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CFTC ADOPTS FINAL RULE ON REGISTRATION EXEMPTIONS

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On August 8, 2003, the Commodity Futures Trading Commission ("CFTC") published in the Federal Register a final rule regarding exclusions from the definition of commodity pool operator ("CPO") and exemptions from registration as a CPO and a commodity trading advisor ("CTA"). Most significantly, the new rule adds two CPO exemptions. One is based on limited commodity interest trading and the sophistication of the pool's investors and the other is based solely on the high sophistication of the pool's investors.

This memorandum briefly summarizes the existing regulatory framework applicable to CPOs and CTAs and discusses the new exemptions and the requirements for currently registered CPOs and CTAs that withdraw from registration in accordance with the new rules. The full text of the CFTC adopting release is available at http://www.cftc.gov/files/opa/opareg_bsg_cpo-cta_part_4_rulemaking_final.pdf.

EXISTING REGULATORY FRAMEWORK

Prior to the new rules described in this memorandum, most private investment funds were completely precluded from trading in commodity futures contracts or options on such contracts for any purpose unless the operator of the fund registered as a CPO with the CFTC and any advisor to the fund registered as a CTA. As a result, many operators of these funds have foregone the use of these instruments rather than subject themselves to the extensive disclosure, reporting and record-keeping requirements that registration with the CFTC entails.

Although the staff of the CFTC in the past has received requests to permit these types of funds to trade in commodity futures contracts and options in limited amounts and for limited purposes without the operators and advisors of the funds having to register with the CFTC, the CFTC has, until the publication late last year and earlier this year of the predecessor proposals to these new rules, generally refused to grant such relief.

NEW EXEMPTIONS

Regarding CPOs

Exclusion from the definition of CPO. The new rule expands the existing exclusion, which is available to operators of certain "qualifying entities,"[1] from the definition of CPO by eliminating trading requirements. Entities eligible for this exclusion are therefore no longer subject to any restrictions on the volume of their commodity interest trading activity. An entity seeking exclusion from the definition of CPO, however, now must disclose in writing to existing and prospective investors that it is claiming such an exclusion and is therefore not subject to registration or regulation under the Commodity Exchange Act of 1974, as amended (the "CEA").

New limited commodity interest *trading and sophisticated investors exemption*. The first new exemption will allow a CPO to avoid registration if:

- interests in the pool are exempt from registration under the Securities Act of 1933, as amended (the "Securities Act") and are not marketed to the public in the United States;

- the CPO meets one of the following two criteria with respect to its commodity interest positions, including positions in security futures products, whether or not entered into for bona fide hedging purposes:

    - for each fund that it operates, the aggregate initial margins and premiums required to establish its commodity interest trading positions, determined at the time the most recent position was established, does not exceed 5% of the liquidation value of its portfolio after taking into account unrealized profits and losses, provided that options that are in-the-money at the time of purchase do not count towards the 5% limit; or

    - the aggregate net notional value[2] of the fund's commodity interest positions, determined at the time the most recent position was established, does not

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[1] Rule 4.5 defines "qualifying entities" as registered investment companies, insurance companies, financial depository institutions, and certain benefit plans.

[2] For this purpose, the notional value of each futures position is calculated by multiplying the number of contracts by the size of the futures contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit. The notional value of each option position is calculated by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), by the strike price. The "aggregate notional value" is the sum of the notional values of all futures positions and option positions.

exceed 100% of the liquidation value of its portfolio, after taking into account unrealized profits and losses;

- the CPO reasonably believes that all of the investors in its funds are, at the time of investment (or, in the case of an existing pool, at the time of conversion to a pool meeting the criteria of this exemption), (1) "accredited investors," as defined in the rules under the Securities Act,[3] (2) "knowledgeable employees," as defined in the rules under the Investment Company Act of 1940, or (3) "qualified eligible persons" as defined in the rules under the CEA;[4] and

- the CPO does not market investments in the fund to the public as or in a commodity pool.

New highly sophisticated investors exemption. The second new exemption provides that a CPO does not need to register if:

- interests in the pool it operates are exempt from registration under the Securities Act and are not marketed to the public in the United States;

- the CPO reasonably believes that at the time of investing (or, in the case of an existing pool, at the time of conversion to a pool meeting the criteria of this exemption) (1) all of its individual investors (and any self-directed employee benefit plans for such individuals) are

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Contracts with the same underlying commodity may be netted across designated contract markets, registered derivatives transaction execution facilities and foreign boards of trade.

3 Accredited investors include: a natural person with an individual net worth (or a joint net worth with a spouse) in excess of $1 million; a natural person with an individual income (without including any income of the investor's spouse) in excess of $200,000, or a joint income with a spouse in excess of $300,000, in each of the two most recent years and who reasonably expects to reach the same income level in the current year; a corporation, trust or partnership not formed for the specific purpose of acquiring interests in the pool, with total assets in excess of $5 million; and various categories of institutional investors.

