it is registered or exempt. In addition, Section 4m(3) of the CEA provides an exemption from CTA registration – but not CPO registration – for an investment adviser registered with the SEC if the investment adviser’s business does not consist “primarily” of acting as a CTA and the investment adviser does not act as a CTA to any commodity pool “engaged primarily” in trading commodity interests.

⁷ The Dodd-Frank Act amended the CPO definition to include swaps. That amendment will take effect the earlier of July 16, 2012 or the effective date of final CFTC rules further defining the term “swap.”

⁸ See CFTC Interpretative Letter No. 86-22, Comm. Fut. L. Rep. (CCH) ¶23,280 (Sept. 19, 1986).

⁹ Final Rules at 11,268.

- **No Exemption for Foreign Advisors to Funds with U.S. Participants.** In adopting the Final Rules, the CFTC declined to adopt a foreign advisor exemption similar to the one available under the Investment Advisers Act of 1940, as amended by the Dodd-Frank Act.¹⁰ Additionally, existing exemptions for foreign CPOs are generally limited to those operating funds whose only trading in commodity interests is in futures and options listed on a foreign exchange, and the CFTC has not proposed to expand them to include trading in swaps of any kind.¹¹
- **Limited Relief for Family Offices.** Although the SEC recently formalized a family office exemption, the CFTC declined to follow suit. Instead, the CFTC suggested that family offices could continue to request relief on a firm-by-firm basis or rely on analogous interpretive letters already issued by the CFTC.

What If a Fund's Derivatives Trading Is De Minimis?

- **De Minimis Exemption.** CFTC Rule 4.13(a)(3) provides an exemption from CPO registration for the managers of funds that engage in limited trading in commodity interests.¹² The conditions to the *de minimis* exemption include:
 - **NFA Notice Filing.** To be eligible, the manager must file a notice of exemption with the NFA. For a new fund, the filing must be made before a subscription agreement is delivered to a prospective investor in the relevant fund. The filing must be updated annually.
 - **Trading Limitations.** The fund must limit its commodity interest trading so as to satisfy one of the following two tests: (1) the aggregate initial margin and premiums required to establish commodity interest positions are 5% or less of the fund's liquidation value (after taking into account unrealized profits and losses) or (2) the aggregate net notional value of such positions is 100% or less of the

¹⁰ See CGSH Alert Memorandum, SEC Adopts Final Rules under the Investment Advisers Act of 1940 Implementing Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (June 27, 2011).

¹¹ See CFTC Rules 30.4 and 30.5.

¹² The CFTC's regulations provide certain other exclusions and exemptions from CPO registration. Those exclusions and exemptions, however, are not likely to be available to most hedge fund and private equity fund managers. For example, CFTC Rule 4.5 excludes from CPO regulation certain entities that are subject to regulation by other federal or state agencies, such as certain employee benefit plans under ERISA or registered investment companies. CFTC Rule 4.13 also provides limited exemptions from registration for operators of single pools, certain small pools with \$400,000 or less in capital contributions, and independent directors or trustees of certain ETFs.

fund's liquidation value (after taking into account unrealized profits and losses).¹³

- Several points should be noted with respect to these tests:
 - Because current and proposed margin requirements for cleared and uncleared swaps, respectively, significantly exceed the 5% limit, even unleveraged strategies involving the use of swaps may fail to satisfy this test;
 - Because margin levels are based on volatility, in times of increased market volatility (and stress), increased margin levels could cause a compliant strategy to become non-compliant requiring either registration or liquidation of positions in adverse market conditions;
 - Because there is no outright exclusion for hedging positions, assets for which there are more than two market factors hedged (*e.g.*, rate and currency or equity and currency) could conceivably fail both tests.
- Sophisticated Investor Requirement. Participation in the fund must be limited to investors the manager reasonably believes to be “accredited investors” as defined in Regulation D under the Securities Act of 1933 (the “**Securities Act**”), trusts formed by an accredited investor for the benefit of a family member, “knowledgeable employees” as defined for purposes of the Investment Company Act of 1940 (the “**40 Act**”) or specified other employees and related persons.
- No Public Offering. Interests in the fund must be exempt from registration under the Securities Act and offered and sold without marketing to the public in the United States.
- Marketing Restrictions. The fund must not be marketed as a vehicle for trading in the commodity futures or options markets.¹⁴

¹³ The application of these restrictions to funds of funds is not entirely clear because, as part of the Final Rules, the CFTC repealed its guidance on that topic without any explanation.

