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Commodity Pool Regulatory Update

March 6, 2013

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CFTC Regulation of Hedge Funds

- The Dodd-Frank Act expanded the scope of the CFTC's jurisdiction to include swaps, subjecting many hedge funds to CFTC regulation.

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CFTC Regulation of Hedge Funds

- Commodity interests are regulated by the CFTC.
- If a hedge fund invests in commodity interests it is a commodity pool.
- The sponsor of a commodity pool is a commodity pool operator (CPO).
- The investment manager of a commodity pool is a commodity trading advisor (CTA).
- Absent an exemption, a CPO & CTA must register with the CFTC. Often the CPO & CTA are the same entity.

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What are Commodity Interests?

- Commodity Interests generally include:
  - Futures Contracts
  - Options on Futures Contracts
  - Swaps
- Investments in a fund or account that trades in commodity interests are also deemed to be commodity interests.

What is a Swap?

- The definition of “swap” is broad and includes:
  - Options on rates, currencies, commodities, indices (including broad-based security indices), debt, or other financial or economic interests.
  - Contracts that provide for purchase, sale, payment or delivery based on a contingent event.
  - Contracts that provide for the exchange of payments based on the value of rates, currencies, commodities, securities, instruments of indebtedness, indices, quantities measures, or other financial or economic interests.
  - Contracts that are commonly known in the business as “swaps.”

- “Security-based swaps” are excluded from the definition of “swap.”

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Are FX Transactions "Swaps"?

- Some FX transactions are considered swaps:
  - Cash-settled FX forwards
  - Non-deliverable forwards
  - Cash-settled FX swaps
  - Currency swaps
- Other FX transactions are not considered swaps:
  - Spot FX transactions that settle in T+2
  - Spot FX transactions in connection with the purchase of a foreign security
  - Physically delivered FX forwards
  - Physically delivered FX swaps

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CPO / CTA Registration

- The Commodity Exchange Act requires the "operator" (*i.e.*, sponsor/adviser) of a commodity pool to register as a CPO.
  - CFTC registration applies to the CPO, rather than the fund itself.
  - An exemption is available for hedge funds if trading in commodity interests is *de minimis.*
- A commodity trading advisor generally is a person who provide commodity interest trading advice for compensation or profit.
  - Exemptions are available for CPOs that provide advice solely for the use of the commodity pools they advise.

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CPO / CTA Registration

- Registration is filed with National Futures Association (NFA).
- Registration process takes about 6 to 8 weeks.
- A CPO/CTA must file:
  - A completed online Form 7-R, which requests general business, disciplinary, and contact information about the CPO.
- Individual principals must file:
  - A completed online Form 8-R, which requests general biographical and disciplinary information about the individual; and a fingerprint card.
- Associated Persons (APs) must file:
  - A completed online Form 8-R; a fingerprint card; and evidence of having passed the required proficiency exam (Series 3).

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Principals and Associated Persons

- Associated persons ("APs") of the registered CPO/CTA must be registered with the CFTC and pass a test.
  - Generally, any individual that solicits customers or customer funds for participation in the hedge fund, or supervises such persons.
  - At least one principal will have to also be registered as an AP (and pass the Series 3 test).
- Principals of the registered CPO/CTA must be listed with the CFTC (but no test required).
  - Individuals who are directors, executive officers or in charge of a business unit, division or function subject to CFTC regulation.
  - Individuals who directly or indirectly have a 10% or more ownership or voting interest in the CPO/CTA.
  - Entities that directly have a 10% or more ownership interest in the CPO/CTA.

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CPO Rule 4.13(a)(3) Exemption

- A CPO is exempt from registration if:
  - Interests in the commodity pool are exempt from registration under the Securities Act of 1933.
  - The commodity pool is offered only to sophisticated investors:
    - *qualified eligible persons (QEPs)*
    - *accredited investors*
    - *knowledgeable employees*
  - The commodity pool conducts a *de minimis* level of commodity interest trading.
  - The commodity pool is not marketed as providing exposure to commodity interests.

