

INVESTMENT MANAGEMENT ALERT

CFTC ISSUES FINAL RULES AFFECTING EXEMPTIVE RELIEF FOR COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS



On August 1, 2003, the Commodity Futures Trading Commission (CFTC) issued final rule amendments (final rules) that expand certain registration exemptions for operators (CPOs) and advisors (CTAs) of pooled investment vehicles that are not offered to the retail public. Exemptions claimed by such pool operators and advisors would also extend to their associated persons.

CPO Exemptions. There are two new CPO exemptions. One of them has a high investor suitability threshold and requires no limitations on the pool's commodity trading activities. The other has a lower investor suitability threshold but requires some trading restrictions. Both exemptions are available only if interests in the relevant pool are not offered to the retail public but are exempt from securities registration under the Securities Act of 1933.

Without Trading Limitations. Under CFTC Rule 4.13(a)(4), a pool operator could claim an exemption from CPO registration without imposing any restriction or trading limitations in the commodity interests by the pool, provided that the ownership in the pool is restricted to highly sophisticated participants. A pool operator may claim this exemption if the pool operator reasonably believes that (i) all natural person participants are either "qualified purchasers," "knowledgeable employees," "non-U.S. persons," or principals and certain other employees of the operator or its affiliates; and (ii) all non-natural person participants are either "qualified eligible persons" or "accredited investors."

With Trading Limitations. Under CFTC Rule 4.13(a)(3), a pool operator could claim an exemption from CPO registration where all pool participants (including natural person participants) meet the "accredited investor" test, provided that the pool for which the

operator is claiming exemption engages in a limited amount of commodity interest trading. Accordingly, a pool operator may claim this exemption if —

- the pool operator reasonably believes that each participant in the pool is an “accredited investor” (including any family trust that is not accredited but is formed by an accredited investor for a family member), a “knowledgeable employee” or certain other qualified eligible person, and
- at all times, the pool satisfies one of the following trading limitations: it does not (i) commit more than 5 percent of its assets to establish commodity interest positions or (ii) have a notional value of its commodity interests positions exceeding 100 percent of its liquidation value.

Operators of Fund-of-Funds. The final rules provide additional guidance on the application of the exemptions in the fund-of-funds context (i.e., an investor fund that indirectly trades commodity interests through participation in one or more investee funds that directly trades commodity interests). For example, an operator of an investor fund who can claim the exemption under Rule 4.13(a)(4) because all pool participants are highly sophisticated, may do so without regard to the scope of commodity trading by an underlying, or investee fund, because there are no limits that restrict the investor fund’s commodity interest trading positions. On the other hand, where an exemption from CPO registration is based on meeting certain trading criteria (i.e., Rule 4.13(a)(3)), whether relief may be extended to the operator of the investor fund will depend on certain criteria and trading activities of each investee fund. Below are certain fact patterns summarized by the CFTC when relief under Rule 4.13(a)(3) should be available:

- where the CPO of each investee fund is either itself claiming an exemption under Rule 4.13(a)(3) or is a registered CPO that is complying with the trading restrictions of Rule 4.13.(a)(3). Accordingly, the CPO of the investor fund should be able to rely on representations of the investee funds to this effect.
- where the CPO of the investor fund has actual knowledge of the trading and commodity interest positions of the investee funds (i.e., when the CPO or an affiliate of the CPO operates the investee funds). In this regard, the CPO of the investor fund may aggregate the commodity interest positions across the subject investee funds to determine compliance with trading restrictions.
- where the investor fund does not trade commodity interests directly, and the CPO has allocated no more than 50 percent of the fund’s assets to investee funds that do trade commodity interests directly. In this regard, the exemption may be available to the CPO of the investor fund because the investor fund’s exposure to the futures market could be deemed comparable to that of a stand-alone pool that meets the net notional value test.
- where an investor fund engages in direct commodity interest trading in addition to its allocation of assets to investee funds, provided that the CPO of the investor fund treats the assets committed to direct trading as a separate pool with its own liquidation value and applies the trading restrictions to that separate pool.

New CTA Exemptions. Under CFTC Rule 4.14(a)(8), an advisor to a pool whose operator meets any of the CPO registration exemptions noted above is eligible to claim an exemption from CTA registration, provided that (i) the advisor is registered as an investment adviser under the Investment Advisers Act of 1940 or under the securities laws of any state (or is exempt or excluded from the federal definition of investment adviser), (ii) the advisor’s trading advice is directed solely to, and for the sole use of, pools operated by CPOs who have claimed the above exemptions and (iii)

the advisor's trading advice is solely incidental to its business of providing securities advice to each such pool. In addition, an advisor claiming this exemption must not otherwise hold itself out as a CTA. Other criteria may apply to pools that are organized and operated outside the United States.

Written Notice Claiming Exemption. While a claim for exemption is automatic, it is not self-executing. To perfect the claim, a pool operator or advisor must file a written notice with the NFA identifying each pool for which the exemption is claimed. In addition, a pool operator must provide specific disclosure to prospective and existing pool participants in each pool that it operates or intends to operate no later than the time it delivers a subscription agreement for the pool to a prospective participant. A CTA claiming exemptive relief has similar disclosure obligations.

On the other hand, a pool operator wishing to withdraw from registration in order to take advantage of one of the above exemptions is required to first provide written notice to each pool participant. This notice must also provide each such participant with a right to redeem its interest in the pool.

A claim for exemption will only provide relief from the registration requirements under the Commodity Exchange Act (CEA). Other relevant provisions under the CEA, such as prohibitions against fraud, manipulation and trader reporting requirements, are preserved.

Effect on Prior Claims for "No Action" Relief. A pool operator who has claimed temporary no-action relief with the NFA will not be required to re-file its claim in order to maintain that relief or to trade in accordance with the above noted exemptions. As long as the pool operator continues to comply with the commodity interest trading restrictions applicable to the prior claimed no-action relief, it will not be required to take any further action to benefit from the exemptions issued in the final rules.

Other Rule Changes. The CFTC also adopted several other rule changes, including the following:

- eliminating all restrictions on commodity interest trading in order to qualify for the Rule 4.5 exclusion from CPO registration for operators of registered investment companies, insurance companies, employee benefit plans and other institutional investors
- facilitating communications by CPOs and CTAs with prospective and existing pool participants and clients, including permitting electronic communications
- eliminating duplicative regulatory requirements for "master/feeder fund" structures
- addressing certain issues related to calculation and presentation of past performance by CPOs and CTAs.

Effective Date. The final rules are effective as of August 8, 2003. Final rules regarding the calculation and presentation of past performance by CPOs and CTAs are effective as of September 8, 2003.

This Alert is provided as a general overview of the final rules and does not address every change to the prior rules. The complete text of the final rules and the CFTC's commentary can be found at the CFTC's Web site at <http://www.cftc.gov/opa/press03/opa4829-03.htm>.

CONTACT INFORMATION

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