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### FUTURES TRADING

## CFTC Provides Family Offices with Certainty and Fund of Fund's with a Temporary Reprieve



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The Commodity Futures Trading Commission's (CFTC's) Division of Swap Dealer and Intermediary Oversight (DSIO) issued two no-action letters providing relief from Commodity Pool Operator (CPO) registration for family offices (Family Office Letter)<sup>1</sup> and fund of funds operators (Fund of Funds Letter) in late November 2012.<sup>2</sup> The Family Office Letter represents a new approach by CFTC staff in the context of family offices while the Fund of Funds Letter is a temporary reprieve from having to confront the CFTC's decision to limit the available exemptions from CPO registration.

### Commodity Pools and CPOs

A commodity pool is a collective investment vehicle (i.e., an entity that pools the investments of multiple investors under common management) that trades com-

modity interests.<sup>3</sup> Commodity interests include futures contracts, swaps and most non-spot foreign exchange transactions.<sup>4</sup> A fund that directly or indirectly invests in commodity interests, such as by investing in a fund that directly invests in commodity interests, is a commodity pool.<sup>5</sup> The operator of a commodity pool is a CPO.<sup>6</sup> Unless excluded from that definition, and, absent

<sup>3</sup> Specifically a "commodity pool" is defined as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests." Section 1a(10) of the Commodity Exchange Act.

<sup>4</sup> See CFTC Rule 1.3(yy).

<sup>5</sup> See *CFTC v. Equity Financial Group*, 572 F.3d 150 (3rd Cir. 2009); see also *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 11,252, 11,268 (2012).

<sup>6</sup> A CPO is generally the person promoting the pool, who will have authority to hire and fire the pool's investment adviser and to elect the pool's futures commission merchant. 49 Fed. Reg. 4778 (Feb. 8, 1984). See also, *CFTC v. Heritage Capital Advisory Services, Ltd.*, (ND ILL. Nov. 8, 1982) [82-'84 Transfer Binder], *Comm. Fut. L. Rep. (CCH) ¶ 21,627* (Company was a CPO where it had control to pool the funds, even though it did not have ultimate control over the investment decisions of the pool); *CFTC Interpretative Letter No. 75-17* [75-'77 Transfer Binder] *Comm. Fut. L. Rep. (CCH) ¶ 20,112* (Nov. 4, 1975) (CPO definition includes any person "that handles or

<sup>1</sup> CFTC No-Action Letter No. 12-37 [Current Transfer Binder] *Comm. Fut. L. Rep. (CCH) ¶ 32,452* (Nov. 29, 2012).

<sup>2</sup> CFTC No-action Letter No. 12-38 [Current Transfer Binder] *Comm. Fut. L. Rep. (CCH) ¶ 32,453* (Nov. 29, 2012).

an exemption, the operator of a commodity pool must register with the CFTC as a CPO. If required to register, a CPO also must become a member of the National Futures Association (NFA) and comply with applicable CFTC and NFA disclosure, reporting, recordkeeping and promotional obligations and restrictions. Additionally, the CPO will be subject to regular regulatory NFA examinations.

## Family Offices

The CFTC staff historically has taken the view, through interpretative letters, that the trading vehicles operated by family offices<sup>7</sup> are not commodity pools and, therefore, the family offices were not CPOs. For example, CFTC staff previously found that a limited liability company whose only members were cousins was not a commodity pool,<sup>8</sup> an investment partnership consisting of a husband and wife, custodial accounts for their children, and trusts for the benefit of the same engaged in investing “directly or indirectly through other partnerships” is not a commodity pool,<sup>9</sup> and a limited liability company and a trust operated by the limited liability company are not commodity pools where all participants are close family members.<sup>10</sup> Family offices that had the equivalent facts and circumstances as those in the interpretive letters were able to rely upon the interpretation in the letters without having to make any formal request or filing with the CFTC.<sup>11</sup>

