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LAST CHANCE TO PREPARE FOR END-OF-YEAR CHANGES IN THE CFTC'S REGULATION OF PRIVATE INVESTMENT FUNDS

Time is running out for managers of hedge funds and other private investment funds that include commodity interests among their investments to lay the groundwork to comply with the substantially altered regulatory regime of the Commodity Futures Trading Commission (the "CFTC") that will be in effect on January 1,2013. Many managers that have previously been able to rely on the exemption from registration as a commodity pool operator ("CPO") provided by CFTC Rule 4.13(a)(4) will, as of January 1, 2013, need to either identify and comply with another exemption, or register with the CFTC and adhere to the applicable regulations. Compliance will, in many cases, require meaningful advance preparations which must be completed prior to year end.

BACKGROUND

Rule 4.13(a)(4) exempted a manager from registration as a CPO with respect to a hedge fund (which the CFTC's regulations define as a "pool"), so long as the investors in the relevant pool were limited to specified types of sophisticated investors – in the case of natural person investors, only "qualified purchasers" ("QPs") as defined in Section 2(a)(51) of the Investment Company Act of 1940 (the "Investment Company Act") and certain other types of "qualified eligible persons" ("QEPs"),[1] as defined in CFTC Rule 4.7 and, in the case of entities and other non-natural person investors, only QEPs and "accredited investors" ("AIs") as defined in Regulation D under the Securities Act of 1933. Because QPs are included in the definition of QEPs, hedge funds that rely on the exclusion from registration as investment companies under Section 3(c)(7) of the Investment Company Act were able relatively easily to limit their investors to the permitted types. Consequently, managers of hedge funds that trade commodities and other commodity interests frequently relied on Rule 4.13(a)(4) to minimize their regulatory burden in connection with such trading.

The CFTC rescinded the exemption available under Rule 4.13(a)(4) by a final rule issued on February 24, 2012. Notably, in repealing Rule 4.13(a)(4), the CFTC initially established two effective dates for compliance with the exemption's rescission: (1) CPOs of pools formed after April 24, 2012 were not permitted to rely on the exemption; and (2) CPOs of pools formed prior to April 24 that relied on the exemption prior thereto were permitted to continue to so rely until December 31, 2012. Belatedly recognizing that this approach created disparate regulatory treatment of similarly situated pools, the CFTC's Division of Swap Dealer and Intermediary Oversight (the "DSDIO") issued a no-action letter on July 13, 2012 (the "July NAL"), that granted blanket no-action relief for managers of pools that would have been exempt from registration as a CPO but for the relevant pool's having been formed after the date of the July NAL[2], provided that the managers of such pools seeking

[1] In order to rely on Rule 4.13(a)(4), a pool operator had to ensure that all of the natural-person investors in the relevant pool were QEPs under Rule 4.7(a)(2), which includes only QEPs that do not have to satisfy Rule 4.7's "portfolio requirement." For more information about the persons that fall within the definition of QEP, see footnote 4.

[2] The DSDIO expressly did not apply the July NAL's relief to pools formed after April 24 but before July 13, 2012, the date the July NAL was issued (notwithstanding that the internal date of the July NAL is July 10, 2012). DSDIO has expressed the view that no-action relief is not permitted to be granted retroactively, but in this case DSDIO may also have taken comfort from a belief that these pools' managers had found a satisfactory way to deal with the transition from

this relief followed certain steps outlined in the no-action letter. Consequently, many managers of pools have been able to postpone addressing the repeal of Rule 4.13(a)(4) until the end of this year.

The July NAL also provided similar relief to commodity trading advisors ("CTAs") that were previously exempt from registration under Rule 4.14(a)(5) because they provided commodity trading advice only to pools that are operated by CPOs that claim relief from CPO registration under Rule 4.13(a)(4). Such CTAs have been allowed to continue to qualify for an exemption from registration as a CTA so long as the pool's CPO is permitted to rely on Rule 4.13(a)(4) or on the July NAL to continue to be exempt from registration as a CPO until the end of 2012.

