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Investment Services Bulletin

CFTC Adopts Final Amendments to Rule 4.5

On February 9, 2012, the Commodity Futures Trading Commission (CFTC) announced the adoption of final rules amending the registration and compliance obligations for commodity pool operators (CPOs) and commodity trading advisors (CTAs). The final rule amendments (Final Rules) impact multiple rules and are likely to impact many registered investment companies, hedge funds and their investment advisers. This Bulletin focuses on the amendments to CFTC Rule 4.5, which is relied upon by many investment companies registered under the Investment Company Act of 1940, as amended (1940 Act).

Current Regulatory Regime

Most registered investment companies that use either futures or options on futures claim relief from registration as a CPO, pursuant to the exclusion set forth in CFTC Rule 4.5 (Rule 4.5). Prior to August 2003, to claim the exclusion under Rule 4.5, registered investment companies were required to represent (i) that commodity futures or options on futures contracts were limited to bona fide hedging purposes, or (ii) the aggregate initial margin and/or premiums for positions that did not meet the bona fide hedging criteria did not exceed 5 percent (5%) of the liquidating value of the company's portfolio, after taking into account unrealized profits and losses. Under the pre-August 2003 rule, registered investment companies claiming relief under the exclusion in Rule 4.5 also could not be marketed as a participant in a commodity pool or otherwise as a vehicle for trading commodity futures or options.

In August 2003, as part of a larger overhaul of its regulations, the CFTC eliminated both the position limits and marketing restrictions set forth above.[1] The policy basis for such changes was that the activities of registered investment companies were subject to substantive regulation by the Securities and Exchange Commission (SEC). Many new investment products have been developed by industry participants as a result of the greater flexibility afforded by the 2003 changes.

Summary of Rule 4.5 Amendments

On January 26, 2011, the CFTC proposed to reinstate the position limits and marketing restrictions described above with respect to registered investment companies claiming exclusion from the definition of CPO.[2] The CFTC expressed concern that registered investment companies were offering "de facto commodity pools" and "managed futures strategies" without being subject to substantially similar regulatory obligations as registered CPOs. The CFTC received numerous comments opposing the proposal, and requests for guidance on a number of interpretative questions stemming from the fact that disclosure and other requirements applicable to CPOs are inconsistent, and in some cases conflict, with requirements for registered investment companies.

On February 9, 2012, the CFTC adopted final rules amending Rule 4.5.[3] Concurrent with the adoption of the Final Rules, the CFTC also proposed amendments to harmonize the CFTC and SEC disclosure and compliance requirements applicable to registered investment companies that now will be required to register as CPOs as a result of the Final Rules.

[1] *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues,* 68 Fed. Reg. 47221 (Aug. 8, 2003).

[2] *See* 76 Fed. Reg. 7976 (Feb. 11, 2011).

[3] *Commodity Pool Operators and Commodity Trading Advisors: Amendment to Compliance Obligations; Final Rule* (Feb. 8, 2012) ("Adopting Release"), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf.

It is important to note that the amended Rule 4.5 will cover swaps. Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), swaps were generally excluded from the Commodity Exchange Act of 1936.[4]

Trading Thresholds

As amended by the Final Rules, the Rule 4.5 exclusion can be claimed by a registered investment company only if one of the following trading thresholds is met:

- The registered investment company limits its trading such that aggregate initial margin and premiums required to establish commodity futures, options on futures, or commodity swap positions do not exceed 5 percent (5%) of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses (the "percentage-of-margin test"). The percentage-of-margin test does not apply to transactions entered into for "bona fide hedging purposes" (as defined by CFTC Rule 1.3(z) (Rule 1.3(z)) and allows registered investment companies to exclude from the calculation any portion of an option that is in-the-money at the time the option is purchased; or
- The registered investment company's aggregate net notional value of its commodities-related trading positions not used for bona fide hedging purposes, determined at the time its most recent position was established, does not exceed 100 percent of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses (the "net notional test"). The term notional value is defined by asset class (e.g., with different definitions applying to futures and swaps) and the ability to net positions is also defined by asset class. For example, a fund may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade, but swaps may be netted only if cleared by the same designated clearing organization.

[4] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The Dodd-Frank Act repealed provisions of the Commodity Futures Modernization Act of 2000, which exempted swaps from the Commodity Exchange Act of 1936.

In the Adopting Release, the CFTC noted that industry analysts had proposed several exclusions from covered activities, including carve-outs for financial and securities-based futures, risk management activities and passive index-based strategies. Generally, the CFTC had concerns that such exceptions would be difficult to define and enforce, and would allow registered investment companies to engage in significant derivatives activity without being subject to regulation by the CFTC.

Registered investment companies who invest in commodity interests through offshore subsidiaries (controlled foreign corporations (CFCs)) will be required to have the CFC separately qualify for a CPO exemption. CFCs may be unable to qualify for a full exemption, and as a result the adviser to the CFC would need to register. In addition, the use of a CFC by a fund and other factors, such as a name connoting commodity exposure, may result in the fund being unable to rely on Rule 4.5 because of the marketing restrictions detailed below.

Similarly, investment advisers to registered funds of hedge funds (FOHFs) will need to evaluate whether they will need to register as a CPO as many FOHFs invest in private funds which trade in commodity interests.

