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COVINGTON & BURLING LLP

E-ALERT | Funds

December 19, 2012

EXEMPTIONS AND NO-ACTION RELIEF HELP FUNDS NAVIGATE YEAR-END CFTC REGISTRATION REQUIREMENTS

Changes to the US Commodity Exchange Act (the "CEA") made by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") subjected a large number of fund sponsors, including sponsors of non-US funds with US investors, to the jurisdiction of the US Commodity Futures Trading Commission (the "CFTC") for the first time. This occurred because the Dodd-Frank Act amended the CEA to include swaps within the commodity interests that will cause a pooled investment vehicle to be considered a "commodity pool." As a result, swap use — the CFTC has indicated even a single swap contract — could cause a fund sponsor or manager to be deemed a "commodity pool operator" ("CPO") required to register with the CFTC. The CFTC also rescinded a broad exemption from registration for managers of commodity pools that are offered only to sophisticated investors (the "private funds exemption").[1]

Although some other exemptions from registration were already available, the breadth of the new requirements led to considerable concern among fund sponsors and resulted in a number of requests for regulatory relief. In response, the CFTC and the US Treasury Department have adopted several different exclusions, exemptions and deadline extensions over the past several weeks. Many fund sponsors could benefit from these regulatory actions, but the piecemeal nature of the relief has created considerable confusion over who needs to register and by when.

This alert is intended to clarify the current state of play regarding registration requirements as funds work toward new filing deadlines, many of which fall on December 31, 2012.

WHO NEEDS TO REGISTER

Because of the Dodd-Frank Act amendments to the CEA and the CFTC's expansive interpretation of the term "commodity pool," effective October 12, 2012, most funds engaging in any swap activities were considered commodity pools.[2] The CEA defines "swap" broadly to include most over-the-counter derivatives contracts. Therefore, unless the CFTC relief described below is applicable or additional relief is forthcoming from the CFTC, managers of funds that are commodity pools solely by

[1] The rescission of the private funds exemption became effective April 24, 2012, but the CFTC provided that fund managers that had formerly claimed this exemption had until December 31, 2012 to register as CPOs or file for another applicable exemption.

[2] A "commodity pool" now includes "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including any . . .swap." "Commodity pool operator" therefore means:

> any person engaged in a business that is of the nature of a commodity pool, 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 commodity interests, including any . . . swap.

virtue of swap activities, or funds that had previously relied on a rescinded exemption, are required to register as CPOs or file for an applicable exemption by December 31, 2012.

EXEMPTIONS

If applicable, fund managers may make use of the following exemptions:

- **Use of Deliverable Foreign Exchange Contracts.** Pursuant to a US Treasury Department determination issued on November 16, 2012, deliverable foreign exchange forwards[3] and foreign exchange swaps[4] were exempted from the definition of a "swap" under the CEA. Funds whose swap activity is limited to deliverable foreign exchange forwards and foreign exchange swaps are therefore not considered to be commodity pools so no CPO registration is required of such funds' managers. Moreover, even funds whose activity is not so limited may disregard such transactions when calculating compliance with the *de minimis* exemptions described below. Non-deliverable foreign exchange forwards and swaps are not covered by the US Treasury Department determination and funds engaging in them would therefore be considered commodity pools.
- ***De Minimis* Exemption.** This narrowly drawn exemption from registration is available to managers of private funds that hold *de minimis* commodity interest positions[5] and in which all investors are non-US persons or sophisticated investors.[6] Many private equity funds will satisfy one or both of the *de minimis* thresholds if they are using swaps solely for hedging purposes. Furthermore, new funds that enter into swaps before putting on their first deals will be given a reasonable amount of time to come into compliance with the *de minimis* threshold.
- **Registered Funds Exemption.** This exemption is available only to funds that are investment companies registered under the Investment Company Act. Formerly a broad, blanket exemption for registered funds, the exemption was amended in connection with the implementation of the Dodd-Frank Act so that registered funds claiming this exemption must now either be engaged solely in bona fide hedging transactions, a term so narrowly defined as to be unlikely to apply to any fund,[7] or hold *de minimis* commodity interest positions.[8] The amendment to the registered

