Client Advisory

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Katten Muchin Rosenman LLP

Financial Services

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Managers of Private Investment Vehicles—Including Private Equity, Real Estate and Securitization Vehicles—That Use Futures or OTC Derivatives Should Consider Claiming CFTC 4.13(a)(4) Exemption by April 23, 2012

As a result of changes made to the Commodity Exchange Act (CEA) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), swaps are now treated as "commodity interests" (along with futures contracts). Any pooled investment vehicle that trades in commodity interests must be operated by a "commodity pool operator" (CPO) registered with the Commodity Futures Trading Commission (CFTC) or exempt from such registration.

While the exact definition of the term "swap" is not yet final, it is clear that most OTC derivative instruments, other than "security-based swaps" and options on securities, will become commodity interests under the CEA. This could cause many pooled investment vehicles—such as private equity funds, real estate funds, hedge funds and securitization vehicles (such as CBOs and CLOs)—to be deemed commodity pools due to their use of interest rate swaps, OTC foreign exchange contracts and other common hedging contracts, even if they do not trade futures or other products commonly thought of as "commodities."

The CFTC has announced that various provisions of the CEA that have been amended by Dodd-Frank but that require further definition will not be enforced until 60 days after the CFTC has adopted final rules defining the term "swap" and certain other terms.

On February 9, 2012, the CFTC eliminated the exemption from CPO registration contained in CFTC Rule 4.13(a)(4), effective April 24, 2012. That exemption allowed for unlimited trading in commodity interests by commodity pools for which the CPO claimed the exemption and that were privately offered only to certain qualified eligible persons. The CFTC gave any CPO that properly claimed the 4.13(a)(4) exemption prior to the April 24 effective date until December 31, 2012, to come into compliance with the revised rules. (See our previous Client Advisory summarizing the CFTC rules eliminating the exemption here.) Operators of funds and vehicles that are likely to be considered commodity pools due to the use of swaps or futures should consider claiming the 4.13(a)(4) exemption immediately to give themselves until December 31, 2012, to evaluate the effect of the new rules and to come into compliance, if necessary.

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Who Is a CPO?

A CPO is any person "engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise" who receives, accepts or solicits from others cash or other property, either directly or through capital contributions or the sale of securities or other interests, for the purpose of trading in commodity interests. Commodity interests include all futures, including security futures, swaps (but not security-based swaps), OTC foreign exchange contracts entered into by persons who are not "eligible contract participants," and commodity options.

Consequences of Being a CPO

The CEA requires all CPOs to be registered with the CFTC unless the CPO can claim an available exemption. While there are registration exemptions other than the Rule 4.13(a)(4) exemption that will continue to be available after April 23 for operators of pooled investment vehicles, those likely to be available to fund managers and operators allow only limited transactions in commodity interests and have other restrictions. If a person who becomes a CPO as a result of the CFTC's final rule defining the term "swap" is not already registered or does not have an exemption on file at that time, that person will have 60 days from publication of the final rule to become registered (a process that can take more than 60 days) and come into compliance with the rules governing CPOs, or claim another available exemption. A CPO that claims the Rule 4.13(a)(4) exemption prior to April 24, 2012, however, will have until December 31, 2012, to claim another exemption, register as a CPO, or determine that it is not a CPO and withdraw its exemption claim.

Who Can Claim the Rule 4.13(a)(4) Exemption?

The exemption from CPO registration is available to operators of pools if the following criteria are met:

1) Interests in the pool are exempt from registration under the Securities Act of 1933 and such interests are offered without marketing to the public in the United States;

2) The operator reasonably believes at the time of claiming the exemption that each participant meets the eligibility criteria;

3) The operator notifies each participant that it is exempt from registration as a CPO, the basis for such exemption and certain other disclosures; and

4) The operator electronically files a notice of exemption with the National Futures Association with respect to each pool for which it claims the exemption.

Recommendation

Persons acting as managers, managing members, general partners, trustees, management boards or in similar roles of privately offered collective investment vehicles that engage in OTC derivative transactions or futures transactions should consider claiming the Rule 4.13(a)(4) exemption for each pool they operate on or before April 23, 2012. Doing so maximizes the amount of time an operator has to consider its options when the CFTC releases its product definitions.

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