

## Client Advisory

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# CFTC Adopts Final Rules Providing Expanded Registration Relief to CPOs and CTAs

As a follow-up to the Commodity Futures Trading Commission's ("CFTC's") recently proposed amendments to its rules related to the creation of several new registration exemptions available to Commodity Pool Operators ("CPOs") and Commodity Trading Advisors ("CTAs") and the expansion of the regulatory relief available to entities excluded from the definition of a CPO, the CFTC announced on August 4, 2003, the adoption of Final Rules on these subjects.

The Final Rules amend CFTC Rules 4.13, 4.14 and 4.5 to add and clarify a number of exclusions from the definition of CPO and CTA, as well as exemptions from the CPO and CTA registration requirements. In addition, the Final Rules also amend CFTC Rules 4.21, 4.22 and 4.31 to provide increased regulatory relief to facilitate communications by CPOs and CTAs. All of the New Rules discussed herein are effective immediately.

### **New CPO Registration Exemptions Under Rule 4.13**

**Limited Trading Exemption:** Under New Rule 4.13(a)(3), which is applied on a pool-by-pool basis, the CPO of a privately offered pool who reasonably believes the participants include only persons who are "accredited investors" (as defined in Rule 501(c) under the Securities Act of 1933), certain family trusts formed by accredited investors, "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act of 1940) and certain other principals, employees or family members of the CPO and who satisfies one of two portfolio tests, qualifies for exemption from registration with respect to such pool. The portfolio tests are that the pool has either (i) an aggregate net notional value of commodity interest positions (whether hedge or speculative) that, at the time of the most recently established position, does not exceed 100% of the liquidation value of the pool's portfolio, *or* (ii) an aggregate initial futures margin and options premium required to establish the pool's commodity interest positions that, at the time of the most recently established position, does not exceed 5% of the liquidation value of the pool's portfolio. In determining a pool's "net notional value," the pool may net the notional value of commodity futures positions across long and short futures positions with the same underlying commodity (e.g., a long position in December 10-year Notes may be netted against a short position in March 10-year Notes).

**Fund-of-Funds Clarification:** Based on comments received by the CFTC in response to its proposed rules, the Final Rules provide some clarity with respect to the applicability of New Rule 4.13(a)(3) to a CPO of a fund-of-funds ("Investor Fund") that invests in commodity pools ("Investee Funds"). The CPO of an Investor Fund may claim exemption from the CPO registration requirement under New Rule 4.13(a)(3) if: (i) the CPO of each Investee Fund has either (A) claimed exemption from CPO registration under Rule 4.13(a)(3) or (B) is registered with the CFTC as a CPO and has operated the Investee Fund in compliance with the trading restrictions of Rule 4.13(a)(3) (the CPO of the Investor Fund may rely on a representation made by the CPO of an Investee Fund that the Investee Fund is operated in compliance with the trading restrictions of

Rule 4.13(a)(3)); (ii) the Investor Fund has allocated no more than 50% of its assets to the Investee Funds that trade commodity interests (regardless of the level of commodity interest trading engaged in by the Investee Funds) and the Investor Fund either does not trade commodity interests directly, or if it does trade commodity interests directly, the assets committed to direct trading separately meet the trading restrictions of Rule 4.13(a)(3); or (iii) the CPO of the Investor Fund has actual knowledge of the commodity interest positions of the Investee Funds (e.g., where the Investee Funds are affiliates of the Investor Fund) and the aggregate commodity interest positions across the Investee Funds complies with the trading restrictions of Rule 4.13(a)(3).

**Highly Sophisticated Participant Exemption:** New Rule 4.13(a)(4), which is applied on a pool-by-pool basis, adds another exemption from CPO registration where the pool participants of a privately offered pool meet a specified level of sophistication. Unlike the exemption provided under Rule 4.13(a)(3), this exemption does not require satisfaction of any portfolio test or limitation on the amount of commodity interest trading. Under this test, a CPO will be exempt from registration if the CPO reasonably believes that (i) any natural person that invests in the pool is a “qualified purchaser” within the meaning of Section 2(a)(51)(A) of the Investment Company Act of 1940, a non-U.S. person or a “knowledgeable employee” and (ii) any non-natural person that invests in the pool is either a qualified eligible person within the meaning of CFTC Rule 4.7 (“QEP”) or an “accredited investor.”