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Rule 4.13(a)(3) *De Minimis* Trading Exemption - 5% Initial Margin Test

- Aggregate *initial margin* and premiums required to establish commodity interest positions do not exceed 5% of the liquidation value of the commodity pool, after taking into account unrealized profits and losses.
  - Although initial margin is not currently required for swaps, under proposed margin rules, it will be for cleared swaps and most OTC swaps.

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Rule 4.13(a)(3) *De Minimis* Trading Exemption - Net Notional Test

- The aggregate net notional value of commodity interest positions does not exceed 100% of the liquidation value of the commodity pool, after taking into account unrealized profits and losses.

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Application of *De Minimis* Trading Exemptions to a Fund-of-Funds

- There are special rules for a fund (investor fund) that indirectly invests in commodity interests through its investment in another fund (an investee fund).
- The investor fund will be required to take into account the commodity interests of the investee fund depending on:
  - the specific instruments in which the investee fund invests
  - the precise relationship between the investor fund and the investee fund
  - the registration status of the CPO of the investee fund
  - the level of trading in investee funds and direct investments in commodity interests

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Marketing Prohibition

- The fund must not market itself as providing exposure to a commodity pool or as a vehicle to obtain exposure to commodity interests.
  - Generic derivatives disclosure (*i.e.*, “the fund may invest in futures and swaps”) will not cause the fund to fail this test.

CTA Rule 4.14 Exemptions

- CFTC Rule 4.14 provides exemptions from CTA registration if:
  - Commodity trading advice is directed solely to pools for which the person is a registered or an exempt CPO.
  - Commodity trading advice is furnished to 15 or fewer persons over the past year, and the person does not hold themselves out as a CTA.

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Filing for an Exemption

- Exemptions are filed with NFA.
- Certain exemptions, such as the Rule 4.13(a)(3) exemption, require an annual affirmation of compliance.

CPO/CTA Regulatory Requirements

- CPOs have Disclosure, Recordkeeping and Reporting Requirements
  - Operators of hedge funds may claim relief under Rule 4.7 if all participants in fund are Qualified Eligible Persons (QEPs).
    - *Disclosure document and prescribed disclosures not required.*
      - Offering Memorandum/Private Placement Memorandum not required to be submitted to NFA.
    - *Quarterly reports to participants instead of monthly*
      - Must still have an audited annual report submitted to NFA and distributed to participants within 90 days of year-end.

- CTAs have Disclosure and Recordkeeping Requirements
  - If all advisory clients, including funds for which acting as sub-advisor, are QEPs, advisor may claim relief under Rule 4.7.
    - *Disclosure document and prescribed disclosures not required.*
      - Disclosure document not required to be submitted to NFA.

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CPO/CTA Regulatory Requirements

- CTA Taping requirements
  - Effective December 21, 2013, CFTC Rule 1.35 requires CTAs that are members of a designated contract market (DCM) or swaps execution facility (SEF) to tape record all oral communications concerning quotes, solicitations, bids, offer, instructions, trading and prices that lead to the execution of a transaction in commodity interests.
  - “Member” of a DCM or SEF is any person “having trading privileges”
  - Tapes must be maintained for 1 year

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CPO/CTA Regulatory Requirements

- NFA Bylaw 1101
  - Prohibits an NFA member from doing business with a person required to be registered with the CFTC that is not also a member of NFA.
    - *Accordingly, NFA membership is essentially mandatory for all CPOs and for any CTA that is exercising discretion over client accounts.*
  - An NFA member must conduct due diligence to ensure that any persons with which it conducts business, including investors in any commodity pool, if required to be registered with the CFTC are also a member of NFA.
  - Although by its terms imposes strict liability, NFA generally has not enforced the rule using this standard, but rather has brought cases where the Member knew or should have known of the violation.
  - CPOs/CTAs generally include a Bylaw 1101 questionnaire in their account/subscription documentation and will conduct additional due diligence, for example by checking an entity's registration status on NFA's web site.

