

PROPOSED AMENDMENTS TO CFTC RULES FOR CPOs AND CTAs

On March 17, 2003, the Commodity Futures Trading Commission (the “CFTC”) published an array of regulations aimed at reducing regulatory barriers and streamlining regulations applicable to professional investment managers who use or wish to use exchange-traded futures and options on futures (“futures”). These regulations continue implementation of the mandates of the Commodity Futures Modernization Act of 2000 by encouraging use of the futures markets and market innovation and by modernizing market regulation. Most importantly, the CFTC proposed new exemptions and/or expanded existing exemptions or exclusions from registration for commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”). These new exemptions and other significant proposed changes are highlighted below. In addition, the CFTC amended and restated its temporary no-action relief from registration for CPOs and CTAs. Appendix A to this memorandum summarizes the amended and restated relief.

1. **New CPO Exemptions.** The CFTC proposes two non-exclusive exemptions from CPO registration.

- *De Minimis Exemption.* Rule 4.13(a)(3) is intended to exempt from registration CPOs of commodity pools that trade only a small amount of futures. Investors must be accredited investors and trading must be limited so that either (i) no more than 2% of the pool’s assets are committed as initial margin or premiums for futures or (ii) the aggregate notional value of the pool’s futures does not exceed 50% of the pool’s liquidation value.
- *Sophisticated Investor Exemption.* Rule 4.13(a)(4) is intended to exempt from registration CPOs of privately offered pools in which all investors are sophisticated persons. As a result of the sophistication of the investors, no trading limitation is imposed. Individual investors must be qualified eligible persons (“QEPs”) who do not have to meet the portfolio requirement in CFTC Rule 4.7. Entity investors must be accredited investors or QEPs.

Both exemptions require compliance with the following:

- The CPO must provide disclosure to pool participants of its exempt status and the criteria for the exemption.
- The CPO must claim the exemption by filing a notice with the National Futures Association (“NFA”).

- The CPO must maintain its records for five years and submit to special calls from the CFTC to demonstrate its eligibility for the exemption claimed.
- In the event that the CPO distributes an annual report to its pool participants, the report must be presented in accordance with generally accepted accounting principles consistently applied, and, if certified by an independent public accountant, so certified in accordance with Rule 1.16.

These exemptions may be claimed on a pool-by-pool basis. In the event that a CPO registers with the CFTC, it may claim exemption from the CFTC requirements applicable to a registered CPO with respect to one or more pools that meet the criteria described above. The CPO must claim the exemptions by filing a notice with the NFA and must also provide disclosure to pool participants that it will operate the pool as if the CPO were exempt from registration as a CPO.

2. **Amendment to CPO Exclusion.** Rule 4.5 excludes from the definition of CPO the operators of certain otherwise regulated entities including investment companies registered with the Securities and Exchange Commission (“SEC”), regulated insurance companies, banks and pension plans, provided that specific trading limitations and other conditions are met. The CFTC’s proposed amendment would remove the trading limitations from Rule 4.5. Thus, these entities would be able to use any amount of futures for speculative or hedging purposes. No other changes to Rule 4.5 are proposed.

This proposal does not affect the availability of the temporary no-action relief provided by the CFTC in October 2002, for CPOs claiming exclusion under the current Rule 4.5. This relief was described in our memorandum dated November 5, 2002.

3. **New CTA Exemptions.**

- *Exemptions for Incidental Advice to Exempt CPOs and their Pools.* Rule 4.14(a)(8) exempts securities investment advisors from registration as CTAs if all of their futures investment advice is incidental to their securities advice and is directed solely to pools the CPOs of which have claimed the exclusion in Rule 4.5. The CFTC proposes amending Rule 4.14(a)(8) to add exemptions from registration for a CTA that also directs advice to (i) pools the CPOs of which are exempt from registration under Rule 4.13(a)(3) or 4.13(a)(4) and/or (ii) offshore pools in which all of the investors are non-U.S. persons.
- *Counting Clients.* The CFTC proposes to add Rule 4.14(a)(10) restating the exemption from CTA registration in §4m(1) of the Commodity Exchange Act for a CTA who advises 15 or fewer clients in a 12 month period and does not hold itself out to the public as a CTA. The proposed Rule would permit the CTA of a pool to count the pool as a single client for this purpose, rather than requiring a “look through” to the pool’s investors. The proposed Rule is modeled on the SEC’s Rule 203(b)(3)-1 under the Investment Advisers Act of 1940.

4. **Communicating with Advisory Clients and Pool Participants.** At present, CPOs and CTAs are generally prohibited from soliciting clients before providing them with a Disclosure Document. The CFTC proposes to amend Rules 4.21(a) and 4.31(a) to allow CPOs and CTAs to solicit clients prior to providing a Disclosure Document, provided that (i) the Disclosure Document is delivered no later than the time of delivery of the subscription agreement for a pool or the advisory agreement for a managed account and (ii) any information provided prior to delivery of the Disclosure Document is either consistent with, or amended by, the information in the Disclosure Document.