¹⁴ Strangely, the CFTC has not proposed or adopted rules to expand this restriction to cover swaps or other commodity interests aside from futures or options, although the parallel restriction it adopted in CFTC Rule 4.5 for registered investment companies does cover swaps. In the context of Rule 4.5, factors that the CFTC has said it might look to in evaluating compliance with this restriction include 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 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 comparisons to a derivatives index, whether the fund has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives, whether derivatives transactions engaged in, by 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. Final Rules at 11,259.

What Requirements Apply to Registered CPOs?

- **Registration.** To register as a CPO, a manager must file a Form 7-R with the NFA, pay a \$200 registration fee and join the NFA (which carries an annual \$750 membership fee). The registration process can take six to eight weeks or more. Information contained in Form 7-R (*e.g.*, contact information and disclosure of certain adverse criminal or regulatory actions) is made public.
- **Associated Persons.** Unlike SEC-registered investment advisers, employees of a manager registering as a CPO who solicit participation in a fund, and those employees' direct and indirect supervisors, generally must become members of and submit fingerprints to the NFA.¹⁵ Associated persons also must pass a proficiency exam administered by the Financial Industry Regulatory Authority.
 - The CFTC has adopted an exemption from these requirements for the chief operating officer, general partner or other person in the supervisory chain-of-command of a CPO, provided that commodity interest-related activity for customers accounts for no more than 10% of the CPO's total annual revenue, and such individual does not engage in any solicitation of fund interests or have direct supervisory or related authority over persons so engaged.¹⁶
- **Principals.** "Principals" of the manager (including officers, directors and 10% or greater owners) must also be listed on the manager's Form 7-R. Principals that are natural persons must submit a Form 8-R and fingerprints to the NFA.
- **Rule 4.7 Exemption.** Many hedge fund and private equity fund managers that register as CPOs will be subject to the more limited "substantive requirements" discussed below under CFTC Rule 4.7.¹⁷ The conditions to this exemption are:

¹⁵ "Associated persons" include natural persons associated with a CPO as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing a similar function), in any capacity that involves (i) the solicitation of funds, securities, or property for a participation in a commodity pool *or* (ii) the supervision of any person or persons so engaged. Section 4k of the CEA; CFTC Rule 1.3(aa)(3). As drafted, the CFTC Regulations include each officer in the line of supervisory authority over associated persons who solicit participations in a pool. The CFTC staff has interpreted the CFTC Regulations to limit those persons required to file Form 8-R to the person, and those below him, in whom the applicant's board of directors has vested final supervisory authority over the activities of associated persons (including the authority to hire and fire associated persons). CFTC Interpretative Letter No. 86-12, Comm. Fut. L. Rep. (CCH) ¶23,054 (May 6, 1986).

¹⁶ See CFTC Rule 3.12(h)(1)(iii). Exemptive relief may be sought under CFTC Rule 3.12(g). See also CFTC Interpretative Letter No. 93-106, Comm. Fut. L. Rep. (CCH) ¶25,898 (Oct. 12, 1993) (personnel soliciting only non-U.S. persons from jurisdictions other than the United States on behalf of a CPO of certain offshore funds were not required to register as associated persons of the CPO, provided that such solicitation complied with local law).

¹⁷ In addition to the relief under Rule 4.7, the CFTC has permitted a registered CPO that operates an offshore commodity pool to claim relief from certain disclosure, reporting and recordkeeping requirements. In order for the registered

- Qualified Eligible Persons. Interests in each relevant fund must be offered and sold exclusively to “qualified eligible persons,” which include “qualified purchasers” and “knowledgeable employees” as defined for purposes of the 40 Act, as well as certain non-U.S. persons, among others.
- No Public Offering. The offerings for each relevant fund must qualify for exemption from registration under Section 4(2) of the Securities Act or Regulation S thereunder.
- NFA Notice Filing. As with the *de minimis* exemption, a manager claiming relief under Rule 4.7 must make a notice filing with the NFA. For a new fund, the filing generally must be made before interests in the fund are *offered* or sold.
- **Substantive Requirements**. The requirements that apply to a manager registered as a CPO but claiming relief under Rule 4.7 include:¹⁸
 - Disclosure. Any offering memorandum soliciting prospective investors must disclose all information necessary to prevent the document from being misleading. The cover page must contain a legend indicating that the fund is operating pursuant to an exemption from CFTC regulation.
 - Quarterly Statement and Annual Reports. The manager must furnish a quarterly statement to participants discussing the net asset value of the fund. It must also file with the NFA, and distribute to participants, an audited annual report discussing the financial condition and operations of the fund. Reports filed with the NFA are confidential.
 - Recordkeeping and Examinations. The manager must maintain the quarterly statements and annual reports described above, as well as all books and records prepared in connection with its activities as a CPO. Those books and records must be open to inspection by the NFA, CFTC and the Department of Justice.

