CFTC Issues No-Action Relief from Commodity Pool Operator Registration Requirements for Business Development Companies

December 5, 2012

On December 4, 2012, the Commodity Futures Trading Commission's (CFTC's) Division of Swap Dealer and Intermediary Oversight (DSIO) issued no-action relief from commodity pool operator (CPO) registration requirements for advisers of business development companies (BDCs). Under the no-action relief, the DSIO will treat BDCs as investment companies registered under the Investment Company Act of 1940 (RICs) for purposes of the Regulation 4.5 exclusion from CPO registration requirements (the Rule 4.5 Exclusion). The Rule 4.5 Exclusion is an exclusion from the definition of CPO available to advisers of RICs that trade commodity interests subject to certain conditions, namely that the RICs meet certain *de minimis* commodity interest trading thresholds. ***The no-action relief afforded by the DSIO is not self-executing; rather, BDCs must submit a claim for relief to the DSIO.*** This Legal Alert describes the DSIO's no-action letter and the relief it affords to BDCs.

I. Background

A. The Dodd-Frank Act and Commodity Pool Operator Requirements

The Dodd-Frank Act amended the definition of "commodity pool operator" in the Commodity Exchange Act (CEA) to include any person who solicits, accepts or receives property for the purpose of trading in commodity interests.[1] The Dodd-Frank Act also added a definition of "commodity interests" to the CEA, which now includes futures, options and swaps.[2] Before the Dodd-Frank Act, this term was only defined in the CFTC's regulations, and it did not include swaps. As a result, swaps trading did not trigger CPO registration concerns, among other things. In connection with the aforementioned changes, however, an investment by a BDC in even one swap contract could "trigger" the CPO registration requirement for the BDC's adviser, unless the adviser meets the criteria for a regulatory exclusion or exemption from CPO registration (*e.g.*, the Rule 4.5 Exclusion).[3]

The Rule 4.5 Exclusion is a regulatory exclusion from the definition of CPO available to advisers of RICs that engage in commodity interest trading. In order for such a RIC's adviser to qualify for the Rule 4.5 Exclusion, the RIC's commodity interest trading must fall below certain specified thresholds.[4] As drafted, the Rule 4.5 Exclusion does not apply to BDCs. This is because, although BDCs are regulated under the Investment Company Act of 1940, they are not technically RICs. In its no-action letter, the DSIO concluded that a BDC that engages in commodity interest trading is technically a commodity pool. Therefore, absent no-action or other relief, such a BDC's adviser would be required to register as a CPO.

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[1] *See* 7 U.S.C. § 1a(11) (2012) (section 721(a) of the Dodd-Frank Act).
[2] *Id.*
[3] *See* Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252, 11,258, 11,263 (Feb. 24, 2012) (stating that one swap contract entered into by a fund would be "enough to trigger the [CPO] registration requirement").
[4] For more information on Rule 4.5, please see Sutherland's Legal Alert on the CFTC's proposed amendments to Rule 4.5 and Sutherland's Legal Alert on the CFTC's adoption of amendments to Rule 4.5.

However, the DSIO determined that it will not recommend that the CFTC take action against advisers of BDCs that meet certain criteria described in the no-action letter, including compliance with the Rule 4.5 Exclusion's *de minimis* commodity interest trading threshold.

II. DSIO No-Action Relief and Business Development Companies

A. No-Action Relief

The CFTC no-action letter affords relief from CPO registration requirements for advisers of BDCs, provided that the relevant BDC meets certain requirements, including limiting its investments in commodity interests to satisfy the *de minimis* trading threshold.[5] There is no substantive difference between the Rule 4.5 Exclusion and the no-action relief, aside from a modification in the no-action letter that tailors the Rule 4.5 Exclusion so that it is available to BDCs. An adviser to a BDC is eligible for the no-action relief so long as the BDC meets the following criteria:

- The BDC has elected to be treated as a BDC under the Investment Company Act of 1940, and continues to be regulated by the Securities and Exchange Commission (SEC) as a BDC;
- The BDC will not be, and has not been, marketed to the public as a commodity pool or as a vehicle for investing in futures, options or swaps; and
- Either:
    - The BDC engages in commodity interest trading for bona fide hedging purposes; provided, however, that the aggregate initial margin and premiums required for the BDC's nonhedge (*i.e.*, speculative) commodity interest positions do not exceed 5% of the liquidation value of the BDC's portfolio; or
    - The aggregate net notional value of the BDC's nonhedge commodity interest positions does not exceed 100% of the liquidation value of the BDC's portfolio.

B. DSIO's Rationale for Affording Relief to BDCs

The DSIO determined that affording no-action relief to BDCs is merited because BDCs are substantially similar to RICs. In its letter, the DSIO confirmed that because BDCs are not "technically RICs," BDCs are ineligible for the Rule 4.5 Exclusion. However, the DSIO relied on, among other things, the following facts in determining that BDCs are substantially similar to RICs, and therefore, should be treated as RICs for purposes of the Rule 4.5 Exclusion:

- BDCs are regulated, and may invest in swaps and other commodity interests in the same manner, as RICs.
- BDCs qualify as "investment companies," and many have external managers that are required to register with the SEC as investment advisers.

[5] The DSIO did not provide guidance on the applicability of other sections of Part 4 of the CFTC's regulations to BDCs, particularly to the extent that a BDC is not able to satisfy the requirements in the DSIO's letter.

- BDCs are almost all listed on an exchange, are subject to exchange rules governing listed companies (including investor protection rules), and are subject to disclosure and other requirements, as well as periodic examination by the SEC.

- BDCs must comply with disclosure requirements and other regulations under the Securities Exchange Act of 1934 and the Sarbanes-Oxley Act of 2002.

The DSIO also relied on the following representations, among others, of the general characteristics of BDCs in reaching its conclusion that BDCs should be treated as RICs for purposes of the Rule 4.5 Exclusion:

- BDCs primarily invest in, and provide managerial assistance to, operating companies, and thus generally use derivatives to manage investments and commercial risks.

- Generally, BDCs limit their derivatives use to interest rate and currency swaps, with the occasional use of credit default swaps and other types of commodity interest transactions.

C. Claiming the No-Action Relief

Any BDC that plans to take advantage of the no-action relief must file a claim for such relief with the DSIO. The claim must include certain basic information about the BDC, as specified in the DSIO's letter.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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