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Form CPO-PQR

- Under CFTC Rule 4.27, the Form CPO-PQR timing for filing and information to be required is based on the amount of aggregate Pool AUM.
- NFA Rule 2-46, as proposed to be amended, will require all CPOs to file quarterly, regardless of size.
  - 60 days after the end of calendar Q1, Q2 and Q3
  - 90 days after the end of the calendar year
    - *60 days for large CPO's ($1.5 billion in aggregate pool AUM)*
- Each filing will include a schedule of investments.
- Even if it files Form PF with SEC, a CPO still will need to make a filing with NFA.
- All CPO-PQR filing requirements (CFTC and NFA) are met by filing with NFA.

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Form CTA-PR

- CFTC Rule 4.27 requires all registered CTAs to file the Form CTA-PR annually within 45 days of the end of the calendar year.
- NFA Rule 2-46, as proposed to be amended, will require CTAs to file quarterly.
- All CTA-PR filing requirements (CFTC and NFA) are met by filing with NFA.

Filing the Form CPO-PQR and Form CTA-PR

- The CFTC has not yet provided guidance on the Form CPO-PQR and Form CTA-PR and guidance not likely until after at least the first round of filings.

- Until guidance is issued, firms may make "reasonable assumptions consistent with a good faith effort in executing their compliance obligations."

NFA Compliance Rule 2-45

- Prohibition of Loans By Commodity Pools to CPOs and Affiliated Entities –
  - No Member CPO may permit a commodity pool to use any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity.

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New CFTC Position Limit Rules

- Dodd-Frank provided the CFTC with new position limit authority for swaps.
- In November 2011, the CFTC adopted new position limit rules expanding and revising its position limit regime for 28 energy, metals and agricultural futures, and options on futures, as well as economically equivalent futures, options and swaps (“referenced contracts”).
- New spot month position limits for referenced contracts were to become effective fall of 2012.

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Challenge to New Position Limit Rules

- In December 2011, financial industry trade associations filed suit against the CFTC.
- On September 28, 2012, the court vacated the CFTC's new position limit rule and remanded it to the CFTC.
- Exchange position limits for futures and options on futures and CFTC position limits for certain agricultural futures and options on futures are still in effect.

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Position Aggregation/Disaggregation

- Position aggregation required for accounts under 10% or more common ownership or common control.
- No aggregation for L.P. in a commodity pool, except that if an L.P. has an ownership interest of 25% or more in a pool that is operated by a 4.13 exempt CPO, aggregation is required.
- Disaggregation (other than in spot month) available for "eligible entities" whose accounts are controlled "independent account controllers."

Position Limit Enforcement

- CFTC and Exchanges are vigorously enforcing current position limit rules.
- Penalties have included fines and disgorgement of profits.
- The position limits apply intra-day, not just at the end of the day.
- The position limits can be violated even by submitting a bid or offer, that if filled, would result in a position in excess of the position limit, even if the bid or offer is not executed.

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Position Limit Enforcement

- Aggregation Example:

  Prominent fund manager violated Nikkei Stock Index position limit of 5,000 contracts by 49 contracts because fund manager failed to aggregate positions held by separate portfolio managers.

  - CME imposed $15,000 fine and $30,625 disgorgement.

- Spot Month Example:

  Trader violated speculative position limit in Feeder Cattle futures by .05% during the spot month.

  - CME imposed $28,000 fine.

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Position Limit Enforcement

- Intraday/Momentary Violation Example:

  While holding a long position of 1,187.75 February 2012 Natural Gas Look-Alike Last Day Financial Futures, the Fund purchased 200 February 2012 Natural Gas Futures, in violation of its Conditional Limit applicable on the last three days of the spot month. The Fund had mistakenly purchased the 200 February 2012 Natural Gas Futures, instead of 200 March 2012 Natural Gas Futures. The Fund realized the error and, within 50 seconds, placed an order to sell the 200 February 2012 Natural Gas Futures to bring itself in compliance with its Conditional Limit. The sell order was fully executed within two minutes and the Fund lost $580 on the trade. The Fund immediately notified the Exchange of this violation.

