Recent CFTC Changes and Looming Deadlines

Written by Jeffrey D. Collins

November 16, 2012

Investment managers who invest in futures or swaps are reminded that important registration and/or filing deadlines with the U.S. Commodity Futures Trading Commission (the "CFTC") are quickly approaching.

The deadline in many cases is December 31, 2012. Managers who invest in futures or swaps who have not considered the impact of the changes in the CFTC regulations outlined below should do so immediately.

Elimination of Rule 4.13(a)(4)

As noted in our earlier client alert, one of the key changes under the new CFTC regulations is the rescission of the exemption from registration under Rule 4.13(a)(4).

Under Rule 4.13(a)(4), a commodity pool operator ("CPO") is exempt from registration with the CFTC if all investors in the CPO's fund are:

- (i) natural persons that are "qualified eligible persons" as defined under CFTC Rule 4.7(a)(2) (generally this means a Qualified Purchaser as defined in the Investment Company Act of 1940) and
- (ii) entities that are "qualified eligible persons" or accredited investors.

Rule 4.13(a)(4) imposes no limits on the amount of futures trading that can be conducted, and for this reason commonly has been relied on by many managers of hedge funds and funds of funds. The CFTC has issued no-action relief that permits CPOs to claim this exemption up through December 31, 2012. The Rule, however, will be rescinded in its entirety effective December 31, 2012.

Registration

As a result, any manager relying on Rule 4.13(a)(4) will need to register with the CFTC before year-end unless it can rely on the de minimis exemption available under Rule 4.13(a)(3).

Any managers who intend to register and have not yet begun the process should do so immediately. Registration requires access to the National Futures Association's ("NFA") online registration system in order to complete Form 7-R and pay the application fee of $200 and membership dues of $750. An application on behalf of each "principal" and "associated person" ("AP") of the CPO/CTA must also be filed, which includes Form 8-R, fingerprint cards, passage of the Series 3 exam (unless a waiver is granted), and an application fee of $85.

Managers registering with the CFTC should consider whether they are eligible for relief under Rule 4.7 (commonly referred to as "regulation lite"). Rule 4.7 provides regulatory relief to registered CPOs and CTAs whose only clients are "qualified eligible persons." Managers registered under Rule 4.7 will be exempt from some of the more onerous requirements imposed upon CFTC registrants, but will still need to comply with certain self-examination, recordkeeping and disclosure requirements. In order to rely on Rule 4.7, a manager must file a notice of claim with the NFA. This notice requires a CPO or CTA to certify that:

- (i) neither the CPO/CTA nor its principals are subject to statutory disqualification under Sections 8a(2) or 8a(3) of the Commodity Exchange Act,
- (ii) the CPO/CTA will comply with the applicable requirements of Rule 4.7, and

- (iii) if a CPO, that the exempt pool will be offered and operated in compliance with the applicable requirements of Rule 4.7.

The notice will generally be effective upon filing. However, to accommodate the transition, the NFA will permit CPOs to register under Regulation 4.7 prior to December 31, 2012 with an effective date of January 1, 2013.

Switching to an Exemption Under 4.13(a)(3)

The CFTC has amended but retained the exemption available under Rule 4.13(a)(3). If a manager determines that its trading complies with the de minimis limits (discussed below), it can claim an exemption from registration under Rule 4.13(a)(3).

In order to switch from an exemption under Rule 4.13(a)(4) to Rule 4.13(a)(3), a non-registered CPO should contact the NFA in writing to withdraw its current notice of claim of exemption. The CPO should wait for confirmation from the NFA that its claim under Rule 4.13(a)(4) has been withdrawn before filing a claim under Rule 4.13(a)(3) through the NFA's website.

For registered CPOs who intend to switch from an exemption under Rule 4.13(a)(4) to Rule 4.13(a)(3), they can login to the NFA online registration system and withdraw the Rule 4.13(a)(4) claim online.

Managers must notify participants of the change in exemption.

Changes to Rule 4.13(a)(3) (the "De Minimis Exemption")

Under Rule 4.13(a)(3), a manager is exempt from registration as a CPO if:

- (i) the fund is engaged in a de minimis amount of futures trading (no more than 5% of the liquidation value of the fund's portfolio is used to establish futures and swaps trading positions or the aggregate net notional value of such positions does not exceed 100% of the liquidation value of the fund's portfolio), and
- (ii) the pool's investors are all accredited.

While swaps previously were not included, beginning on December 31, 2012, managers trading in swaps (alone or together with futures) will have to factor such trading into their analysis to determine whether they can operate under the de minimis exemption. Managers should include all swaps entered into prior to December 31, 2012 and all swaps going forward.

In addition, the CFTC adopted an annual notice filing requirement under which CPOs and CTAs must reaffirm their claim of exemption or exclusion from registration. The annual notice must be filed at the end of each calendar year.

With respect to funds of funds relying on Rule 4.13(a)(3), the CFTC is expected to release new guidance. We will provide updates as they become available.

Swaps

In addition to counting swaps in the de minimis calculations, CPOs, CTAs and their APs trading in swaps subject to CFTC jurisdiction will need to be approved by the NFA as a swaps firm or swaps AP. This requirement, set forth under NFA Bylaw 301, will be effective January 1, 2013 but requests for approval may be submitted now and effective immediately.

A CPO or CTA seeking approval as a swaps firm must have at least one principal that is registered as an AP and designated as a swaps AP. Firms and APs seeking designation as a swaps firm and swaps AP, respectively, should apply through the NFA's online registration system.

CICIs and LEIs

Swap counterparties will need to obtain CFTC Interim Compliant Identifiers ("CICI") in order to comply with the new reporting requirements. A CICI is a code that identifies a legal entity for purposes of monitoring systemic risk associated with certain financial transactions. Any fund that is a counterparty to a swap agreement must obtain a CICI. More information is available here.

As apparent from its name, CICIs are being used in the interim only until the Legal Entity Identifier (LEI) plan is implemented. Similar to CICIs, the purpose of the global LEI system is to establish a common entity identifier that applies internationally so that information can be gathered and shared across borders.

RELATED INDUSTRIES

- Investment Advisers & Private Funds
- Professional Services