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[3] The term "foreign exchange forward" is narrowly defined under the CEA to mean a transaction that involves the "exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."
[4] The term "foreign exchange swap" is narrowly defined under the CEA to mean a transaction that "solely involves (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of [such currencies] at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."
[5] A fund will be considered to hold *de minimis* swap positions if either the margin required to establish any swaps or other commodities positions does not exceed five percent of the fund's portfolio's liquidation value *or* the net notional value (calculated in accordance with the CFTC regulation) of the fund's swaps or other commodities positions does not exceed one hundred percent of the fund's portfolio's liquidation value (the "*de minimis* thresholds"). As noted above, because the Treasury Department determined to exempt them from the definition of "swap," deliverable foreign exchange forwards and foreign exchange swaps should not be included in any *de minimis* calculation. The *de minimis* calculations must be determined at the time the fund's most recent position is established; however, the fund must comply with at least one of these tests at all times to satisfy the exemption.
[6] CPOs of commodity pools comprised entirely of non-US investors and "qualified eligible persons," which include "qualified purchasers," as that term is defined in Section 2(a)(51)(A) of the Investment Company Act of 1940, as amended (the "Investment Company Act") or "accredited investors," as that term is defined in Rule 501 under the US Securities Act of 1933, as amended, among other categories of sophisticated investors, that also meet the other requirements of the exemption will qualify.
[7] Under applicable CFTC definitions, "bona fide hedging" is limited to transactions (i) whose purpose is to offset price risks incidental to commercial cash or spot commodity operations; (ii) where positions are established

funds exemption recently survived a challenge in federal court; the US District Court for the District of Columbia rejected the claims of the Investment Company Institute and the United States Chamber of Commerce that the amendment to the rule was "arbitrary and capricious" and that the CFTC failed to conduct a sufficient cost-benefit analysis.[9]

The foreign exchange contract exemption takes funds engaging in such transactions but not engaging in any other swap or commodity futures transactions outside of CFTC regulation and no registration or exemption filing is required. Sponsors of such funds that have already filed for another exemption with the National Futures Association ("NFA") may withdraw the exemption filing. If the fund sponsor is not registered as a CPO, it may send an email to the NFA requesting that the NFA withdraw the exemption. Registered CPOs may withdraw the exemption by deleting it from their online accounts.

The *de minimis* and registered funds exemptions are not self-executing, and a fund manager that otherwise would have been required to register as a CPO must electronically file a notice of exemption with the NFA through its electronic exemption filing system.[10] This notice must be re-affirmed annually.[11] In addition, the fund manager claiming either exemption from CPO registration must provide to investors in the fund for which such fund manager is claiming the exemption a statement that such fund manager is exempt from registration with the CFTC as a CPO and is not required to deliver a disclosure document or a certified annual report to fund investors. Fund managers filing for a new exemption due to the rescission of an exemption for which they had previously qualified must provide a statement regarding the change in exemption to investors in connection with filing for the new exemption. While the CFTC has not provided clear guidance with respect to the investor statement requirement for fund managers of existing funds filing for an exemption for the first time due to the swap amendments, such managers should, as a best practice, provide existing investors with such statement in connection with their next quarterly or annual report to investors and must, in accordance with the requirements of the exemption, provide new investors with such statement at the time they deliver a subscription agreement.

CFTC RELIEF

In addition to the exemptions described above, the CFTC staff has provided relief to the following categories of funds:

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and liquidated in an orderly manner in accordance with sound commercial practices; and (iii) that represent a substitute for a physical commodity market transaction.

[8] Funds that had qualified and filed for the exemption prior to the amendment, but no longer qualify following the amendment, have until December 31, 2012 to register as CPOs or file for another applicable exemption.

[9] Investment Company Institute v. U.S. Commodity Futures Trading Commission, Civ. Act. No. 12-00612 (D.D.C. 2012).

[10] The web page for exemption filings is located at http://www.nfa.futures.org/NFA-electronic-filings/exemptions.HTML. The exemption filing must be made by a person with authority to bind the person claiming the exemption (the potential CPO) and must contain the following information: (i) the name, main business address, main business telephone number, main facsimile number and main email address of the person claiming the exemption and the name of the fund for which it is claiming the exemption and (ii) the section of the CFTC regulations pursuant to which such person is filing the exemption and a representation that the fund will be operated in accordance with such section.

[11] Under CFTC rules, this reaffirmation must occur within 60 days of the end of the calendar year, commencing for the year ending December 31, 2012. Under recently issued NFA guidance, this means that funds that file for an exemption on or before December 31, 2012 must reaffirm by March 1, 2013 or the exemption will be considered withdrawn.