In August 2003, as part of a larger overhaul of its regulation of CPOs and commodity trading advisors (CTAs), the CFTC adopted an exemption from CPO registration for operators of commodity pools where all pool participants were highly sophisticated, as set forth in CFTC Rule 4.13(a)(4).<sup>12</sup> Some family offices chose to seek relief from CPO registration pursuant to CFTC Rule 4.13(a)(4) because of uncertainty as to whether the specific circumstances of their family office were sufficiently similar to those addressed in the previously issued interpretative letters. In February 2012, however, the CFTC rescinded the exemption available under CFTC Rule 4.13(a)(4), and, as a result, family offices were required to rely on prior interpretative letters, claim an alternative exemption from CPO registra-

*exercises control over*” the assets of persons investing in a commodity pool. Even though an investment company did not solicit funds for purposes of trading commodity futures, since it was subsequently authorized to engage in such trading, it is a CPO).

<sup>7</sup> A family office is an organization created and operated by a family for the purpose of, among other things, managing the investments of the members of the family and trusts set up for the benefit of members of the family.

<sup>8</sup> CFTC Interpretative Letter No. 12-27 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 32,418 (October 5, 2012).

<sup>9</sup> CFTC Interpretative Letter No. 97-29, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,039 (March 21, 1997).

<sup>10</sup> CFTC Interpretative Letter No. 10-25, [2009-2011 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 31,585 (June 25, 2010) No. 10-25 (June 25, 2010)

<sup>11</sup> See CFTC Rule 140.99(a)(3).

<sup>12</sup> Additional registration and Other Regulatory Relief for Commodity Pool Operator and Commodity Trading Advisors; Past Performance Issues, 68 Fed. Reg. 47221, 47231 (Aug. 8, 2003).

tion, or register as a CPO.<sup>13</sup> In connection with the proposed rescission of Rule 4.13(a)(4), commenters requested that the CFTC adopt an exemption from CPO registration for family offices similar to the exemption from investment adviser registration under the Investment Advisers Act of 1940 provided for under Investment Advisers Act Rule 275.202(a)(11)(G)-1 adopted by the Securities and Exchange Commission (SEC). At the time the CFTC rescinded Rule 4.13(a)(4), it noted that it would withhold consideration of such an exemption until it had “developed a comprehensive view” of family offices so as “to better assess the universe of firms that may be appropriate to include within the exemption.” The CFTC made clear, however, that family offices could continue to rely upon interpretative letters previously issued.<sup>14</sup>

In the Family Office Letter, DSIO provided that family offices that meet the definition of “family office” under SEC rules<sup>15</sup> would be exempt from CPO registration and associated regulatory requirements. In support of this position, DSIO noted the time and resources the SEC had devoted to this issue, and that the customer protection standards of the SEC and the CFTC are “substantially similar in the issue at hand” and that “placing both agencies on equal footing” would facilitate compliance with both the CFTC and SEC regimes.

Under SEC rules, a “family office” is an entity providing investment advisory services that meets the following criteria:

(i) Its only clients are “family clients” (i.e., family members and certain alter ego family entities formed for tax, charitable, or estate planning purposes);

(ii) It is wholly owned by family clients and exclusively controlled by “family members” or family entities; and

(iii) It does not hold itself out to the public as an investment adviser.<sup>16</sup>

As with the SEC rule on family offices, the relief provided in the Family Office Letter does not extend to multifamily offices.

Although DSIO indicated that it was “placing both agencies on equal footing” with regard to family offices, in one seemingly small, but important aspect, the CFTC’s relief is more onerous than the SEC’s, because, unlike under the SEC rule, the CFTC relief is not self-executing. A CPO wishing to claim the relief in the Family Office Letter must file a claim with DSIO to perfect the relief. The claim for relief must be filed within 30 days for a family office that began operating after December 1, 2012. The claim for relief will be effective upon filing and must include the following information:

- the name, main business address, and main business telephone number of the CPO claiming the relief;

- the capacity (i.e., CPO); and

- the name of the pool(s) for which the claim for relief is being filed.

The claim for relief must be signed electronically by the CPO and filed with DSIO through submission of an

<sup>13</sup> Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11252 (Feb. 24, 2012).

<sup>14</sup> *Id.* at 11263.