**Procedures for Claiming Relief Under Rule 4.13:** To claim relief under Rules 4.13(a)(3) or (4), a CPO must file a notice of exemption with the National Futures Association (“NFA”) in prescribed form and disclose to each prospective pool participant that the CPO is exempt from registration with the CFTC, state the basis for the exemption, and make certain other required disclosures.

A currently registered CPO wishing to withdraw its registration or otherwise claim relief pursuant to Rules 4.13(a)(3) or (4), must first notify all existing clients of its intent to withdraw from registration or claim relief and must give such clients the right to redeem their interests in the pool before claiming the exemption. Any entity that has previously filed a claim of no-action relief with the NFA pursuant to the temporary no-action relief granted by the CFTC in its proposed amendments to Rule 4.13 need not re-file a claim with the NFA to maintain an effective exemption.

**Tandem Use of 4.13(a)(3) and (4):** New Rules 4.13(a)(3) and 4.13(a)(4) (as well as the amendments to Rule 4.13(a)(2) discussed below) can be applied in tandem by the same CPO with respect to different pools and, more significantly, also can be applied by a registered CPO to those pools falling within one of the exempt pool categories provided in New Rule 4.13. Accordingly, New Rule 4.13 not only operates as an exemption from CPO registration, but also operates as a complement to Rule 4.7 in exempting CPOs of Rule 4.13 pools from certain disclosure and reporting obligations.

**Small Pool Exemption:** The CFTC also has liberalized the *de minimus* exemption for small pools, increasing the amount of the gross capital contribution criterion under Rule 4.13(a)(2) to \$400,000 from \$200,000 and expanding the participants excluded from the “no more than 15 participants” limitation to include certain family members of otherwise excluded individuals.

## **Expansion of CPO Exclusion Under Rule 4.5**

**Expansion of Rule 4.5:** Rule 4.5 provides an exclusion from the definition of CPO available to otherwise regulated “Qualifying Entities” (i.e., mutual funds, pension plans, insurance company separate accounts, bank trust funds and similar otherwise regulated institutional investors). The New Rules amend Rule 4.5 to broaden the scope of the exclusion by eliminating the requirement that Qualifying Entities limit their commodity interest positions to a certain percentage of their overall portfolio. Accordingly, Qualifying Entities are excluded from the definition of CPO (and therefore are not required to register as a CPO), regardless of the amount of commodity interest positions held by such entities. The amendment to Rule 4.5 also eliminates the so-called “marketing restriction,” which formerly prohibited a Qualifying Entity relying on the exclusion available under Rule 4.5 from marketing itself as a commodity pool or otherwise as a vehicle to trade commodity interests.

The New Rules require Qualifying Entities relying on Rule 4.5 to provide written notice to each of its participants that it has claimed exclusion from the definition of a CPO and, therefore, is not subject to registration or regulation as a CPO.

**Procedures for Claiming Relief Under Rule 4.5:** Any entity that desires to claim an exclusion from the definition of CPO under Rule 4.5 must file a notice of eligibility with the NFA pursuant to the requirements set forth in Rule 4.5(c). Any entity that has previously filed a claim of no-action relief with the NFA pursuant to the temporary no-action relief granted by the CFTC in its proposed amendments to Rule 4.5 need not re-file a claim with the NFA to maintain an effective exemption.

