JACKO LAW GROUP, PC
SECURITIES & CORPORATE COUNSEL

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COMMODITY INVESTMENTS: WHAT IT MEANS FOR ADVISERS AND INVESTMENT COMPANIES

Historically, the Commodity Exchange Act (the "CEA") had limited application to investment advisers and sponsors of private funds because of the "sophisticated investor" exemption. Funds that traded in futures, options on futures, and hard commodities were exempt from the definition of a commodity pool, their sponsors exempt from the definition of a commodity pool operator ("CPO"), and their advisers exempt from the definition of a commodity trading advisor ("CTA") as long as all of their investors were accredited investors.

Dodd-Frank, however, has changed that. Dodd-Frank eliminated the long-standing "sophisticated investor" exemption and expanded the definition of commodity pool with the overall effect of capturing "trading" in security futures products and swaps. As a result, a large number of investments advisers that were not CTAs and CPOs under prior regulations must consider whether they need to register as CPOs or CTAs, or both, and fulfill other regulatory requirements, or take action to claim an exemption. As investment advisers to private fund continue to rely more and more on derivative instruments to hedge their portfolios (e.g., currency, interest rate, index futures and options), knowledge of, and compliance with, the CEA becomes increasingly important.

Commodity Interests – The Investment Portfolio

Determining what constitutes a commodity is not always straight forward. Originally, a commodity was any item included on an enumerated list of agricultural goods, grain, sugar and other "tangible goods." However, in 1974 the administration of the CEA was transferred from the US Department of Agriculture to the Commodities Futures Trading Commission ("CFTC"), who subsequently expanded the definition of a commodity to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." Ensuing judicial cases and Congressional legislation further pushed the boundaries of what could be included as a commodity.

Today, a commodity is considered any homogenous good, traded in bulk on an exchange that is standardized, usable upon delivery, and whose price varies enough to justify the creation of a market. Thus, the expanded definition now encompasses intangible items as well - including financial products such as foreign currencies and indexes, futures contracts, options and swaps; where contracts for a commodity do not necessarily involve settlement through delivery of a tangible underlying asset.

The Commodity Pool – The Fund

A commodity pool is an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures contracts, options on futures, forex contracts or swaps, or to invest in another commodity pool. Many investment advisers of equity funds that occasionally use derivatives to hedge their portfolios are under the false impression that their funds are not commodity pools. Many take the position that the purpose of their funds is to trade securities and not commodities. However, the CFTC interprets very broadly the terms "for the purpose of" so that a single commodity position within the fund's portfolio would be enough for the fund to fall within the definition of a commodity pool.

The Commodity Pool Operator - The Entity that Sponsors the Fund

A CPO is any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility. In the private fund context, and depending how the fund is structured, this could include the general partner or managing member, or the investment adviser.

The Commodity Trading Advisor – The Investment Adviser to the Fund

A CTA is any person who for compensation or profit (a) engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in: (i) any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market or derivatives transaction execution facility; (ii) any commodity option authorized under Section 6c of the CEA; or (iii) any leverage transaction authorized under section 23 of the CEA; or (b) and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to above. In the private fund context, this will include the investment adviser/general partner or managing member, unless the general partner or managing member has elected to retain the services of an outside investment adviser to manage the portfolio.

The Associated Person

An associated person is an individual who solicits orders, customers or customer funds, who supervises salespersons for any of these categories of individuals or firms and any person in the supervisory-chain of command. The CFTC has indicated that not only are immediate supervisors associated persons, but everyone in the "line of supervisory authority," regardless of how senior their position, including the president of the firm, are associated persons well. The analysis of who should register in small firms that sell interests in commodity pools appears straight forward – everyone should register. In larger organizations with layers of assistants, sales personnel, and supervisors, the analysis becomes more complex.

Registration Requirements

In general, registration is required unless the CPO or CTA qualifies for one of the exemptions from registration outlined in CFTC Regulations 4.13 and 4.14. CTAs and CPOs are regulated by government entities and an industry-wide self-regulatory organization ("SRO"). The Commodity Futures Trading Commission ("CFTC") is the government entity responsible for regulating commodity trading. The National Futures Association is the SRO responsible for regulating futures markets. Membership in NFA is mandatory and the association is financed exclusively from membership dues and assessment fees paid by the users of the futures markets. NFA has the authority to take disciplinary actions against any firm or individual who violates its rules.