  – NYMEX imposed a fine of $70,000. Aggravating circumstance was that this was the Fund's fourth position limit violation within 24 months.

Position Limit Enforcement

- Bid/Offer Example:

  Trader failed to adhere to the spot month speculative position limit for Corn futures by entering an order to purchase 2,500 December – March Corn futures spreads. At this time, Trader had already established a long December Corn futures position of 134 contracts. His order, if accepted, would have caused the trader to exceed the spot month speculative position limit of 600 contracts by 2,034 contracts.

  - CBOT fined the trader $5,000 and suspended his membership privileges, access to any CME Group trading floors, and direct access to any CME Group electronic trading or clearing platform for 20 business days.

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Block Trades

- Block trades are privately negotiated futures or options on futures that meet minimum quantity thresholds that are permitted to be executed away from the competitive auction market
  - Each party must be an ECP; or a registered or exempt CTA or IA with at least $25 million under management
  - Price must be “fair and reasonable”
  - Blocks must be reported within 5-15 minutes
  - Complete records and timestamps must be retained for all blocks
- Block trades between affiliated parties are permitted provided:
  - the block trade is executed at a fair and reasonable price,
  - each party has a legal and independent bona fide business purpose for engaging in the trade, and
  - each party’s decision to enter into the block is made by an independent decision maker.
- If solicited to conduct a block and you do not trade the block you may not trade in that contract on the basis of non-public information until the exchange prints the block.

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Simultaneous Buy/Sell Orders For Different Beneficial Owners

- In electronic markets, opposite orders for different beneficial owners (managed accounts) that are "simultaneously" placed by a party with discretion (a CTA) over both accounts may be entered on the electronic platform provided:
  - One order is exposed for a minimum of 5 seconds in the case of futures, or 15 seconds in the case of options on futures, before the second opposite order is entered.

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Pre-Execution Communications

- General Rule: No prearrangement or pre-negotiation of any purchase or sale or noncompetitive execution of any futures or option on future transactions.

- Exceptions: The foregoing restriction does not apply to Block trades, Exchange for Related Positions (EFPs, EFSs) transactions, and certain electronically executed crosses effected pursuant to Exchange rules **(not all Exchanges permit this for all of their contracts, you must check the specific Exchange rules).**

- Parties who have been involved in a pre-execution communication may not disclose the details of that communication to other parties, nor may a party place any order to take advantage of the information conveyed in such communications except to facilitate the trade in accordance with the rule.

Pre-Execution Communications

- Pre-Execution Cross Rule (where permitted)
  - Parties may engage in pre-execution communications with regard to transactions executed on the Globex/ICE platform where one party (the first party) wishes to be assured that a contra party (the second party) will take the opposite side of the order under the following circumstances:
  - 1. A party may not engage in pre-execution communications with other market participants on behalf of another party unless the party for whose benefit the trade is being made has previously consented to permit such communications.
  - 2. Parties to pre-execution communications shall not (i) disclose to a non-party the details of such communications or (ii) enter an order to take advantage of information conveyed during such communications except in accordance with this rule.
  - 3. In the case of futures orders, the first party's order must be entered into the electronic trading platform first and the second party's order may not be entered into the electronic trading platform until a period of 5 seconds has elapsed from the time of entry of the first order.
  - 4. For Globex transactions, in the case of options orders, subsequent to the pre-execution communication, a Request for Quote ("RFQ") for the particular option or option spread or combination must be entered into the electronic trading platform. Thereafter, in equity and interest rate options, a Request for Cross ("RFC") order which contains both the buy and the sell orders must be entered no less than five (5) seconds and no more than thirty (30) seconds after the entry of the RFQ in order to proceed with the trade. In all other options, the RFC order must be entered no less than fifteen (15) seconds and no more than thirty (30) seconds after the entry of the RFQ in order to proceed with the trade. The RFQ and the RFC order must be entered within the same trading session. Failure to enter the RFC order within 30 seconds after the entry of the RFQ will require a new RFQ to be entered prior to the entry of the RFC order, which must be entered in accordance with the time parameters described above in order to proceed with the trade.

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