4 U.S. persons that are qualified eligible persons generally include a "qualified purchaser" under the Investment Company Act of 1940, as amended (as described below), a broker-dealer, a futures commission merchant and certain U.S. banks or thrift institutions, registered investment companies, insurance companies and pension plans. In addition, non-U.S. persons are generally qualified eligible purchasers. Certain natural persons that meet a minimum portfolio requirement of $2,000,000 in investments are also qualified eligible purchasers.

Qualified purchasers are comprised of individuals and certain family investment vehicles with at least $5 million of "investments" (defined to exclude, for example, real estate used for personal reasons) and entities with at least $25 million of investments.

qualified eligible persons that do not need to meet the portfolio requirement[5] and (2) all of its other investors are either accredited investors or qualified eligible persons.

Any CPO claiming one of these exemptions will be required to deliver to each prospective investor in the pool, at a time no later than it delivers a subscription agreement to such prospective investor, a written statement that the CPO is not required to furnish investors with disclosure documents or annual reports required to be furnished by CFTC-registered CPOs. The statement must also contain a description of the criteria pursuant to which it qualifies for exemption from registration.

In addition, the CPO must file a manually signed notice with the NFA, at a time no later than it delivers a subscription agreement to its prospective investors, listing the contact information for the CPO and the name of the funds for which it is claiming exemption. The notice must also state the section number of the rule under which the CPO is claiming exemption and contain a representation that the funds will be operated in accordance with the criteria of that exemption. This notice will be effective upon filing, provided that it is materially complete. In the event that a CPO becomes aware that any information contained in the notice or any representations therein becomes inaccurate or incomplete, it must update such notice within 15 days.

Finally, a CPO availing itself of any registration exemption must retain all books and records in connection with its activities as a CPO for a period of five years (keeping them readily accessible for the first two of the five years) and make them available to inspection by the CFTC, the United States Department of Justice or other appropriate regulatory agency. It must also demonstrate compliance with the criteria under which it claims exemption upon request by the CFTC.

Withdrawing from registration. If a CPO intends to withdraw from registration and claim exemption under the new rule, it must notify in writing all of the investors in the pools it operates of such intention and provide each such investor with the right to redeem its interest in the relevant fund prior to the CPO's filing of a notice of exemption.

Regarding CTAs

New CTA exemptions. The new rule provides parallel exemptions from CTA registration for an advisor to an operator of a fund that qualifies for either of the new CPO exemptions. Additionally, the new rule expands the existing exemption from registration available to a CTA which, within the last 12 months, has not furnished commodity trading advice to more than 15 persons and does not hold itself out to the public as a commodity trading advisor, by adopting the SEC's approach under the Investment Advisers Act to the definition of a single client and, therefore, generally counting collective investment vehicles as a single client.

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5 See footnote 4.

Prior to the date on which the exempted person delivers an advisory agreement for the trading program pursuant to which it will offer commodity interest trading advice to its clients, it is required to file a manually signed notice of exemption with the NFA. The notice must list the contact information for the CTA and state the section number of the rule under which the CTA is claiming exemption. It must also contain a representation that the CTA will be operated in accordance with the criteria of that exemption. This notice will be effective upon filing provided that it is materially complete. In the event that the CTA becomes aware that any information contained in the notice or any representations therein becomes inaccurate or incomplete, it must update such notice within 15 days.

Finally, a CTA availing itself of any registration exemption must retain all books and records in connection with its activities as a CTA for a period of five years (keeping them readily accessible for the first two of the five years) and make them available to inspection by the CFTC, the United States Department of Justice or other appropriate regulatory agency. It must also demonstrate compliance with the criteria under which it claims exemption upon request by the CFTC.

Withdrawing from registration. If a CTA intends to withdraw from registration and claim exemption under the new rule, it must notify in writing all of its clients of such intention and provide each client with the right to terminate its investment advisory agreement prior to the CTA's filing of a notice of exemption.

Regarding Fund of Funds

The CFTC clarifies that under the new rule, a CPO operating a fund of funds will be exempt from registration under any of the following four different circumstances:

- if the CPO of each investee fund represents that it is either (1) exempt under the new CPO exemption based on limited commodity interest trades or (2) a registered CPO that is nonetheless in compliance with such trading restrictions;

- if the CPO of the fund of funds has actual knowledge of the trading and commodity interest positions of the investee funds (e.g., the investee funds are operated by the CPO or its affiliates) and the commodity interest positions of the investee funds, in the aggregate, are in compliance with the trading restrictions of the new rule;

- if the fund of funds does not trade commodity interests directly and allocates no more than 50% of its assets to investee funds that trade commodity interests (regardless of the level of commodity interest trading by the investee funds); or

- if a fund of funds engages in direct commodity interest trading in addition to its allocation of assets to investee funds, provided that the assets committed to direct commodity interest trading are treated as a separate pool with its own liquidation value and such "separate pool" complies with the trading restrictions of the new rule.

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If you have any questions concerning the new rules, please contact John E. Riley (jriley@stblaw.com), Olga Gutman (ogutman@stblaw.com) or Heath N. Weisberg (hweisberg@stblaw.com) of our Firm at (212) 455-2000.

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