Marketing Restrictions

As amended by the Final Rules, Rule 4.5 reinstates the marketing restrictions in place prior to the August 2003 amendments for registered investment companies. Specifically, the Rule prohibits a registered investment company from marketing itself "as a vehicle for trading in the commodity futures, commodity options, or swaps markets." As proposed, the Rule also would have included the parenthetical "(or otherwise seeking investment exposure to)" following the phrase "as a vehicle for trading in." Analysts had argued that such phrase was ambiguous and could impact a large number of funds. The Final Rules do not include this language. In response to requests for guidance on what factors may be considered in determining compliance with the marketing restrictions, the CFTC provided that the following list of non-exclusive factors is relevant to making a determination of whether or not a registered investment company is marketed as a vehicle for investing in commodity futures, commodity options or swaps:

- The name of the fund;
- Whether the fund's primary investment objective is tied to a commodity index;
- Whether the fund makes use of a controlled foreign corporation for its derivatives trading;

- Whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;
- Whether, during the course of its normal trading activities, the fund or entity acting on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;
- Whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will, directly or indirectly, be its primary source of potential gains and losses; and
- Whether the fund is explicitly offering a managed futures strategy.

The Adopting Release noted that more weight would be given to the final factor in the list, but that a fund that does not expressly hold itself out as a managed futures fund could nevertheless be viewed as violating the marketing restrictions if other indicia of a managed futures strategy are present. The Adopting Release also noted that merely disclosing that a fund may engage in derivative transactions incidental to its main strategy would not violate the marketing restrictions.

Impact of the Final Rules

Although the commentary in the Adopting Release suggests that the amendments were prompted by the recent development of "managed futures funds," the Final Rules will have much wider impact on virtually all registered investment companies that engage in derivatives strategies covered by Rule 4.5 and their investment advisers. Many innovative products have been developed to take advantage of the greater flexibility afforded by the August 2003 amendments to Rule 4.5, including target date funds, principal protected funds and complex derivatives overlay strategies. In addition, offshore wholly owned subsidiaries have proliferated as a vehicle for investing in commodities-based derivatives following the issuance of a number of favorable private letter rulings addressing certain tax issues applicable to regulated investment companies under the Internal Revenue Code. Many of these products would not have been able to comply with Rule 4.5 as it existed prior to August 2003. The inclusion of swaps within the scope of Rule 4.5 and the recent narrowing of the scope of the bona fide hedging definition will make compliance with the Final Rules even more difficult to comply with than its pre-August 2003 predecessor.

Under the current regulatory regime, registered investment companies are rarely, if ever, requested to register as CPOs. Under the new regime, investment advisers to funds who can no longer claim the exclusion will need to register as CPOs or the registered investment company may need to modify its investment strategies to comply with Rule 4.5. We note that the CFTC clarified that the investment adviser to a registered investment company is the entity required to register as a CPO if the exclusion in Rule 4.5 is no longer available. Accordingly, directors and trustees of registered investment companies will not need to register. This was a source of confusion prior to the Final Rules. Funds that will be able to rely on the exclusion in amended Rule 4.5 will need to meet new filing requirements and update compliance systems to monitor the new trading thresholds and marketing restrictions.

Stay Tuned

The Final Rules have spawned, and will continue to spawn, many interpretative, operational and compliance issues that will need to be identified, resolved and implemented on or before the effective date. The CFTC has yet to define the term "swap" or to provide guidance regarding the margin requirements for swaps. Guidance for dually registered investment companies to ease certain of the compliance burdens under the Commodity Exchange Act are at the proposal stage. In addition, the netting provisions with respect to the aggregate net notional test are complex and will require detailed analysis. While the changes in the Final Rules with respect to the marketing restrictions, and the guidance provided alleviate certain ambiguities, the application of the marketing restrictions remains subjective and difficult to apply in some cases. Additional issues are likely to arise in specific circumstances, such as the impact of the Final Rule on subadvisers to registered investment companies.

Action Required

All registered investment companies that currently claim an exclusion pursuant to Rule 4.5 and their investment advisers should promptly begin to develop a comprehensive action plan to assess the impact of the Final Rules. Fund Boards should request an analysis of the impact of the Final Rules on the funds they oversee and should request periodic updates of the status of an action plan. Funds that use derivatives only for risk management and hedging purposes (as commonly defined in the industry) should not presume that they will be able to claim the exclusion but should undertake a thorough analysis of the issues. Key elements of an action plan should include:

- Identifying funds that currently claim the Rule 4.5 exclusion, and creating a consistent and systematic process for collecting information regarding permitted and actual uses of derivatives.
- Developing systems and methodologies for simulating compliance with the percentage-of-margin and aggregate net notional tests for purposes of assessing the impact of the Final Rules and, longer term, for monitoring compliance with those tests on an ongoing basis. This will require resolving any interpretative questions regarding defined terms and margin requirements, as well as defining rules for netting.
- Creating a timeline and task list for making key decisions (such as a decision to register as a CPO, modify investment policies or maintain the status quo), and identifying all required approvals or other actions necessary to implement such final decisions. This will include identifying Board action items and disclosure change as well as filing requirements for all funds.

Additionally, investment advisers will need to re-assess any exclusion that they currently rely on, including the exclusion in Rule 4.14(a)(8) for advisers that provide commodities advice solely to entities satisfying the Rule 4.5 exclusion. If registration as a CPO and/or CTA will be required, the adviser will need to assess other issues, such as (i) licensing requirements for individual representatives, (ii) Form ADV disclosure and (iii) developing and implementing compliance policies and procedures for compliance with the Commodity Exchange Act.

Effective Dates

Investment advisers required to register as CPOs as a result of the changes in Rule 4.5 must register by the later of December 31, 2012 or sixty (60) days after the effective date of the final rulemaking by the CFTC defining the term “swap.”

Once an investment adviser is registered as a CPO for a registered investment company, it will not be required to comply with the recordkeeping, reporting and disclosure requirements of the CFTC until 60 days after the adoption of final rules governing the compliance framework for registered investment companies subject to the jurisdiction of both the CFTC and SEC.

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