

CFTC Registration Considerations for Private Fund Managers

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Whether you are a seasoned firm launching a new fund or an emerging private fund manager, this article summarizes fundamental steps for determining registration related requirements for the management entity under the Commodity Exchange Act of 1936, as amended (“CEA”). SEC registration and registration considerations for non-U.S. jurisdictions are not addressed in this summary.

A. Futures/Forex/Derivatives Trading

If a manager intends to invest a fund’s assets in *any* futures, options on futures, forex (foreign currency), swaps or other related derivatives products, the manager will need to determine if it needs to register as a commodity pool operator (“CPO”) or a commodity trading advisor (“CTA”) with the U.S. Commodity Futures Trading Commission (the “CFTC”) and become a member of the National Futures Association (the “NFA”).

Examples of products that are generally subject to CFTC jurisdiction include the following: listed futures products (including security futures products), options on futures, forex (a common abbreviation used for “foreign exchange” (*e.g.*, selling dollars to buy Euros)), credit default swaps (CDS) on a broad security index (> 9 names), commodity swaps, correlation swaps on a broad security index (> 9 names), correlation swaps that are commodity-based, dividend swaps on a broad security index (> 9 names), guarantees of swaps, interest rate swaps, credit default swaps on loans (LCDS) on multiple loans, total return swaps on loan mortgage backed securities (LTRS) on multiple loans, non-deliverable forwards, options on swaps, swaps on an exempt security (other than municipal securities), total return swaps (TRS) on a broad security index (> 9 names), variance swaps on a broad security index (> 9 names), weather, energy or emissions swaps, contracts for difference (CFD) that are not securities based, securities-based swaps (SBS) also based on certain CFTC-regulated rates, indices, currencies, commodities, etc. (note that CFTC and SEC regulations apply) and listed forex options contracts.

As detailed below, a number of exemptions from CFTC registration may apply if a manager intends to trade in any of the above commodities related products. If the manager is required to register with the CFTC as a CPO or CTA, at least one individual must register as an associated person (“AP”) of the manager and also be listed as a principal of the manager. In general, any person that seeks to become a registered AP of the manager must pass the Series 3 exam (*i.e.*, the futures trading exam). In addition, if such person also wishes to work with retail customers in off-exchange forex business, they will need to take the Series 34 exam (*i.e.*, the forex trading exam).

B. CPO Exemptions

1. Minimal Commodities Investments – 4.13(a)(3)

If the fund’s manager only intends to make minimal investments in commodity interests for a privately offered pool that is exempt from registration under the Securities Act of 1933

("1933 Act"), it can likely rely upon CFTC Regulation 4.13(a)(3) in order to avoid CPO registration with respect to the fund. In this regard, the pool cannot be marketed as a vehicle for trading commodities. For this exemption to apply, either: (1) the fund's *aggregate initial margin and premiums for commodity interests* cannot exceed 5% of "liquidation value" of the fund's portfolio (the "5% Test") (taking into account unrealized profits and losses; provided that in the case of an option that is in-the-money at the time of purchase, the in-the-money amount may be excluded in computing such 5%) or (2) the fund's *aggregate net notional value of commodity interests* cannot exceed 100% of the fund's "liquidation value" (the "Notional Test") (taking into account unrealized profits and losses). Application of both *de minimis* tests is determined at the time the most recent position was established and applies regardless of whether such positions were entered into for bona fide purposes or otherwise. The "Notional Test" is an especially useful alternative to the "5% Test" because margin levels for broad-based stock index futures and security futures tend to exceed levels for other commodity interests, which may make it difficult to satisfy the "5% Test." The "Notional Test" sets forth specific details regarding how to calculate the notional value by asset class and how to net contracts.

In order to claim the exemption, the manager must reasonably believe that each investor in the commodity pool is an "accredited investor," a trust that is not an "accredited investor" but that was formed by an "accredited investor" for the benefit of a family member, a "knowledgeable employee" of the manager, or a qualified eligible person as defined under CFTC Regulation 4.7. The 4.13(a)(3) exemption is not self-executing and a request for relief must be filed with respect to the fund with NFA. An annual affirmation to maintain this exemption must be filed within 60 days of the calendar year-end with the NFA. Each person who files for such relief must still keep books and records of its activities as a pool operator for 5 years, and such records must be readily accessible for 2 years. *See* CFTC Regulation 4.13(c)(1). Such person is not required to keep full books and records, however, as detailed in CFTC Regulation 4.23.

