Investment Funds Alert

CPO Registration and Related Considerations for Non-U.S. Managers

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The availability of a wide-ranging exemption to registration with the U.S. Commodity Futures Trading Commission ("CFTC") has meant that most non-U.S. Managers have been able to avoid the full reach of futures regulation in the U.S.

On 24 April 2012, the most commonly used exemption, CFTC Regulation 4.13(a)(4), will be rescinded. Consequently, fund managers with at least one U.S. investor that are currently relying on that exemption have until 31 December 2012 to do one of the following:

- stop trading in commodity futures, retail foreign exchange contracts and most swaps on U.S. markets
- seek to qualify under the *de minimis* exemption from Commodity Pool Operator ("CPO") registration set forth in CFTC Regulation 4.13(a)(3) and file for such exemption with the U.S. National Futures Association ("NFA")
- determine whether any other exemption is applicable, or
- register with the CFTC as a CPO and comply with certain post-registration requirements.

The applicability of the rules is generally determined by whether there is at least one U.S. investor in a fund being managed by that manager although there is a limited registration exemption available under Part 30 of the CFTC regulations for commodity pool operators located outside the United States that have U.S. investors but who trade only in "foreign futures and foreign options".

Avoiding CPO Registration: *De minimis* Exemption

Registered CPOs are generally subject to a significant regulatory burden. As such, fund managers that continue to manage funds that have U.S. investors that trade, on U.S. markets, in futures contracts, options on futures contracts, retail foreign exchange contracts and swaps other than security based swaps ("commodity pools") should consider carefully whether they are able to rely on the *de minimis* exemption from CPO registration set forth in CFTC Regulation 4.13(a)(3).

Under the revised CFTC Regulation 4.13(a)(3), an exemption from registration can be claimed if the commodity pool at all times meets one of the following tests:

a. the aggregate initial margin, premiums, and required minimum security deposit for retail forex transactions required to establish such positions do not exceed 5% of the liquidation value of the pool's portfolio, or

b. the aggregate net notional value of the pool's commodity interest positions does not exceed 100% of the liquidation value of the pool's portfolio.

The net notional value of the pool's commodity interest positions referenced in (B) above are calculated as follows:

- for each futures position: by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit

- for each option position: by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), by the strike price per unit

- for each retail forex transactions: by calculating the U.S. Dollar value of such transaction at the time the transaction was established, excluding for this purpose the value in U.S. Dollars of offsetting long and short transactions, if any

- for any cleared swap: by the value of the notional underlying commodity used to calculate periodic settlement payments during the life of the swap as reported pursuant to part 45 of the CFTC's regulations.[1]

In addition, futures contracts may be netted with the same underlying commodity across designated contract markets and foreign boards of trade, and swaps may be netted with swaps cleared on the same designated clearing organization.

CPO Registration

Fund managers currently relying on the unlimited trading exemption that are not able to rely on the *de minimis* exemption are required to determine whether they fall under another exemption or register as CPOs by 31 December 2012. Other than the exemption for CPO's trading foreign futures and foreign options, it is not thought likely that any wide-ranging exemption will be available to fund managers.

In order to register as a CPO, fund managers must file an online form and pay a one-off, non-refundable application fee of U.S.$200. In addition, for each natural person who is a "principal" or "associated person" of the applicant fund manager, a separate online form must be submitted together with a fingerprint card and a non-refundable fee of U.S.$85.00. Initial NFA membership dues are U.S.$750 and annual renewal fees are currently U.S.$850 per year. The registration process usually takes between two and three months.

The "principals" of a fund manager generally include, as applicable, its directors, officers, managers and members, together with persons holding certain percentage interests and/or voting rights. Details of each "principal" will be made available publicly on the NFA website.

"Associated persons" are generally those people who are involved in any capacity in the solicitation of funds, securities or property for participation in a commodity pool or the supervision of persons so engaged. The CEO of a fund manager is also deemed to be an "associated person". Each "associated person" is required to pass a particular NFA exemption test (typically the Series 3 exam or the Series 32 exam if registered with the FSA in the United Kingdom) prior to registration.

Both principals and associated persons are subject to a fingerprint requirement and background check.

[1] For notional value to be reported under Part 45, it would have to be matched or affirmed by counterparties prior to reporting. Presumably, the notional value of a swap that is not required to be cleared would also be the value reported under Part 45 of the CFTC's regulations, but such swaps would not be permitted to be netted.

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Post-Registration Requirements

Registered CPOs are subject to quarterly reporting requirements and must complete an annual NFA questionnaire to update certain basic information about their business and newly adopted form CPO-PQR reporting. A self-examination checklist, which may be requested as part of a NFA audit, must also be completed and retained internally. There is also a requirement for registered CPOs to maintain certain business records, including copies of account agreements and proprietary trading records. Registered CPOs who limit investors in funds they operate to “qualified eligible persons” may claim an exemption from certain specific disclosure, periodic and annual reporting and record-keeping requirements pursuant to CFTC Regulation 4.7.

As members of the NFA, registered CPOs are required to adhere to applicable NFA compliance rules and by-laws. Among other things, these requirements cover the content of promotional materials and the establishment of written business continuity and disaster recovery plans.

Commodity Trading Advisors: Exemption from Registration

For completeness, it is worth clarifying that the CFTC has neither rescinded, nor proposed to rescind the exemption from commodity trading advisor (“CTA”) registration set forth in Section 4m1 of the U.S. Commodities and Exchange Act, as amended, as clarified by CFTC Regulation 4.14(a)(10).

Individuals or entities providing advisory services in respect of commodity futures and relying on that exemption from registration can therefore continue to do so.

The above summary is general in nature and is not intended to be exhaustive.

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