CLIENT
MEMORANDUM

AMENDMENTS TO CFTC RULES FOR CPOs AND CTAs

On August 8, 2003, the Commodity Futures Trading Commission (the "CFTC") published final versions of an array of regulations proposed on March 17, 2003, and 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"). Other amendments were published on June 11, 2003 and July 20, 2003. 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 adopted new exemptions and expanded existing exemptions and exclusions from registration for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). These new exemptions and other significant changes are highlighted below.

1. **New CPO Exemptions**. The CFTC adopted two non-exclusive exemptions from CPO registration. These exemptions are effective immediately.

    - *De Minimis Exemption*. Rule 4.13(a)(3) exempts from registration CPOs of commodity pools that trade only a small amount of futures.

        - *Permitted Investors.* Each investor must be (i) an accredited investor as defined in Regulation D under the Securities Act of 1933, (ii) a trust that is not an accredited investor but was formed by an accredited investor for the benefit of a family member, (iii) a knowledgeable employee as defined under the Investment Company Act of 1940 ("1940 Act") or (iv) a qualified eligible person ("QEP") under Rule 4.7(a)(2)(viii)(A), which includes a group of CPO employees, agents and affiliates. Non-U.S. persons are not permitted investors unless they fall within one of the categories noted above.

        - *Alternative Trading Limitations.* Trading must be limited so that at all times either (i) required initial margin and premiums for futures do not exceed 5% of the pool's liquidation value, after taking into account unrealized profits and unrealized losses on open positions (but excluding the in-the-money amount of an option purchased) or (ii) the aggregate net notional value of the pool's futures does not exceed 100% of the pool's liquidation value, after taking into account unrealized profits and unrealized losses on open positions.

    - 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. For the purpose of calculating aggregate net notional value, contracts with the same underlying commodity may be netted across designated contract markets, registered derivatives execution facilities and foreign boards of trade.

  - *Marketing Limitation*. Interests in the pool may not be marketed as a vehicle for trading in futures.

  - *Application to Funds of Funds*. The CFTC has adopted a new appendix to Part 4 of its rules providing guidance on the application of the trading limitations in Rule 4.13(a)(3) to CPOs of funds of funds. The six sample scenarios in the appendix are based on the following principles:

    - 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 4.13(a)(3).

    - If the CPO has actual knowledge of the futures positions in the investee funds, the CPO may aggregate all futures positions across the investee funds to determine compliance with the trading limitation in 4.13(a)(3).

    - The CPO of a fund of funds that does not trade futures directly and allocates no more than 50% of the fund of funds' assets to investee funds that trade futures may claim the exemption in Rule 4.13(a)(3).

    - The CPO of a fund of funds that trades futures directly as well as through investee funds may claim the exemption in Rule 4.13(a)(3) if it treats the assets committed to direct trading as a separate pool with its own liquidation value and trading limitations.

- *Sophisticated Investor Exemption*. Rule 4.13(a)(4) exempts from registration CPOs of pools in which all investors are sophisticated persons. As a result of the sophistication of the investors, no trading or marketing limitation is imposed.

- *Permitted Investors.* Individual investors must be QEPs who do not have to meet the portfolio requirement in CFTC Rule 4.7. Generally, these QEPs are qualified purchasers or knowledgeable employees under the 1940 Act or non-U.S. persons. Entity investors must be either accredited investors or QEPs. The definition of QEP includes non-U.S. persons.

- *General Requirements*. Both exemptions described above require compliance with the following:

  - Interests in the pool must be exempt from registration under the Securities Act of 1933 and must not be offered to the public in the United States.

  - 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"). A CPO that previously claimed temporary registration no-action relief based on *de minimis* use of futures does not need to refile in order to take advantage of the exemption in Rule 4.13(a)(3). If the pools operated by the CPO continue to adhere to the trading limitations required by the no-action relief, the CPO is not required to provide the disclosure required by Rule 4.13(a) and described above.

  - The required disclosure and claim for exemption generally must be made no later than the time at which the CPO delivers to the prospective participant a subscription agreement for the pool. In the case of a registered CPO that wishes to withdraw from registration and claim one of these exemptions, each pool participant must be provided with notice of the CPO's intention to withdraw and the right to redeem the participant's interest in the pool prior to the time that the CPO files its claim for exemption.

  - 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 CFTC rules.

  - o 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.

2. **Amendment to Rule 4.5**. Rule 4.5 has excluded 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 and marketing limitations and other conditions are met. The CFTC's amendment to Rule 4.5 removes the trading and marketing limitations, effective immediately. Thus, qualified entities may now use any amount of futures for speculative or hedging purposes and may market their interests as commodity pools or futures-related investments. The amended rule now requires disclosure to participants that the CPO has claimed the exclusion and therefore is not subject to registration or regulation under the Commodity Exchange Act ("CEA"). This disclosure may be included in any document required by another regulator to be furnished to participants. If no such document is required to be furnished, the disclosure may be contained in an instrument establishing the entity's investment policies and objectives that is required to be made available to participants.