<sup>15</sup> Investment Advisers Act Rule 275.202(a)(11)(G)-1.

<sup>16</sup> *Id.*

email to [dsionoaction@cftc.gov](mailto:dsionoaction@cftc.gov) with the subject line of "Family Office."

In addition to the above filing, prior to March 31, 2013, (or, for a family office that begins to operate after that date, within 30 days after it begins to operate as a family office) a CPO seeking the exemption must confirm to DSIO that it is a family office within the meaning and intent of the SEC's "family office" definition and that it will notify DSIO if it ceases to meet that definition.

Some family offices have significant concerns with making a filing in which they must disclose the name of their trading vehicles and identify themselves as organizations operated for the benefit of a wealthy family. These concerns relate to issues of both privacy and security for the family and its members. Thus, some family offices may prefer to seek the relief offered by reliance on the former interpretative letters rather than filing a claim for relief under the Family Office Letter. However, in the Family Office Letter, DSIO did not indicate whether the relief superseded the interpretative letters that found family offices were not commodity pools. Nor did DSIO indicate whether family offices may or may not continue to rely upon the previously issued interpretative letters. Absent further guidance from DSIO that the interpretative letters may continue to be relied upon by a family office that is not itself the recipient of an interpretative letter, to obtain greater certainty, a family office should file the claim for relief under the Family Office Letter.

## Fund of Funds

A fund that gains exposure to commodity interests indirectly through investment in another fund is itself a commodity pool. Under CFTC Rule 4.13(a)(4), an investor fund did not have to be concerned with the level of commodity interest trading in any fund in which it invested in order to avail itself of the exemption from CPO registration. So long as the participants in the investor fund met the sophistication requirements, the operator of the fund was permitted to claim an exemption from CPO registration. Additionally, prior to CFTC amendments in February 2012, the operator of a fund registered under the Investment Company Act of 1940 was exempted from CPO registration because of its status as a registered investment company, regardless of the amount of commodity interest trading conducted.<sup>17</sup> As a result of the rescission of Rule 4.13(a)(4), private funds that are seeking to be exempt from registration as a CPO must look to CFTC Rule 4.13(a)(3). Rule 4.13(a)(3) requires that in addition to all of the investors being sophisticated persons,<sup>18</sup> the fund may not enter into more than a *de minimis* amount of commodity interest transactions. For the operator of a fund to avail itself of the exemption, the fund must meet either of the following *de minimis* commodity interest trading tests:

(i) the aggregate initial margin and/or premium attributable to commodity interests does not exceed 5% of the liquidation value of the fund's portfolio, i.e. the fund's NAV; or

(ii) the aggregate net notional value of the commodity interests held by the fund does not exceed the liquidation value of the fund's portfolio.

Similarly, after amendments to CFTC Rule 4.5, an operator of a registered investment company may claim an exemption from CPO registration only if the fund limits its trading in commodity interests for non-bona fide hedging purposes to the same *de minimis* limits as under 4.13(a)(3). Under this trading restriction, however, there is no limit on the amount of positions in commodity interests that a registered investment company may hold, so long as such positions are used for bona fide hedging purposes. The CFTC, however, has noted that risk management transactions (e.g., transactions to offset the risk inherent in positions taken in the securities or bond markets, or to equitize cash efficiently) would not qualify as bona fide hedging transactions so as to be excluded from the *de minimis* trading calculation under CFTC Rule 4.5.<sup>19</sup> Given these limitations, it is unlikely that a hedging transaction by a registered investment company would qualify for exclusion as a bona fide hedging transaction.

In Appendix A to Part 4 of its rules, the CFTC previously provided guidance for fund of funds in applying the *de minimis* test.<sup>20</sup> Depending on (i) the specific instruments in which the investee fund invests, (ii) the precise relationship between the investor fund and the investee fund, (iii) the registration status of the investee fund, and (iv) the level of trading in investee funds and direct investments in commodity interests, the investor fund would be required to take into account the commodity interests of the investee fund. The CFTC removed Appendix A as part of the February 2012 amendments to Part 4, but DSIO staff subsequently clarified that an operator of a fund of funds may continue to rely on the former Appendix A until further guidance is provided.<sup>21</sup>

The Investment Advisor Association and the Managed Funds Association, as well as other representatives from the private funds industry, requested that DSIO provide updated guidance for application of the *de minimis* test to fund of funds and provide additional time for affected CPOs to come into compliance with any updated guidance. In the Fund of Funds Letter, DSIO provided no-action relief from registration for certain operators of fund of funds until the later of June 30, 2013, or six months from the issuance of any revised guidance on the application of trading restrictions to fund of funds.

