

CLIENT MEMORANDUM

DC Circuit Upholds Commodity Futures Trading Commission Rule Affecting Registered Investment Companies

July 2, 2013

AUTHORS

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The CFTC rule requiring registration of certain advisers to registered investment companies has been affirmed by the Court of Appeals for the D.C. Circuit.¹ As a result, any adviser trading more than a *de minimis* amount of commodity interests on behalf of a RIC,² calculated in accordance with CFTC Rule 4.5, will have to register with the CFTC as a commodity pool operator (“CPO”).

¹ *Investment Company Institute, et al. v. United States Commodity Futures Trading Commission*, No. 12-5413 (D.C. Cir. June 25, 2013), *affirming Investment Company Institute, et al. v. United States Commodity Futures Trading Commission*, No. 12-00612 (D.C. Dist. Dec. 12, 2012).

² See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Final Rules, 77 Fed. Reg. 11252 (Feb. 24, 2012) (the “Rulemaking”). In the Rulemaking, the CFTC stated that a RIC’s SEC-registered investment adviser is its CPO for purposes of CFTC registration and compliance.

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BACKGROUND

Prior to 2003, Rule 4.5 provided that an investment company registered as such with the Securities and Exchange Commission need not have a registered CPO as long as (i) the RIC was not held out as a commodity pool and (ii) the RIC's speculative commodity interest trading was *de minimis*.³ Bona fide hedge positions were excluded from the *de minimis* limits. In 2003, the CFTC lifted the restrictions in Rule 4.5. Between 2003 and 2012, Rule 4.5 did not contain any limits on commodity interest trading or the manner in which a 4.5 vehicle could be offered. In 2012, Rule 4.5 as applied to RICs was amended to include trading and marketing restrictions once again.⁴

TRADING AND MARKET RESTRICTIONS

Rule 4.5, in its current form, generally limits a RIC's commodity interest trading such that, at all times, either (i) no more than 5% of the RIC's liquidation value is committed to initial margin and premiums to establish speculative positions, or (ii) the aggregate net notional value of the RIC's speculative positions does not exceed 100% of the RIC's liquidation value.⁵

In addition, the RIC may not be marketed as a commodity pool or vehicle for trading in commodity interests. The CFTC has stated that whether a RIC's marketing materials violate the marketing restriction will be determined on a case-by-case basis by examination of all relevant facts.

REGISTRATION/COMPLIANCE

If a RIC's speculative commodity interest positions remain below at least one of the *de minimis* thresholds at all times and the marketing restriction is satisfied, the RIC's investment adviser may claim exclusion under Rule 4.5 from the definition of CPO with respect to that RIC. Otherwise, the adviser must register with the CFTC as a CPO and become a member of the National Futures Association.

Generally, a registered CPO is required to comply with the CFTC's disclosure, reporting and recordkeeping requirements, including the requirement to file CFTC Form CPO-PQR under CFTC Rule 4.27.⁶ Recognizing that registered CPOs of

³ At the time, the term "commodity interest" included futures and options on futures but not swaps. Post Dodd-Frank, "commodity interest" also includes swaps that are subject to the CFTC's jurisdiction.

⁴ The main difference between the 2003 and current versions of the *de minimis* limitation is the inclusion of swaps within the definition of "commodity interests." For more information regarding the Rulemaking's amendments to Rule 4.5, please see our client memorandum dated February 24, 2012, entitled "[CFTC Reinstates Restrictions on Registered Investment Companies](#)."

⁵ Bona fide hedge positions may be excluded from these calculations. The CFTC has stated that "risk management" positions are not considered bona fide hedges for purposes of Rule 4.5.

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RICs would be required to comply with the often conflicting requirements of the CFTC's and SEC's regulations, the CFTC proposed certain rule amendments that would harmonize the regimes for RICs.⁷ Thus, in the Rulemaking, the CFTC stated that investment advisers to RICs that are required to register as CPOs need not comply with the CFTC's disclosure, reporting and recordkeeping requirements until 60 days after the effective date of the final harmonization rules.

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⁶ Rule 4.27 was also adopted in the Rulemaking. CFTC Form CPO-PQR collects extensive data on the CPO and the pools it operates. For more information regarding Rule 4.27 reporting, please see our client memorandum dated February 17, 2012, entitled "[CFTC Adopts CPO and CTA Reporting Rules](#)."

⁷ The Court noted that its decision does not preclude challenges to the harmonization rules once they become final. For more information regarding the harmonization proposal, please see our client memorandum dated March 27, 2012, entitled "[CFTC Proposes Harmonization Rules for Mutual Funds](#)." For information regarding the SEC's view on the use of derivatives by RICs, please see our client memorandum dated September 27, 2011, entitled "[SEC Issues Derivatives Concept Release – Significant Changes May Be In Store for Registered Funds](#)."