

## **NFA Petitions the CFTC to Restrict Exclusions from the Commodity Pool Operator Definition for Investment Companies**

**July 1, 2010**

On June 29, National Futures Association (NFA) submitted to the Commodity Futures Trading Commission (CFTC) a petition for rulemaking (the Petition) that would subject an adviser or other person associated with a registered investment company, including a mutual fund or exchange-traded fund (ETF), and other entities seeking futures- and commodities-related performance, to register with the CFTC as a commodity pool operator (CPO). If such a rule is passed, operation of these funds and other entities would become subject to CFTC and NFA regulation.<sup>1</sup>

CFTC Rule 4.5 currently provides an exclusion from the definition of CPO for eligible persons operating certain qualified entities, including registered investment companies.<sup>2</sup> Prior to August 2003, persons claiming eligibility for the exclusion under Rule 4.5 were required to represent that commodity futures or options contracts entered into by the qualified entity were for *bona fide* hedging purposes<sup>3</sup> and that the aggregate initial margin and/or premiums for positions which did not meet the *bona fide* hedging criteria did not exceed 5% of the liquidating value of the qualifying entity's portfolio, after taking into account unrealized profits and losses. The rule further required that participation in the qualifying entity not be marketed as participation in a commodity pool or otherwise as a vehicle for trading commodity futures or options. In August 2003, as part of a larger overhaul of its regulation of CPOs and commodity trading advisors (CTAs), the CFTC eliminated as conditions to eligibility for Rule 4.5 that the qualified entity limit speculative trading to 5% of the liquidating value of its portfolio and not market itself as a vehicle for exposure to commodity futures or options.<sup>4</sup>

In its Petition, NFA notes that it has recently become aware of at least three mutual funds that have filed notices of eligibility for the exclusion under Rule 4.5, but market themselves to retail investors as a way to invest in commodity futures. NFA expressed concern that, under these structures, commodity futures investments are effectively being marketed to retail investors without the protections of CFTC rules. NFA was also concerned that mutual funds provide exposure to commodity futures through transactions conducted in wholly owned subsidiaries, which are neither registered with the SEC as investment companies nor regulated as commodity pools. NFA indicated that this structure undercuts the premise on

<sup>1</sup> The Petition may be found on NFA's website at <http://www.nfa.futures.org/news/newsPetition.asp?ArticleID=2491>.

<sup>2</sup> 17 C.F.R. § 4.5.

<sup>3</sup> *Bona fide* hedging transactions and positions are defined at CFTC Rule 1.3(z) (17 C.F.R. § 1.3(z)).

<sup>4</sup> 68 Fed. Reg. 47221 (Aug. 8, 2003).

which the CFTC eliminated the speculation and marketing limitations, namely that restrictions were not necessary since the qualifying entities were “otherwise regulated.”

In its petition, NFA requested that the CFTC reinstate the requirement that persons claiming exclusion from the CPO definition represent that the qualifying entity will not be marketed as a vehicle for trading in or exposure to commodity futures or options, and that the aggregate initial margin and premiums for establishing speculative commodity futures and options positions not exceed 5% of the liquidation value of the qualifying entity’s portfolio, after taking into account unrealized profits and losses. If the CFTC adopts NFA’s petition, “operators” (i.e., advisers or other persons associated with the fund) of registered investment companies and other qualifying entities, which are unable to make the speculation and marketing representations, will be considered to be CPOs. As a result, absent an exemption,<sup>5</sup> these entities will be required to register with NFA and comply with the rules and regulations of the CFTC and NFA, including all applicable disclosure and reporting requirements.

In addition, certain investment advisers that currently operate under an exemption from CTA registration will be required to register as a CTA and be required to comply with the rules and regulations of the CFTC and NFA. Many investment advisers currently operate under the exemption from CTA registration for entities that provide commodity advice solely incidental to providing investment advice to “qualifying entities” under Rule 4.5.<sup>6</sup>

If the CFTC grants NFA’s petition, an investment vehicle that is a qualifying entity under Rule 4.5 will no longer be considered a qualifying entity if the fund cannot represent that the investment vehicle complies with the marketing and 5% limitations. As a result, a person associated with the fund, such as an adviser or trustee, will need to register as a CPO. In addition, the investment adviser to the fund will itself have to register as a CTA unless otherwise exempt. To the extent that an investment adviser registers as the CPO, it will not be required to also register as a CTA.

If the CFTC wishes to make the petitioned-for changes, it will have to first publish them for comment. We would expect that the CFTC would do so with a relatively brief period for comments to be submitted, so that it may quickly move toward finalizing changes to the rule. Accordingly, investment companies and other entities that will find themselves affected by these possible rule changes should be prepared to submit comments if, as expected, the CFTC seeks to adopt these changes.

We will continue to monitor this issue and keep you updated on further developments. If you have any questions or would like more information on the issue discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

**Miami**

Ethan W. Johnson	305.415.3394	<a href="mailto:ejohnson@morganlewis.com">ejohnson@morganlewis.com</a>
Rebecca Leon	305.415.3396	<a href="mailto:rleon@morganlewis.com">rleon@morganlewis.com</a>

**New York**

P. Georgia Bullitt	212.309.6683	<a href="mailto:gbullitt@morganlewis.com">gbullitt@morganlewis.com</a>
Michael A. Piracci	212.309.6385	<a href="mailto:mpiracci@morganlewis.com">mpiracci@morganlewis.com</a>

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<sup>5</sup> See generally, CFTC Rule 4.13 (17 C.F.R. § 4.13) (providing exemptions from registration as a CPO for operators of funds that meet certain criteria, including conducting a *de minimis* amount of commodity futures or options trading and/or limiting participation to sophisticated investors).

<sup>6</sup> See CFTC Rule 4.14(a)(8) (17 C.F.R. § 4.14(a)(8)).

**Washington, D.C.**

W. John McGuire

Laura E. Flores

202.739.5654

202.739.5684

[wjmcguire@morganlewis.com](mailto:wjmcguire@morganlewis.com)

[lflores@morganlewis.com](mailto:lflores@morganlewis.com)

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