Complicating the picture is the publication on August 13, 2012 of the CFTC's and the SEC's final rules defining "swaps" as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Because the CFTC's regulations apply to operators of pools that trade "commodity interests," which includes "swaps," a manager of a pool may be required to register as a CPO (or qualify for an exemption from such registration), even if it trades no commodity interest other than swaps that are subject to the CFTC's regulation. Such swaps include swaps based on a broad index of securities, as well as credit default swaps on broad-based security indices, total return swaps on broad-based security indices, and guarantees of swaps. Managers of, and advisers to, pools that trade these instruments should already be evaluating whether they are required to register as CPOs or CTAs. Managers of pools who seek to be exempt from such registration may be more concerned, however, with being able to determine whether their pool's trading in commodity interests is sufficiently small so as to permit them to qualify for the exemption from CPO registration set out in Rule 4.13(a)(3). This exemption, often referred to as the *de minimis* exemption, is discussed below.

PLANNING FOR THE CHANGES

In anticipation of the changes in the CFTC's regulatory regime, many managers and advisers to private investment funds will seek to either (a) qualify for the exemption from registration under Rule 4.13(a)(3) or (b) register as a CPO but qualify for the less onerous requirements imposed on a registered CPO under Rule 4.7.

*Rule 4.13(a)(3) ("*De Minimis*" Exemption)*

Rule 4.13(a)(3) exempts a pool operator from the requirement to register as a CPO with respect to each privately offered pool whose investors the pool operator reasonably believes are AIs or certain other specified types of sophisticated investors[3] and for which trading in commodity interests does not exceed specified thresholds – namely, either of the following:

- Margin threshold – the aggregate value of initial margin, premiums, and required minimum security deposit for retail forex transactions required to establish the pool's trading in commodity interests does not exceed 5% of the liquidation value of the pool; or
- Notional value threshold – the notional value of the pool's commodity interests does not exceed 100% of the liquidation value of the pool.

Rule 4.13(a)(3) Practice Points and Action Items

Compliance systems and monitoring. A manager of a private investment fund that plans to rely on the exemption provided by Rule 4.13(a)(3) should establish and test systems now to ensure that all contracts can be

the prior regulatory regime to the new one and thus did not need the benefit of extra time to complete their preparations for compliance with the applicable CFTC regulations.

[3] In addition to AIs, a pool relying on Rule 4.13(a)(3) may also include among its investors (a) trusts that are not AIs but that were formed, in each case, by an AI for the benefit of a family member, (b) "knowledgeable employees" as defined in Rule 3c-5 under the Investment Company Act, and (c) "qualified eligible persons" as defined in Rule 4.7(a)(2)(viii)(A), which constitutes a subset of QEPs that includes the CPO, CTA, or investment adviser of the exempt pool, and any affiliate or principal of the foregoing.

identified as swap contracts or security-based swap contracts, and then to compute, on the one hand, the margin and initial premiums for the swap contracts and, on the other hand, the net notional value of the swap contracts. The manager should also review its historical and anticipated use of swaps and other commodity interests to ensure that it is feasible on an ongoing basis for the pool to rely on this *de minimis* exemption, and establish trading monitoring and alerts to ensure that these thresholds continue to be met. The manager must also comply with, and have procedures designed to ensure compliance with, the books and records requirements of Rule 4.13(c).

Notices to the NFA. A pool operator that seeks to rely on Rule 4.13(a)(3) must file a notice of exemption with the National Futures Association (the "NFA") that includes, among other things, the name and main business address of the pool operator claiming the exemption and the pool with respect to which the exemption is claimed. This notice is filed electronically with the NFA. For any pool operator that currently has on file with the NFA a valid exemption from registration under Rule 4.13(a)(4), the pool operator must withdraw the 4.13(a)(4) exemption before it will be able to file for a 4.13(a)(3) exemption. The pool operator can withdraw the 4.13(a)(4) exemption by notifying the NFA via email, or by allowing the exemption to automatically expire on December 31. In addition, a pool operator's reliance on Rule 4.13(a)(3) requires that it affirm on an annual basis, through the NFA's electronic exemption filing system, that it satisfies the conditions for the exemption.

Legends and Disclosures to Investors. If a pool operator concurrently operates one or more pools for which it is exempt from registration as a CPO in reliance on Rule 4.13(a)(3), but also operates pools for which it is registered as a CPO, then the pool operator must deliver in writing (including by email) to each prospective investor in the exempt pool a statement that the operator will operate such pool as if the operator were exempt from registration as a CPO and a description of the criteria pursuant to which it will operate the pool and qualify for such exemption. In addition, DSDIO has expressly indicated that a pool operator that converts from relying on the exemption under Rule 4.13(a)(4) to that under Rule 4.13(a)(3) must provide notice to each applicable fund's investors of the change in exemption.[4]