   Entities that have previously claimed the exclusion under Rule 4.5 are not required to re-file in order to perfect the exclusion under the amended Rule. Entities that continue to adhere to the trading limitations in the prior Rule are not required to provide the new disclosure described above.

3. **New CTA Exemptions**. These rules are effective immediately.

   - *Exemptions for Incidental Advice to Exempt CPOs and their Pools*. Rule 4.14(a)(8) exempts investment advisers from registration as CTAs if all of their futures investment advice is incidental to their securities advice and is directed solely to (i) pools the CPOs of which have claimed the exclusion in Rule 4.5, (ii) pools the CPOs of which are exempt from registration under Rule 4.13(a)(3) or 4.13(a)(4) and (iii) offshore pools in which all of the investors are non-U.S. persons. The amended rule applies to investment advisers who are registered with the SEC or a state or are exempt from such registration or excluded from the definition of investment adviser under the Investment Advisers Act of 1940.

   - *Counting Clients*. New Rule 4.14(a)(10) restates the exemption from CTA registration in §4m(1) of the CEA 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 Rule permits 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 new provision is modeled on the SEC's Rule 203(b)(3)-1 under the Investment Advisers Act of 1940.

4. **Communicating with Pool Participants and Advisory Clients**. These rules are effective immediately.

- *Solicitation.* Rules 4.21(a) and 4.31(a) have been amended 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. In the event that previously distributed information is materially amended by the Disclosure Document, the prospective participant or client must be in receipt of the Disclosure Document at least 48 hours prior to signing the subscription agreement or advisory agreement.

- *Master/Feeder Funds.* The CPO of a master fund in a master/feeder structure is not required to provide reports or disclosure to the CPO of a feeder fund, provided that the CPO of the feeder fund is the same as the CPO of the master fund or controls, is controlled by or is under common control with the CPO of the master fund.

- *Electronic Distribution of Reports*. CPOs may distribute periodic Account Statements and Annual Reports electronically (with the consent of each investor).

- *Oath or Affirmation*. Facsimile signatures comply with the oath or affirmation requirements for Account Statements and Annual Reports, provided that manually signed copies are maintained and, in the case of the Annual Report, filed with the NFA.

- *Signatures.* The signature requirements for Part 4 documents have been conformed so that all documents may now be signed by "a representative duly authorized to bind" the eligible person.

5. **Computation and Presentation of Performance Data.**

- *Partially Funded Accounts*. Effective August 20, 2003, the CFTC adopted a core principle in lieu of detailed rules relating to computing rates of return for partially funded accounts. The core principle requires a CTA to present performance of partially funded accounts in a manner that is balanced and is not in violation of the antifraud provisions of the CEA.

- *Other Performance Presentation Issues.* These rules are effective September 8, 2003.

    - *Range of Rates of Return for Closed Accounts*. Rule 4.35(a)(1)(viii) has been amended to require that a performance capsule include a measure of variability of returns experienced by clients who opened and closed accounts during the period, for accounts closed with positive lifetime rates of return and for those closed with negative lifetime rates of return. This requirement may be satisfied by disclosing ranges of returns or by using standard deviation or another method.

- *Composite Drawdown*. The CFTC confirmed that presentation of monthly and peak-to-valley drawdown information on a composite basis for a performance table that complies with 4.34(a)(3) is acceptable.

- *Treatment of Additions and Withdrawals*. The CFTC adopted a new appendix to Part 4 to provide guidance regarding alternative methods by which CPOs and CTAs may treat additions and withdrawals in computing rate of return. Compounded rate of return and time weighting, as described, are both acceptable methods of computation.

6. **Bunched Orders.** Effective July 11, 2003, the CFTC amended Rule 1.35 to expand the availability of bunched orders and post-execution allocation of those orders as well as to simplify the process and clarify the responsibilities of account managers and futures commission merchants in connection with bunched orders.

- *Eligible Customers*. All customers who provide written investment discretion to an account manager are eligible to participate in bunched orders.

- *Eligible Account Managers*. Eligible account managers now include CFTC-registered CTAs and SEC or state-registered investment advisers ("IAs"), CTAs and IAs which are exempt from registration or excluded from the definition of CTA or IA and foreign advisors with discretion over the accounts of non-U.S. persons.

- *Information*. Account managers must provide customers with disclosure regarding the manager's allocation methodology and data to permit the customer to compare its performance with the performance of other customers.

- *Allocations*. All post-execution allocations must be made as soon as practicable, but no later than the time before the end of day that will permit clearinghouse records to identify the ultimate customer. Allocations must be fair and equitable and must be determined in an objective manner that permits independent verification of fairness.

If you have any questions regarding any of the amendments, 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.

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