2. FOF Exemption – 12-38 Letter

If the fund's manager acts in whole or in part as a CPO of one or more fund of funds, the manager may be able to rely on CFTC No-Action Letter 12-38 (the "**Letter 12-38**") to avoid registration as a CPO. In order for Letter 12-38 to apply, the amount of commodity interest positions to which the fund is directly exposed cannot exceed the levels specified in the "5% Test" or "Notional Test" (as described above with respect to 4.13(a)(3) funds) and the manager must not know and could not have reasonably known that the fund's indirect exposure to commodity interests derived from contributions to the various third-party funds exceed such levels, either calculated directly, or through the use of Prior Appendix A under Rule 4.13(a)(3) relating to such relief.

In addition, the fund for which the manager seeks relief must be compliant with the provisions of Regulation 4.13(a)(3)(i), (iii) and (iv) (namely that, all interests in the pool are part of a private offering, the manager must have a reasonable belief that each pool participant is an accredited investor, qualified eligible person, knowledgeable employee or other enumerated type of sophisticated investor, and the pool is not marketed as a vehicle for trading in futures or commodities options markets). This Letter 12-38 relief is not self-executing, and the manager must file a claim to perfect the relief with the NFA with respect to the fund. No annual

affirmation is required to maintain this exemption. Once final fund of fund guidance is issued by the CFTC, affected CPOs must reevaluate whether they can continue to rely on Letter 12-38. Letter 12-38 is only intended to be effective through the later of June 30, 2013 or six months after the effective date of the revised guidance (or the compliance date, if later) regarding the application of *de minimis* thresholds to fund of funds in the context of CFTC Regulations 4.13(a)(3) and 4.5.

3. **CFTC Registration Lite – 4.7**

If a fund's manager was unable to claim an exemption from CPO registration, a manager can register as a CPO and then claim relief under CFTC Regulation 4.7 – oftentimes referred to as “registration lite.” In order to claim the exemption, the fund must limit its sales activity to qualified eligible persons (“QEPs”), as defined under CFTC Regulation 4.7. Although CFTC Regulation 4.7 necessitates registration of the fund's manager as a CPO, reduced disclosure, reporting, recordkeeping and other regulatory requirements would apply with respect to the fund. Briefly stated, “QEPs” include persons such as certain investment professionals, knowledgeable employees, qualified purchasers as defined under the Investment Company Act of 1940, as amended (“1940 Act”), non-U.S. persons and accredited investors that meet the portfolio requirement. The 4.7 exemption is not self-executing, and a request for relief must be filed with respect to the fund with NFA. No annual affirmation is required to maintain this exemption.

4. **Non-U.S. Managers**

An exemption from CPO registration under CFTC Regulation 3.10(c)(3) is available if a manager is advising a non-U.S. fund of which all investors are located outside of the U.S. and no solicitations are directed into the U.S. In addition, all trading must be conducted on non-U.S. exchanges, bilaterally with non-U.S. counterparties for swaps or on U.S. exchanges, or bilaterally with U.S. counterparties for swaps, and submitted for clearing through a registered futures commission merchant. A manager acting in accordance with this exemption remains subject to Section 4(o) of the CEA (which relates to fraud and misrepresentations). No filing is required for this exemption to be effective.

5. **Non-U.S. Pools – Advisory 18-96**

Registered U.S. CPOs are provided relief from certain reporting, recordkeeping and disclosure requirements for their funds that are organized offshore and only have non-U.S. participants. For this exemption to apply, the fund must also: (1) not hold meetings or conduct administrative activities in the U.S.; (2) not receive, hold or invest any capital directly or indirectly contributed from sources within the U.S.; and (3) conduct no marketing that could reasonably be expected to have the effect of soliciting U.S. investors. A hard copy of the exemption under CFTC Advisory 18-96 must be filed with NFA's Compliance Department to be effective. No annual affirmation is required to maintain this exemption.

6. **Incidental Commodities Trading**

Registered CPOs are afforded relief from certain reporting and disclosure requirements with respect to their private funds operating pursuant to the 1933 Act or a related exemption where the fund routinely engages in securities business. For the relief to apply, the aggregate initial margin and premiums for the fund cannot exceed 10% of the fair market value of the fund's assets. Further, commodities trading must be only incidental to the fund's securities trading activities.

