Futures & Derivatives Law REPORT
The Journal on the Law of Investment & Risk Management Products
April 2011 ■ Volume 31 ■ Issue 4

Recent Regulatory Developments Affecting Private Fund Managers

BY NATHAN A. HOWELL, ZEKE JOHNSON, ANDREW E. NELSON, BRANDON E. ORTIZ, NIRAJ M. PATEL AND PREDRAG ROGIC[1]

The Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") have recently proposed new rules implementing sweeping changes passed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). If adopted these proposed rules will have a significant impact on many investment funds and their managers. The discussion below focuses on certain of these proposed rules as well as related provisions of Dodd-Frank, including:

- proposed amendments to commodity pool operator ("CPO") and commodity trading advisor ("CTA") compliance obligations, including the proposed rescission of key exemptions from CPO and CTA registration;
- the expansion of the definition of CPO under Dodd-Frank to include managers that operate investment funds trading swaps;
- the extensive proposed reporting obligations applicable to registered investment advisers, CPOs and CTAs;
- the proposed "entity definitions" under Dodd-Frank, including the definitions of "swap dealer" and "major swap participant," as well as the definition of "eligible contract participant" and the interplay of this new definition with recently finalized retail forex rules;
- proposed CFTC position limits; and
- proposed changes to the "accredited investor" definition under SEC rules.

Comments on the rule proposals were due on the date specified in the relevant release.[2]

These proposals follow other recent regulatory developments affecting private fund managers, including but not limited to, changes to investment adviser registration exemptions, Financial Industry Regulatory Authority, Inc. Rule 5131, retail forex rules, municipal advisor registration, California and New York City lobbyist registration requirements and Massachusetts privacy rules.[3]

CONTINUED ON PAGE 3

Article REPRINT

Reprinted from the Futures & Derivatives Law Report. Copyright © 2011 Thomson Reuters. For more information about this publication please visit www.west.thomson.com

WEST®

© 2011 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651)687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

For subscription information, please contact the publisher at: west.legalworkspublications@thomson.com

West LegalEdcenter

LOG ON.
LOOK UP.
LEARN.

Quality legal training and
CLE - online, anytime

westlegaledcenter.com
1.800.241.0214

WEST®
Part of Thomson Reuters

Editorial Board

STEPHEN W. SEEMER
Publisher, West Legal Ed Center

JANNA M. PULVER
Publication Editor, Thomson Reuters/West

RICHARD A. MILLER
Editor-in-Chief, Prudential Financial
Two Gateway Center, 5th Floor, Newark, NJ 07102
Phone: 973-802-5901 Fax: 973-367-5135
E-mail: richard.a.miller@prudential.com

MICHAEL S. SACKHEIM
Managing Editor, Sidley Austin LLP
787 Seventh Ave., New York, NY 10019
Phone: (212) 839-5503
Fax: (212) 839-5599
E-mail: msackheim@sidley.com

PAUL ARCHITZEL
Alston & Bird
Washington, D.C.

GEOFFREY ARONOW
Bingham McCutchen LLP
Washington, D.C.

CONRAD G. BAHLKE
OTC Derivatives Editor
Weil, Gotshal & Manges
New York, NY

RHETT CAMPBELL
Thompson & Knight LLP
Houston, TX

ANDREA M. CORCORAN
Align International, LLC
Washington, D.C.

W. IAIN CULLEN
Simmons & Simmons
London, England

WARREN N. DAVIS
Sutherland Asbill & Brennan
Washington, D.C.

SUSAN C. ERVIN
Dechert LLP
Washington, D.C.

RONALD H. FILLER
New York Law School

EDWARD H. FLEISCHMAN
Linklaters
New York, NY

DENIS M. FORSTER
New York, NY

THOMAS LEE HAZEN
University of North Carolina at Chapel Hill

DONALD L. HORWITZ
One Chicago
Chicago, IL

PHILIP MCBRIDE JOHNSON
Skadden Arps Slate Meagher & Flom
Washington, D.C.

DENNIS KLEJNA
MF Global
New York, NY

ROBERT M. MCLAUGHLIN
Katten Muchin Rosenman
New York, NY

CHARLES R. MILLS
Kirkpatrick & Lockhart
Washington, D.C.

DAVID S. MITCHELL
Fried, Frank, Harris, Shriver & Jacobson LLP
New York, NY

RICHARD E. NATHAN
Los Angeles

PAUL J. PANTANO
McDermott Will and Emery
Washington, D.C.

