Legal Risk Management Tip
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COMMODITY INVESTMENTS: WHAT IT MEANS FOR ADVISERS AND INVESTMENT COMPANIES

Historically, the Commodity Exchange Act (the "CEA") focused on advisers and operators of collective investment vehicles that traded in commodity futures on registered exchanges. Money managers managing institutional separate accounts, private funds, and securitization vehicles among other types of entities were exempt from CEA registration because their clients and investors in the funds were "sophisticated investors." The CEA exempted sponsors of mutual funds outright.

Today, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") has changed the landscape for investment advisers. Dodd-Frank eliminated the long-standing "sophisticated investor" exemption, severely limited the registered fund exemption, and expanded the definition of commodity pool and commodity pool operator with the overall effect of capturing "trading" in security futures products and swaps. As a result, a large number of advisers and investment vehicles that were not commodity pools under prior regulations could now be classified as commodity pools, and the advisers to and operators of such vehicles must consider whether they need to register as Commodity Pool Operators ("CPOs") or Commodity Trading Advisors ("CTAs"), take action to claim exemption, or fulfill additional regulatory obligations.

Commodity Interests

Determining what constitutes a commodity is not always straight forward. Originally, a commodity was any item included on an enumerated list of agricultural goods, oil, precious metals, 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.

In July 2012, the CFTC and Securities Exchange Commission ("SEC") finalized their definition of swaps and security-based swaps to include: foreign exchange forwards, foreign exchange swaps, foreign currency options (not traded on a national securities exchange), non-deliverable forward contracts involving foreign exchange, currency swaps, cross-currency swaps, forward rate agreements, contracts for differences, and certain combinations and permutations of (or options on) swaps and security-based swaps, among others. Futures and options on futures including securities futures and narrow based securities index, swaps.

What You Need to Know – Definitions and Considerations

The Commodity Pool

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, retail off-exchange forex contracts or swaps, or to invest in another commodity pool. Historically, registered investment companies relied on the exemption found in CFTC Rule 4.5. Last year, the CFTC amended the Rule limiting the availability of the exclusion from the definition relied upon by many registered investment companies triggering an obligation in several cases to register with the CFTC.

The Commodity Pool Operator

A commodity pool operator means 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.

The Commodity Trading Advisor

A commodity trading advisor is any person who for compensation or profit (i) 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: (a) 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; (b) any commodity option authorized under Section 6c of the CEA; or (c) any leverage transaction authorized under section 23 of the CEA; or (ii) and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities referred to above.

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 register 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.

Registration Requirements

In general, registration is required *unless* the CPO or CTA qualifies for one of the exemptions from registration outlined in CFTC Regulations 4.5 or 4.13. Full registration as a CPO 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.

<u>Rule 4.13(a)(3) Exemption</u>

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.

<u>Rule 4.5 Exemption</u>

Rule 4.5, the "mutual fund de minimis exemption," exempts sponsors of mutual funds that hold minimal positions in commodity interests. In order to rely on Rule 4.5, a mutual 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 mutual 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). The new exclusion added by the rule allows a registered investment company to enter into derivatives having a net notional value equal to up to 100% of the fund's net asset value.

Rule 4.14 Exemption

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, and (b) their trading in commodity interests must be (i) solely for "qualified entities,"[1] 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.

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, Esq., Of Counsel; Editor: Michelle L. Jacko, Esq., 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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[1] Under CFTC Rule 4.5(b) a "qualifying entity" means (1) an investment company registered as such under the Investment Company Act of 1940; (2) a separate account established and maintained or offered by an insurance company pursuant to the laws of any State, under which income, gains and losses, whether or not realized, form assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account, without regard to other income, gains, or losses of the insurance company; (3) the assets of any trust, custodial account or other separate unit of investment for which a bank or trust company is acting as a fiduciary and for which it is vested with investment authority; and (4) a pension plan that is subject to title I of ERISA.