Full registration as a CPO and CTA is a relatively involved process and typically takes from six to eight weeks to complete. Registration involves submission of Form 7-R for the CPO and Form 8-Rs for all natural person Principals and for all Associated Persons ("APs"), along with fingerprints for such

Principals and APs, as well as proof that each AP passed the required proficiency exams (generally the Series 3 or 31). At least one Principal will be required to be registered as an associated person. Fully registered CPOs will also be subject to CFTC and NFA regulation. Such regulation includes providing disclosure documents to pool participants that are subject to review by NFA and recordkeeping and periodic and annual reporting requirements, including delivery of audited annual financial statements. In addition, associated persons of a registered CPO or CTA must satisfy proficiency requirements, generally by taking and passing the Series 3 Examination.

Exemptions from Registration

Below are some of the most notable exemptions for registration.

Rule 4.13(a)(3) Exemption for CPOs

Rule 4.13(a)(3), also referred to as the "private fund de minimis exemption," exempts persons who are operators of funds for which: interests in the pool are exempt from registration under the Securities Act of 1933 (the "Securities Act"); the pool engages in a limited amount of trading in commodity interests (e.g., futures, swaps and options); participation in the pool is limited to certain types of qualified investors; and the pool is not marketed as a vehicle for trading in commodity interests. There are two tests used to determine whether there is "limited trading."

The first is a "five percent (5%) test," which compares the amount of margin, premiums and minimum security deposits used to establish the positions in commodity interests to the fund's liquidation value. The second is the "alternative net notional" test, which looks at whether the net notional value of the commodity interest positions, measured at the time the most recent position is put on, is more than 100 percent of the fund's liquidation value. Accordingly, to satisfy the "limited trading" test, the private fund will have to limit the aggregate initial margin it posts for its speculative commodities-related trading to 5% of the liquidating value of its portfolio, after taking into account unrealized profits and losses. Alternatively, a private fund may limit the aggregate net notional value of its speculative commodities-related trading positions to 100% of the liquidation value of its portfolio, after taking into account unrealized profits and losses (excluding the in-the-money amount of an option at the time of purchase).

In November, the CFTC issued a time-limited no-action letter providing relief from CPO registration for sponsors of fund of funds. Historically, fund of funds could rely on the de minimis exemption along with guidance provided in Appendix A to Part 4 of the CFTC regulations used to calculate whether the fund was within the de minimis threshold. Since Appendix A was rescinded, the CFTC informally indicated that Appendix A may continue to be relied upon until revised guidance was issued. The no-action letter is the CFTC's formal indication that funds of funds may continue to rely on the guidance in the rescinded Appendix A until the later of June 30, 2013, or six months from the date the CFTC issues revised guidance on the methods for calculating the de minimis thresholds under CFTC Regulations 4.5 and 4.13(a)(3). In order to claim this relief, a fund of funds must comply with the eligibility requirements stated in the no-action letter and must file a claim of exemption.

Rule 4.14 Exemption for CTAs

Rule 4.14 is the registered investment adviser exemption from registration as a CTA. In order to rely 4.14, the adviser must (a) be registered under the Investment Advisers Act of 1940 or with the applicable securities regulator of any state; (b) their trading in commodity interests must be (i) solely for "qualified entities" and (ii) solely incidental to its business of providing securities and other investment advice; and (c) the entity must not hold itself out as a CTA.

Rule 4.7 Registration Lite

CPOs of funds whose investors are qualified eligible purchasers must still register with the NFA; however, they may be able to take advantage of the scaled-back disclosure, recordkeeping, and periodic reporting requirements applicable to other registered CPOs.

Investment advisers that qualify for the exemption described above are still generally subject to the following requirements either under CFTC SEC rules:

- Investment advisers must file a publicly available notice disclosing the exempt status which may be reviewed on the CFTC or NFA website
- Investment advisers must provide investors with an offering memorandum containing information such as fees, transferability of fund interests, conflicts of interest and other matters
- Investment advisers must provide investors with quarterly account statements and an annual report
- Claiming the Exemptions

The exemptions described above are not self-executing. To claim the exemption, the adviser needs to file electronically a notice of eligibility with the NFA. In addition, private funds must make certain disclosures to each prospective investor regarding the fund's exempt status. In order to retain on-going eligibility for the exemption, advisers that are still eligible for relief must on an annual basis affirm the accuracy of their original notice of exemption.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

Author: Charles H. Field, Of Counsel; Editor: Michelle L. Jacko, Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters.

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