FRANK PARTNOY
University of San Diego
School of Law

GLEN A. RAE
Banc of America Securities LLC
New York, NY

KENNETH M. RAISLER
Sullivan & Cromwell
New York, NY

RICHARD A. ROSEN
Paul, Weiss, Rifkind, Wharton & Garrison LLP
New York, NY

KENNETH M. ROSENZWEIG
Katten Muchin Rosenman
Chicago, IL

THOMAS A. RUSSO
New York, NY

HOWARD SCHNEIDER
MF Global
New York, NY

STEPHEN F. SELIG
Brown Raysman Millstein Felder & Steiner LLP
New York, NY

PAUL UHLENHOP
Lawrence, Kamin, Saunders & Uhlenhop
Chicago, IL

EMILY M. ZEIGLER
Willkie Farr & Gallagher
New York, NY

Futures & Derivatives Law Report
West LegalEdcenter
610 Opperman Drive
Eagan, MN55123

© 2011 Thomson Reuters

One Year Subscription ■ 11 Issues ■ $535.95
(ISSN#: 1083-8562)

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered. However, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

I. Proposed Amendments to CPO and CTA Compliance Obligations and Exemptions

The CFTC recently issued a notice of proposed rulemaking (the "Proposed Compliance Rules") outlining amendments that would rescind or significantly limit exemptions from CFTC registration currently used by many managers or on which managers trading swaps intended to rely when Dodd-Frank becomes effective in July 2011.[4] The Proposed Compliance Rules, among other things, rescind the exemptions from registration as a CPO currently provided by Rules 4.13(a)(3) and 4.13(a)(4) and narrow the Rule 4.5 exclusion from the definition of CPO for investment companies registered under the Investment Company Act of 1940, as amended (the "Investment Company Act"). The Proposed Compliance Rules also rescind relief from the certification requirement for annual reports of pools operated pursuant to Rule 4.7 and require the annual confirmation of exemptive notices filed pursuant to Rules 4.5, 4.13 and 4.14. In addition, they include a new Rule 4.27 which sets out additional reporting requirements for certain CPOs and CTAs via Forms CPO-PQR and CTA-PR (discussed in Section III, below).

Rescission of CPO Registration Exemptions Under Rules 4.13(a)(3) and 4.13(a)(4)

The Proposed Compliance Rules rescind both Rule 4.13(a)(3) and Rule 4.13(a)(4). Under current law, Rules 4.13(a)(3) and 4.13(a)(4) exempt CPOs from registration with respect to qualifying pools, with the key requirements being, respectively, that (i) investors be "accredited investors" as defined in Regulation D ("Reg D") under the Securities Act of 1933, as amended (the "Securities Act"), and commodity interest positions not account for more than a limited amount of the commodity pool's assets, or (ii) investors meet certain sophistication tests, which are met by natural person investors who are "qualified purchasers,"[5] "knowledgeable employees" and certain affiliates and entity investors that are "accredited investors" or meet other specified requirements.

The CFTC has not indicated when the rescission of these exemptions would be effective but has solicited comments on how much time previously exempt managers would need in order to comply with the proposed changes. The CFTC is also requesting comments on whether it should consider an alternative, presumably more restrictive, *de minimis* exemption similar to Rule 4.13(a)(3) and whether any entities that have previously relied on these exemptions should be exempt from the rescission of Rules 4.13(a)(3) and 4.13(a)(4).

Amendments to CPO Exclusion Under Rule 4.5

Concerned with "investment companies offering futures-only investment products without [CFTC] oversight," the CFTC is proposing to narrow the exclusion from the definition of "commodity pool operator" in Rule 4.5 as applicable to investment companies registered under the Investment Company Act ("registered investment companies"). Under the current Rule 4.5, registered investment companies are excluded from the definition of CPO without any limitations regarding their trading or marketing activities.

The proposed amendments would allow a registered investment company to claim the exclusion only if it will (i) use commodity futures, commodity options or swaps solely for bona fide hedging purposes and limit initial margin and option premiums for non-hedging commodity futures, commodity options or swaps transactions to not more than 5% of the registered investment company's portfolio and (ii) not market participations to the public as a commodity pool or otherwise as a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures, commodity options or swaps markets.[6]

These proposed amendments reinstate elements of the exclusion that existed prior to the rule's amendment in 2003 but apply them to only registered investment companies and not other regulated institutions that can claim the exclusion, such as insurance companies. In addition, in keeping with

the changes promulgated under Dodd-Frank, the trading restrictions apply to trading (non security-based) swaps as well as other commodity interests. In proposing the changes to the Rule 4.5 exclusion, the CFTC raised various questions, including: (i) whether the proposed restriction on marketing should be broader or more narrow and whether the term "marketing" needed to be clarified and how; (ii) what types of investment strategies may be disproportionately impacted, especially those implementing "life cycle" strategies; (iii) what rules and regulations of the SEC regarding registered investment companies may conflict with those of the CFTC; (iv) whether the trading thresholds set out in the proposed amendments are appropriate; and (v) what considerations should be taken into account in implementing the amendment, including what issues arise regarding the ability of investment companies to implement CFTC disclosure and reporting requirements, how much time will be necessary for affected registered investment companies to comply with the amendments and whether those who have previously claimed the exclusion should be exempt from the amendments to Rule 4.5.