C. **CTA Exemptions**

In addition to the CPO exemptions described above, the fund's manager will also need to consider whether any CTA exemptions from registration apply. Registered CTAs must also generally become members of the NFA.

1. **Exempt CPO Advising Own Fund**

An exemption from CTA registration under CFTC Regulation 4.14(a)(5) is available for an exempt CPO that is acting as a trading advisor to its own fund. For this relief to apply: (1) the CPO must be exempt from registration as a CPO; and (2) the person's commodity trading advice must be directed solely to, and for the use of, the fund(s) for which it is so exempt. No filing is required for this exemption to be effective.

2. **Registered CPO Advising Own Fund**

An exemption from CTA registration under CFTC Regulation 4.14(a)(4) is available for a registered CPO that is acting as a trading advisor to its own fund. For this relief to apply: (1) the CPO must be registered under the CEA as a CPO; and (2) the person's commodity trading advice must be directed solely to, and for the use of, the fund(s) for which it is so exempt. No filing is required for this exemption to be effective.

3. **Less than 15 Persons**

A manager who, in the preceding 12 months, has not furnished commodity trading advice to more than 15 persons and who does not hold itself out generally to the public as a CTA is exempt from CTA registration. *See* CEA § 4(m)(1) and CFTC Rule 4.14(a)(10). CFTC Rule 4.14(a)(10) provides additional guidance regarding how a manager relying on this exemption should count clients toward the 15-client limit. In particular, non-U.S. firms need only count U.S.-resident clients towards the 15-client limit. In addition, the exemption provides that a manager shall not be deemed to hold itself out generally to the public for purposes of Section 4m(1) solely because the manager participates in a non-public offering of interests in a collective vehicle (e.g., a private offering of securities exempt from registration under the 1933 Act). "Holding oneself out" briefly means that a person is not advertising to obtain clients or actively trying to get new accounts. No filing is required for this exemption to be effective.

4. **Investment Advisers – Not Primarily Engaged**

An exemption from CTA registration under CEA § 4(m)(3) is available for a manager who is: (1) registered with the U.S. Securities and Exchange Commission (the “SEC”) as an investment adviser; (2) whose business does not consist *primarily* of acting as a CTA; and (3) who does not act as a CTA to any investment trust, syndicate or similar form of enterprise that is engaged primarily in trading in any commodity for future delivery on or subject to the rules of any contract market or registered derivatives transaction execution facility. In this regard, the exemption provides that a CTA or a commodity pool shall be considered to be “engaged primarily” in the business of being a CTA or commodity pool if it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding or trading in commodity interests, respectively. No filing is required for this exemption to be effective.

5. **Investment Advisers – Solely Incidental**

An exemption from CTA registration under CFTC Regulation 4.14(a)(8) is available for an investment adviser that is acting as a trading advisor. For this exemption to apply: (1) the CTA must only provide advice to pools operating under a 4.13(a)(3) exemption, non-U.S. pools or CFTC Regulation 4.5 exempt pools; (2) such trading advice must be *solely incidental* to its securities advice; and (3) the manager cannot otherwise hold itself out as a CTA. This exemption is not self-executing. For the relief to apply, the manager must make the exemption filing with the NFA. An annual affirmation to maintain this exemption must be filed within 60 days of the calendar year-end with the NFA.

6. **CFTC Registration Lite – 4.7**

CFTC Regulation 4.7 makes available an exemption from certain CEA Part 4 requirements for a CTA when the manager’s investments are only made by qualified eligible persons (i.e., QEPs) – oftentimes referred to as “registration light.” In order to claim the exemption, the manager must limit its sales activity to QEPs, as defined under CFTC Regulation 4.7. Briefly stated, “QEPs” include persons such as certain investment professionals, knowledgeable employees, qualified purchasers as defined under the 1940 Act, non-U.S. persons and accredited investors that meet the portfolio requirement. Although CFTC Regulation 4.7 necessitates registration of the manager as a CTA, reduced disclosure, reporting, recordkeeping and other regulatory requirements still apply with respect to the manager’s activities. The 4.7 exemption is not self-executing, and a request for relief must be filed with respect to the manager with NFA. No annual affirmation is required to maintain this exemption.

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