CPO to be eligible for relief, the commodity pool must be organized and operated outside of the United States, no marketing activities may be undertaken that could reasonably be expected to have the effect of soliciting the participation of U.S. persons, no participants in the pool may be U.S. persons, the pool may not hold or invest any capital directly or indirectly contributed from U.S. sources and the CPO must file a notice of eligibility for the relief with the NFA. See CFTC Advisory 18-96, Comm. Fut. L. Rep. (CCH) ¶26,659 (Apr. 11, 1996).

¹⁸ If a registered CPO is not eligible for Rule 4.7 or other relief, it must (a) file a detailed disclosure document with the NFA, distribute the document to prospective investors at the time or before it delivers a subscription agreement and obtain an acknowledgement from each investor before accepting funds or other property from the investor; (b) keep detailed and extensive records regarding trading activity, portfolio positions, a general ledger, marketing activity, financial condition and other matters; and (c) comply with more detailed requirements regarding periodic statements and annual reports.

- Supervision. The manager will be subject to extensive NFA supervision requirements, including requirements to maintain a compliance procedures manual and similar documentation, handle customer complaints, supervise the preparation and use of promotional materials, supervise sales solicitations, review e-mails and other communications, and provide compliance training sessions to employees.
- Form CPO-PQR. The manager will be required to file Form CPO-PQR. Depending on the extent of assets under management, Form CPO-PQR requires more or less detailed disclosure regarding, among other items: (1) basic information about the relevant fund(s), (2) key personnel, (3) investment positions, (4) creditors, (5) counterparty credit exposure, (6) borrowings and (7) clearing mechanisms. A manager that files Sections 1 and 2 of SEC Form PF¹⁹ is exempt from filing most of Form CPO-PQR, while managers that are not dually registered must complete the entire form. Most of the information contained in Form CPO-PQR may be filed on a confidential basis.
- Antifraud. Whether registered or not, any manager that qualifies as a CPO is subject to CFTC antifraud and antimanipulation provisions, including prohibitions on deceptive advertising.
- **No Restrictions on Performance Fees, Affiliate Trades or Advisory Contracts.** Unlike SEC-registered investment advisers, CFTC-registered CPOs are not subject to restrictions on performance fees, transactions with affiliates or assignment of advisory contracts.

What Are the Consequences If a Manager Does Not Register?

- **Enforcement Actions.** Willful violation of the CPO registration requirement is a felony punishable by a fine of not more than \$1,000,000 or imprisonment for not more than ten years, or both, together with the costs of prosecution.²⁰
- **Private Rights of Action.** There is an express private right of action by certain persons against any person who violates the Commodity Exchange Act or who willfully aids or abets such a violation. This right of action is potentially available to any person who purchases an interest in a commodity pool from a CPO and who suffers a loss determined to have been caused by the CPO's failure to register with

¹⁹ See CGSH Alert Memorandum, "SEC and CFTC Adopt Final Rule Requiring Private Fund Reporting" (Nov. 2, 2011).

²⁰ Failure to register may also subject a delinquent CPO to state commodities and other laws.

the CFTC. Recovery is generally limited to actual damages, and the statute of limitations is two years from the date the cause of action arises.

What Is the Deadline for Registration?

- **Effective Date.** The Final Rules were published on February 24, 2012 and will go into effect on April 24, 2012, subject to an extended compliance period for managers of existing funds. Since the Rules are final, there is no further opportunity for a comment period.
- **Existing Funds.** The Final Rules do not provide “grandfathering” for managers of existing funds. Instead, covered managers must either register with the CFTC or rely on an exemption from registration by December 31, 2012.
- **New Funds.** For commodity pools formed after April 24, 2012, the manager must either register with the CFTC or qualify for an exemption.

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Please call any of your regular contacts at the firm or any of the partners and counsel listed under Derivatives in the Practices section of our website (www.cgsh.com) if you have any questions.

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