Investor representations. When a pool operator elects to rely on Rule 4.13(a)(3) after the commencement of the applicable pool's operation, a strict application of the Rule would require the pool operator to have a reasonable belief that the pool's investors were accredited investors at the time of the pool's conversion to reliance on Rule 4.13(a)(3), and the status of each new investor thereafter is evaluated at the time of its investment. While DSDIO has not provided specific guidance in this context, it would seem consistent with DSDIO's guidance in other contexts (including the notice requirement referred to above and the approach taken to investor qualifications in connection with the transition from reliance on Rule 4.13(a)(4) to Rule 4.7 referred to below) that pool operators be able to rely on the accredited investor affirmations made by the applicable pool's investors at the time of their investment and are not required to seek new affirmations from such investors concurrently with the conversion to the exemption under Rule 4.13(a)(3).

Rule 4.7

With respect to their qualifying pools, registered CPOs can rely on Rule 4.7 for an exemption from certain of the otherwise applicable disclosure and record-keeping requirements of the Commodity Exchange Act and associated rules. Managers of private investment funds who cannot qualify for an exemption from registration will usually seek to be subject to this lower level of CFTC regulation, sometimes referred to as "the Lite Touch" registration or "registration lite." In order to rely on the relief provided in Rule 4.7 with respect to a pool, the pool's operator must ensure that interests in such pool are offered and sold only to QEPs[5] in a private offering.

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[4] Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations (August 14, 2012 (the "August FAQ")). This release can be found at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq_cpocta.pdf,

[5] QEPs comprise two distinct groups of sophisticated investors: (1) those that are not required to meet any asset-based test, including QPs, "knowledgeable employees," Non-United States persons (as defined in Rule 4.7), registered broker-dealers, and registered CPOs and registered CTAs that have been so registered and active for at least two years or operate

Rule 4.7 Practice Points and Action Items

Registration and related-submissions. Unlike a pool operator that qualifies to rely on Rule 4.13(a)(3), who is exempt from registration, a pool operator that qualifies to rely on Rule 4.7 must nonetheless register with the CFTC as a CPO. A pool operator registers as a CPO with the CFTC by completing and filing a Form 7-R with the NFA. This filing is made on-line through the NFA's Web site. In addition, a pool operator must file applications for its "associated persons"[6] and its "principals".[7] Each principal and associated person is required to submit a Form 8-R and to complete and submit fingerprint cards. Although the Form 8-R can be submitted on-line, managers should nonetheless allot ample time for these submissions to be completed and processed, particularly as delays can occur if the NFA finds that a fingerprint is illegible or a fingerprint card is improperly completed. As part of the transition from being exempt to being registered as a CPO, pool operators need to establish procedures to evaluate whether new employees, or employees who are promoted or change functions, are principals or associated persons.

Series 3 exam. Most importantly for purposes of compliance planning, each associated person of a registered CPO is required to take and pass the Series 3 exam.[8] The Series 3 exam is administered frequently through the Financial Industry Regulatory Authority. Nonetheless, a pool operator seeking to register as a CPO should expect that its aspiring associated persons will need to study and prepare for this exam, using resources available on the NFA's Web site as well as other generally available materials.

Filing of claim for exemption. In order to qualify for the exemption under Rule 4.7, a pool operator must file with the NFA a claim for exemption that satisfies the requirements of Rule 4.7(d). This claim is filed on-line through the NFA's Web site.

Required disclosures in PPM and financial reports. In transitioning from its reliance on Rule 4.13(a)(4) to Rule 4.7, a pool operator should note that these two rules require that different legends and disclosures be included in the pool's offering memorandum. Consequently, in connection with this transition, a pool operator should evaluate whether its offering memorandum must be amended or supplemented with a wrapper to include the

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pools or advise commodity accounts, respectively, with aggregate assets of at least $5 million, and (2) those that are subject to the "portfolio requirement," including registered investment companies and business development companies, banks, insurance companies, government plans with aggregate assets of at least $5 million, certain employee benefit plans, and natural persons that are AIs under Rule 501(a)(5) or 501(a)(6) of Regulation D. A person satisfies Rule 4.7's "portfolio requirement" if that person (a) owns investments with an aggregate market value of at least $2,000,000; (b) has, in connection with its commodity interest transactions, had on deposit with a futures commission merchant, for its own account and at any time during the previous 6-month period specified in Rule 4.7, at least $200,000 in exchange-specified initial margin and option premiums, together with required minimum security deposit for retail forex transactions; or (c) owns a portfolio comprising a combination of the funds or property specified in the preceding clauses (a) and (b) which, on a proportionate basis as set out in Rule 4.7, reflects a commensurately significant portfolio.