- **Family Offices.** The CFTC staff will take no action for failure to register as a CPO against operators of family offices[12] that file a notice claim by March 31, 2013 (or, if such family office begins to operate after March 31, 2013, within 30 days after commencing operation) with the CFTC's Division of Swap Dealer and Intermediary Oversight via email by using the email address *dsionoaction@cftc.gov* (subject heading "Family Office").
- **Funds of Funds.** Operators of certain funds of funds holding *de minimis* direct commodities positions[13] that file a notice claim prior to December 31, 2012 with the CFTC's Division of Swap Dealer and Intermediary Oversight via email by using the email address *dsionoaction@cftc.gov* (subject heading "Fund-of-Funds") will have until the later of June 30, 2013 or six months from the date the CFTC's Division of Swap Dealer and Intermediary Oversight issues revised guidance on the application of the *de minimis* threshold in the *de minimis* exemption and the registered funds exemption to such funds of funds[14] to register as CPOs or file for an applicable exemption.

Any notice claims for family offices or funds of funds should (i) include the name, main business address, and main business telephone number of the person or entity claiming the relief (ii) state the capacity (*i.e.* CPO) and the name of the fund(s) for which such claim is being filed and (iii) be electronically signed by the person or entity claiming the relief.

CONCLUSION

Because of recent amendments to the CEA, most funds engaging in swaps transactions are considered commodity pools. Consequently, managers of those funds are considered CPOs and are subject to CFTC regulation. While many funds will meet the requirements of one of the exemptions from registration or be eligible for the no-action relief that has been extended by the CFTC staff, fund managers should be aware that the exemptions and the no-action relief are, in most cases, not self-executing and should be prepared to file claims to avail themselves of such exemptions and relief by the applicable deadline. With respect to funds that engage in swaps and do not qualify for any exemption or permanent relief, fund managers, if not already registered as CPOs because of other commodities transactions, must file an application for registration by December 31, 2012. In addition, fund managers should add relevant CFTC filings or notices to their closing checklists going forward.

[12] This relief is available to family offices as defined in Rule 202(a)(11)(G)-1 under the US Investment Advisers Act of 1940, as amended (the "Advisers Act").

[13] In amending its rules to implement the Dodd-Frank Act, the CFTC rescinded its guidance on the application of the *de minimis* thresholds to entities that indirectly trade commodity interests as a result of their investments in other vehicles. Because funds of funds may not have visibility into investee funds' portfolio exposures, they may be unable to perform the calculations to determine if they meet the *de minimis* thresholds. The CFTC's rescinded guidance enumerated the situations under which a fund of funds operator could infer compliance with the *de minimis* threshold and its rescission left many fund of funds operators unable to determine whether registration was required.

[14] To be eligible for the relief, the fund of funds (i) must not have direct exposure to commodity interest positions in excess of the *de minimis* threshold, (ii) must not know and must not have reasonably been able to have known that the fund of fund's indirect exposure to commodity interests derived from contributions to investee funds exceed the *de minimis* threshold and (iii) must be either a registered investment company or a private fund offered exclusively to sophisticated investors.

The following table summarizes the filing deadlines for managers of the funds described:

Type of Fund	**Registration/Exemption Filing Deadline**
Any fund that is a commodity pool solely by virtue of its swaps transactions	December 31, 2012
Any fund for which a fund manager had, prior to April 24, 2012, claimed the private funds exemption	December 31, 2012
Any fund for which a fund manager had, prior to April 24, 2012, claimed the registered funds exemption and to whom such exemption is no longer available	December 31, 2012
Any fund of funds that is either a registered investment company or offered exclusively to sophisticated investors and that (i) does not have direct exposure to commodity interest positions in excess of the *de minimis* threshold and (ii) does not know and could not have reasonably known that its indirect exposure to commodity interests derived from contributions to investee funds exceeds the *de minimis* threshold	December 31, 2012 to file a claim perfecting the relief and then the later of June 30, 2013 or six months from the date the CFTC's Division of Swap Dealer and Intermediary Oversight issues revised guidance on the application of the *de minimis* threshold in the *de minimis* exemption and the registered funds exemption to funds of funds to register or file for an exemption
Any family office (as defined in Rule 202(a)(11)(G)-1 under the Advisers Act)	March 31, 2013 (or, if such family office begins to operate after March 31, 2013, within 30 days after commencing operation) to claim relief from registration

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