To be eligible for the relief, an operator must comply with the following provisions:

(i) The CPO structures its operations in whole or in part as an operator of one or more fund of funds;

(ii) The amount of direct commodity interest positions by the investor fund does not exceed the levels specified in Rule 4.13(a)(3);

<sup>19</sup> 77 Fed. Reg. at 11,256 – 11,257 (citing a distinction between bona fide hedging transactions and those undertaken for risk management purposes, noting that bona fide hedging transactions are unlikely to present the same level of market risk because they are offset by exposure in the physical markets).

<sup>20</sup> Part 4, Appendix A.

<sup>21</sup> Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations.

<sup>17</sup> See CFTC Rule 4.5.

<sup>18</sup> Generally, qualified eligible persons (QEPs) as defined in CFTC Rule 4.7, accredited investors as defined in Securities Act Rule 230.501(a)(5) or (6), and knowledgeable employees as defined in Investment Company Act Rule 270.3c-5.



(iii) The CPO does not know and could not have reasonably known that the investor fund's indirect exposure to commodity interests from investee funds exceeds the *de minimis* levels (calculated either directly or using prior Appendix A); and

(iv) The commodity pool is either (a) an investment company registered under the Investment Company Act of 1940 or (b) in compliance with CFTC Rule 4.13(a)(3)(i), (iii), and (iv).<sup>22</sup>

As with the relief in the Family Office Letter, the CPO wishing to claim the relief provided for in the Fund of Funds Letter must file a claim with DSIO to perfect the relief. The claim will be effective upon filing and must include the following information:

- the name, main business address, and main business telephone number of the CPO claiming the relief;
- the capacity (i.e., CPO); and
- the name of the pool(s) for which the claim is being filed.

The claim for relief must be signed electronically by the CPO and filed with the DSIO by submission of an email to [dsionoaction@cftc.gov](mailto:dsionoaction@cftc.gov) with the subject line of "Fund-of-Funds."

Fund of funds operators that are able to determine their indirect commodity interest exposure are not permitted to claim relief under the Fund of Funds Letter and must file an exemption from registration as a CPO under Rule 4.5 or 4.13(a)(3), if available, or register as a CPO.

Those operators that are able to claim relief under the letter should be aware that the relief from CPO registration is only temporary. Within six months of the

CFTC issuing revised guidance regarding operators of fund of funds, the operators will need to determine whether their exposure to commodity interests are below or above the *de minimis* thresholds based on the revised guidance.

If it is determined that a fund's commodity interest exposure is below the *de minimis* threshold, the operator of the fund will have to file a claim for exemption from registration under CFTC Rule 4.5 or 4.13(a)(3), as applicable. If it is determined that a fund's commodity interest exposure is in excess of the *de minimis* threshold, the operator will either have to reduce the fund's commodity interest exposure so as to be able to claim an exemption under CFTC Rule 4.5 or 4.13(a)(3) or register with the CFTC as a CPO. Operators of fund of funds should continue to monitor this issue and be prepared to possibly make operational changes to either ensure their fund's do not exceed the *de minimis* threshold under any revised guidance or to register with the CFTC as a CPO and comply with the relevant regulatory requirements.

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<sup>22</sup> CFTC Rule 4.13(a)(3)(i) requires interests in the pool to be exempt from registration under the Securities Act of 1933; 4.13(a)(3)(iii) requires that at the time of investment each investor in the pool is an accredited investor, a knowledgeable employee, or a QEP; and 4.13(a)(3)(iv) requires that participations in the pool are not marketed as or in a vehicle for trading in the commodity futures or commodity options markets.