CFTC Repeals Rule 4.13(a)(4) Exemption from Registration and Amends Rule 4.13(a)(3)

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As noted in our earlier client alert, the U.S. Commodity Futures Trading Commission (the "CFTC") recently adopted a final rule that, among other changes, rescinds the exemption from registration currently available under CFTC Rule 4.13(a)(4). Rule 4.13(a)(4) was commonly relied upon by managers of 3(c)(7) funds to avoid the need to register under, and operate the fund in compliance with, the Commodity Exchange Act. The CFTC has also made important changes to Rule 4.13(a)(3), the so-called "de minimis exemption," as discussed below.

Repeal of 4.13(a)(4) Exemption

Under the current 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.

Next Steps

The effective date of rescission of Rule 4.13(a)(4) is April 24, 2012. Following this date, managers will no longer be able to claim this exemption for new funds. *Accordingly, managers about to launch a new fund that would seek to rely on Rule 4.13(a)(4) must file a claim of exemption by April 23, 2012.* Furthermore, Rule 4.13(a)(4) will be rescinded in its entirety effective December 31, 2012, and managers that are currently relying on the exemption for existing funds will no longer be able to do so. *Any manager relying on a Rule 4.13(a)(4) exemption should begin to consider whether it will register with the CFTC before year-end, or whether it can rely on the exemptive relief still available under Rule 4.13(a)(3)* (discussed below).

Rule 4.13(a)(3) De Minimis Exemption

The exemption available under Rule 4.13(a)(3) remains in place for CPOs engaged in a de minimis level of futures trading. Although the CFTC had initially proposed rescinding both Rules 4.13(a)(3) and 4.13(a)(4), following the comment period the CFTC decided to keep the 4.13(a)(3) exemption for entities engaged in a de minimis amount of futures trading. 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 trading positions <u>or</u> 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. Managers of funds currently relying on Rule 4.13(a)(4) should consider whether they can operate instead under this de minimis exemption and avoid registration with the CFTC on that basis. *While this exemption remains in place, the CFTC did adopt 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. *In addition, the CFTC intends to include swap exposure in the de minimis tests going forward, so managers trading in swaps (alone or together with futures) will have to factor that into their analysis as to whether they can operate under the de minimis exemption.*

Funds of Funds Structures

Despite comments received during the comment period, the CFTC declined to include a revised exemption for funds of funds that rely on the 4.13(a)(4) exemption. Specifically, commenters suggested that the CFTC retain the 4.13(a)(4) exemption for funds that do not invest directly in commodities but do so indirectly through a fund of funds structure. The CFTC declined to adopt such an exemption and will withhold any further consideration of that matter until it has collected and reviewed data as provided on Forms CPO-PQR and/or CTA-PR. These forms are required of registered commodity pool operators and commodity trading advisors. The CFTC will, however, consider exemptive requests from funds of funds on a case by case basis.

Managers of funds of funds that have relied on 4.13(a)(4) will now have to (a) register with the CFTC, (b) seek exemptive relief (which may or may not be granted) or (c) operate in compliance with Rule 4.13(a)(3) after December 31, 2012. The application of Rule 4.13(a)(3) in a fund of funds context is complex. The simplest way for a fund of funds to comply with Rule 4.13(a)(3) is to invest only in funds that are themselves all relying on Rule 4.13(a)(3). In addition, the CFTC has stated that it will deem a fund of funds to be in compliance with Rule 4.13(a)(3) if it invests no more than 50% of its assets in funds that trades any futures/swaps (i.e., without regard to the level of futures/swap trading engaged in by those underlying funds).

The CFTC also declined to provide any reporting relief for registered CPOs merely because they are funds of funds. The CFTC noted that the statutory definition of commodity pool does not distinguish between direct and indirect commodity investments. Accordingly, indirect investments in commodities do not exempt funds of funds from reporting. The CFTC did acknowledge that funds of funds might not have access to the same kind of information and the schedules to Form CPO-PQR address this information gap.

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