## **Expansion of CTA Registration Exemption Under Rule 4.14**

**Amendments to Rule 4.14(a)(8):** Rule 4.14(a)(8) provides an exemption from CTA registration for registered and unregistered investment advisers, so long as such investment advisers satisfy certain conditions (e.g., they don't hold themselves out as CTAs) and their advice is directed solely to the categories of clients listed in Rule 4.14(a)(8). Formerly, Rule 4.14(a)(8) was available only to investment advisers registered with the Securities and Exchange Commission ("SEC") (and to certain unregistered investment advisers that qualify for one of two narrow exemptions from the SEC registration requirement). The New Rules have expanded Rule 4.14(a)(8) to make the registration exemption available both to state-registered investment advisers and all unregistered investment advisers (i.e., investment advisers exempt from both the SEC's and states' investment adviser registration requirements).

**Foreign Funds and 4.13(a)(3) and (4) Exempt Pools:** The New Rules also expand the categories of clients under Rule 4.14(a)(8) that a CTA may provide commodity interest trading advice to and still claim registration relief, to include (i) commodity pools organized and operated outside of the United States that do not have any participants that are U.S. persons or (ii) commodity pools that meet the requirements of the new exemptions contained in New Rules 4.13(a)(3) and (4).

**Procedures for Claiming Relief Under Rule 4.14:** To claim relief from CTA registration under Rule 4.14(a)(8), a CTA must file a notice of exemption with the NFA. With respect to a CTA registered with the CFTC that desires to withdraw its registration pursuant to 4.14(a)(8), prior to such CTA filing a notice of exemption from registration, it must notify all existing clients of its intent to withdraw from registration and must give such clients the right to terminate their advisory agreement with the CTA. Any entity that has previously filed a claim of no-action relief with the NFA pursuant to the temporary no-action relief granted by the CFTC in its proposed amendments to Rule 4.14 need not re-file a claim with the NFA to maintain an effective exemption.

**Counting "Clients" for Purposes of "15 or fewer" - New Rule 4.14(a)(10):** To conform the treatment of CTAs with that of investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"), the CFTC has adopted New Rule 4.14(a)(10). Under Rule 4.14, certain legal organizations may be deemed a single person for purposes of determining whether the CTA has advised 15 or fewer clients within the prior 12 months, similar to the counting methods permitted by Rule 203(b)(3)-1 under the Advisers Act. No filing is required to claim relief under Rule 4.14(a)(10).

## **New Rules Related to CPO/CTA Communications**

**Delivery of Disclosure Documents - Amendment to Rules 4.21 and 4.31:** Formerly, Rules 4.21 and 4.31 prohibited CPOs and CTAs, respectively, from soliciting prospective clients prior to providing a Disclosure Document. The New Rules amend Rules 4.21 and 4.31 to allow Disclosure Documents to be delivered no later than the time a CPO delivers a subscription document or a CTA delivers an advisory agreement to the solicited party. The New Rules also require that any material distributed in advance of the delivery of the Disclosure Document be consistent with the information contained in the Disclosure Document and with applicable rules and regulations.

**Master/Feeder Fund Reports - Amendment to Rules 4.21 and 4.22:** The New Rules clarify that a CPO of a master/feeder fund complex need not deliver Disclosure Documents, periodic account statements and annual reports for a master fund to its affiliated investee feeder funds.

**Electronic Distribution of Account Statements - Amendment to Rule 4.22:** The CFTC amended Rule 4.22 to establish procedures by which a CPO may distribute account statements to pool participants electronically. Prior to transmitting account statements to pool participants electronically, the New Rule requires that the CPO notify the pool participants that it intends to distribute such statements electronically, and the CPO may distribute account statements electronically to those pool participants that do not object within 10 business days of such notice.

## Conclusion

The New Rules adopted by the CFTC represent a major liberalization of the CPO and CTA registration requirements and significantly reduce the barriers to entry of advisors and fund managers who wish to transact business in commodity interests on behalf of their clients. They also present a potential opportunity for current registrants to free themselves of the costs and burdens of many regulatory obligations.

## We Can Help

For more information regarding the New Rules or for assistance in claiming regulatory relief, please contact one of the attorneys listed below or your primary Katten Muchin Zavis Rosenman attorney.

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