[6] With respect to a CPO, CFTC Rule 1.3(aa)(3) defines an "associated person" as any natural person who is associated with the CPO as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (a) the solicitation of funds, securities, or property for a participation in the commodity pool or (b) the supervision of any person or persons so engaged.

[7] Pursuant to CFTC Rule 3.1, a "principal" of a CPO includes the sole proprietor of a sole proprietorship; a general partner of a partnership; a director, president, chief executive officer, chief operating officer, or chief financial officer of a corporation, limited liability company, or limited partnership; an individual in charge of a business unit, division or function of a corporation, limited liability company or limited partnership if the unit, division or function is subject to regulation by the CFTC; a manager, managing member, or a member vested with the management authority for a limited liability company or limited liability partnership; the chief compliance officer; or a 10% owner.

[8] An AP that has passed the Series 3 exam within the prior two years will, in general, not be required to retake the exam. In addition, the NFA has historically granted waivers from the Series 3 exam in certain relatively limited circumstances. A pool operator who anticipates seeking waivers should also initiate this process as early as possible, particularly in light of the anticipated increase in the NFA's registration-related workload at the end of this year.

legend required by, and otherwise to comply with, the provisions of Rules 4.7(b)(1)(i) and 4.7(b)(ii). Rule 4.7 also specifies certain information and legends that must be included in the pool's quarterly and annual financial reports to investors. Procedures must be established to ensure that this information, legends, and required signatures and affidavits are properly included, as well as to make the required submission of such financial statements to the NFA and/or the pool's participants by the deadlines imposed by Rule 4.7(b)(3). In the absence of specific relief from the NFA, annual reports are required to be submitted to the NFA within 90 days after the end of the applicable year, and quarterly reports within 30 days after the end of the applicable quarter.

Subscription documents and investor representations. Notwithstanding the text of Rule 4.7, DSDIO has confirmed that a pool operator will not be required to reaffirm that all of the investors in its funds previously operated pursuant to the exemption under Rule 4.13(a)(4) continue to qualify as QEPs so as to support the operator's claim for an exemption under Rule 4.7.[9] Each new investor thereafter, however, is required to meet the QEP standard at the time of its investment.

Separately, as a member of the NFA, a registered CPO (even if relying on Rule 4.7) is subject to NFA Bylaw 1101. Bylaw 1101 bars any NFA member from carrying an account, accepting an order, or handling a transaction in commodity futures contracts with any person that should be, but is not, registered with the CFTC as a CPO, CTA, or certain other specified capacities. Consequently, the pool's subscription agreement may need to be updated to incorporate an appropriate representation (and concomitant covenant to update such representation in the case of changes) from each investor that it is registered with the CFTC, and a member of the NFA, to the extent it is required to be.

Compliance systems and monitoring. Although Rule 4.7 provides an exemption from certain record-keeping requirements, the pool operator must establish policies and procedures to ensure that certain records specified in Rule 4.7(b)(4) are kept in the operator's main business address and accessible if requested by the CFTC, NFA, or the Department of Justice. Similarly, a procedure must be in place for the pool operator to identify, and notify the NFA of, any change that would cause the pool to cease to qualify for the relief under Rule 4.7. Generally speaking, the relief ceases to be available upon the occurrence of such a change.

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The foregoing is merely a discussion of certain elements of the CFTC's regulations applicable to private investment funds. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Bertrand C. Fry at bfry@pryorcashman.com, Michael T. Campoli at mcampoli@pryorcashman.com, or Meghan Dwyer at mdwyer@pryorcashman.com.

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[9] See the August FAQ.

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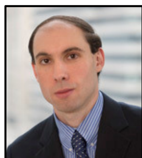

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- Henry Schein, Inc. (NASDAQ: HSIC) in connection with the acquisition of various private companies in the medical equipment and software industries
- Cowen and Company, LLC, Rodman & Renshaw, LLC and Global Hunter Securities, LLC in connection with various underwritten public offerings for domestic and foreign issuers
- Briad Restaurant Group in its prevailing tender offer for Main Street Restaurant Group, Inc., the largest T.G.I. Friday's franchisee
- The Kushner Companies in connection with its acquisition of the office building located at 666 Fifth Avenue, New York, New York
- A private telecommunications company in connection with the issuance of secured notes to the Rural Utilities Service of the U.S. Department of Agriculture and the concurrent placement of preferred stock to venture capital investors

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