The CFTC also proposes other changes to Rules 4.21 and 4.22 intended to facilitate communication between CPOs and CTAs and their clients. These changes include removing duplicative filing and reporting requirements for CPOs in a master/feeder structure, codifying prior staff guidance that permits CPOs to distribute periodic Account Statements electronically (with the consent of each investor) and specifically permitting facsimile signatures to comply with the oath or affirmation requirements.

5. **Computation and Presentation of Performance Data for CTAs (aka Notional Funds).** The CFTC has republished an amended proposal to permit CTAs to use nominal account size as the basis for computing a client's rate of return rather than actual funds under the CTA's control. In order to use nominal account size, the CTA would be required to meet certain documentation and disclosure requirements designed to ensure that the client agrees to the nominal account size employed and receives meaningful disclosure concerning the potentially increased size of losses, fees and expenses and historical volatility of the CTA's programs in light of the increased leverage provided through notional funding.

In addition, the CFTC seeks comment on whether the current and proposed detailed rules concerning presentation of past performance should be replaced with a core principles approach. The core principles approach would permit CTAs to present performance information to prospective clients in any manner they choose as long as the information is presented in a manner that is factual and balanced and is not fraudulent or misleading.

6. **Bunched Orders.** Many CTAs wish to bunch futures orders for multiple customers for execution and then allocate them among accounts at the end of a trading day. Current rules permit bunching for certain CTAs and accounts, provided that various conditions are met and certain procedures undertaken. The CFTC proposes to expand the availability of bunched orders to all customer orders and account managers as well as to simplify the process and clarify the responsibilities of account managers and futures commission merchants in connection with bunched orders.

WILLKIE FARR & GALLAGHER

If you have any questions regarding any of the proposals, please call Emily M. Zeigler ((212) 728-8284, ezeigler@willkie.com) or Rita M. Molesworth ((212) 728-8727, rmolesworth@willkie.com) of our New York office.

Willkie Farr & Gallagher is headquartered at 787 Seventh Avenue, New York, NY 10019. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111.

March 21, 2003

Copyright © 2003 by Willkie Farr & Gallagher.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information.

Continuation and Clarification of Temporary No-Action Relief

In November 2002, the CFTC established criteria and procedures for claiming temporary no-action relief from CPO and CTA registration pending the adoption of permanent exemptions from registration. The CFTC has continued the availability of that relief, added an alternative trading limitation and clarified certain provisions of the no-action relief.

A. No-Action Relief for CPOs.

- *Investors.* Participation in the pool is limited to (i) “accredited investors” as defined in Rule 501(d) of the Securities Act of 1933, (ii) “knowledgeable employees” as defined in Rule 3c-5 under the Investment Company Act of 1940, (iii) “Non-United States Persons” as defined in CFTC Rule 4.7 and (iv) persons described in CFTC Rule 4.7(a)(2)(viii)(A).
- *Trading Limitations.* One of the following tests must be met at all times. Either test is calculated at the time that the most recent futures position is established.
 - The aggregate notional value of the pool’s commodity futures and options on futures positions does not exceed 50% of the liquidation value of the pool’s portfolio, after taking into account unrealized profits and losses on existing positions¹; or
 - The aggregate initial margin and premiums required to establish commodity interest positions does not exceed two percent of the liquidation value of the pool’s portfolio, after taking into account unrealized profits and losses on positions it has entered into, provided that in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defined in Rule 190.01(x) may be excluded in computing such two percent.
- *Funds of Funds.* The application of the no-action relief to CPOs of funds of funds has been clarified based on comments received by the CFTC.
 - The CPO of a fund of funds may claim registration relief if the CPO of each of its investee funds has either (i) registered with the CFTC as a CPO or (ii) claimed no-action relief as described above.

¹ Notional value is calculated for each futures position by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit and for each options position by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the strike price per unit.

- The CPO of a fund of funds may rely on representations from the CPOs of its investee funds that the CPOs are operating the investee funds in compliance with the requirements of the interim no-action relief.

B. No-Action Relief for CTAs.

- The CTA is the CPO of a pool or pools, has claimed interim no-action relief and provides commodity trading advice solely to the pool or pools that it operates; **or**
- The CTA is registered as an investment adviser with the SEC or a State securities regulatory agency or is exempt from registration or excluded from the definition of investment adviser, provided that
 - its commodity trading advice is (i) directed solely to pools operated by CPOs who are eligible to claim interim no-action relief from CPO registration, (ii) is solely incidental to its business of providing securities advice to such pool or pools and (iii) consistent with the limitations on the use of futures and options on futures required to claim interim no-action relief; **and**
 - it is not otherwise holding itself out as a CTA.
- The CTA may rely on representations by the CPO that the CPO is operating a pool in compliance with the requirements of the interim no-action relief.

C. Procedure to Claim No-Action Relief. In order to claim the interim no-action relief from registration, the CPO or CTA must do the following:

- File a claim for relief with the CFTC and the NFA including specified information and representations.
- Provide specified disclosure to prospective and existing clients.
- Comply with any final action taken by the CFTC with respect to the proposed CPO and CTA registration exemptions described above or withdraw its claim for no-action relief and cease engaging in business as a CPO and/or CTA.

* * *