If the proposed amendments to Rule 4.5 are adopted without a grandfathering provision, a registered investment company or its sponsor that does not meet the trading or marketing limitations in the amended rule will have to register as a CPO with the CFTC and become a member of the National Futures Association ("NFA"), the self-regulatory organization of the futures industry, if it has not already done so. In addition, such a registered investment company will have to comply with all CFTC disclosure document delivery and other CFTC requirements, unless relieved from such requirements, which may make the operation and marketing of such registered investment companies impractical.

Changes to CTA Registration Exemptions

A manager that advises only investment funds exempt under Rules 4.13(a)(3) or 4.13(a)(4) can currently claim exemption from registration as a CTA pursuant to Rule 4.14(a)(5) if its commodity interest trading advice is directed solely to, and for the sole use of, the investment funds for which it is exempt as a CPO. If Rules 4.13(a)(3) and 4.13(a)(4) are rescinded, a manager will no longer be able to claim such exemption. The Proposed Compliance Rules also eliminate the exemption from registration as a CTA currently found in Rule 4.14(a)(8)(i)(D), which applies to a CTA that is also a CPO exempt from registration pursuant to Rules 4.13(a)(3) or 4.13(a)(4) and whose commodity interest trading advice is solely incidental to its business of providing securities or other investment advice to the investment funds for which those exemptions have been claimed.[7]

The proposed amendments to Rule 4.5, if adopted in their current form, would also affect a relevant CTA exclusion. Rule 4.6(a)(2) generally provides an exclusion from the definition of CTA for those entities that are excluded from the definition of CPO under Rule 4.5. If a registered investment company will no longer be able to claim an exclusion under the amended Rule 4.5, it will not be excluded from the definition of CTA under Rule 4.6.

Remaining Exemptions from Registration as a CPO or CTA

Only two exemptions from registration as a CPO will remain if Rules 4.13(a)(3) and 4.13(a)(4) are rescinded. These exemptions are unlikely to apply to the vast majority of managers.[8]

Even if the proposed changes to Rules 4.13 and 4.14 are adopted, several exemptions from CTA registration will remain intact. A manager that is registered as a CPO and provides commodity interest trading advice solely to, and for the sole benefit of, the pool or pools for which it is registered generally qualifies for an exemption from CTA registration under Rule 4.14(a)(4). This exemption is not, however, available to a CTA that advises managed accounts in addition to its own sponsored pools and may not apply where the CTA and CPO of an investment fund are affiliated but separate entities. CTAs also may qualify for other CTA exemptions under CFTC Rule 4.14 or may be able to rely on the exemption pursuant to Section 4m of the Commodity Exchange Act, as amended (the "CEA").[9]

The Proposed Compliance Rules also contain a requirement that all persons claiming exclusion-

© 2011 THOMSON REUTERS

ary relief under Rule 4.5, and the unaffected exemptive relief under Rules 4.13 and 4.14, confirm their notices of claim of exclusion or exemption on an annual basis.

CPO/CTA Registration and NFA Membership

If the proposed changes to Rules 4.5, 4.13 and 4.14 are adopted, a manager that is not registered as a CPO or CTA in reliance on one or more of these exemptions or exclusions will have to register with the CFTC in such capacity and become a member of NFA, unless another exemption from registration is available. Given that the CPO exemptions that would remain if these proposals were adopted would be very limited, most managers that operate investment funds that trade commodity interests (which, under Dodd-Frank, include non security-based swaps) would have to register as CPOs. Similarly, managers would have to register as CTAs, unless otherwise exempt.

As a general matter, registration as a CPO or CTA requires the manager to make filings and pay fees with respect to itself and each of its principals and associated persons. Associated persons have testing and ethics requirements. CPOs and CTAs must also comply with a number of disclosure (including NFA review of the relevant offering document), compliance, ongoing reporting (monthly or quarterly and annually) and recordkeeping requirements and are subject to audit. If an entity is required to register as a CPO or CTA, it will be required to become a member of NFA. NFA has its own set of rules, including certain reporting, compliance and conduct requirements.

Relief from Certain CFTC Requirements Pursuant to Rule 4.7; Proposed Amendment to Rule 4.7

Registered CPOs and CTAs may be able to claim relief from certain CFTC requirements pursuant to Rule 4.7 for those investment funds for which they previously were exempt from registration. Rule 4.7 provides, among other things, relief from the requirement that NFA review and approve an investment fund's or CTA's disclosure document. It also provides that fund or CTA disclosure documents do not have to meet the detailed disclosure requirements set out in Rules 4.24 and 4.34. In addition, Rule 4.7 provides relief from certain reporting and recordkeeping requirements. In particular, Rule 4.7 currently provides relief from the requirement that annual reports for investment funds be audited by certified public accountants. The Proposed Compliance Rules, however, include an amendment requiring that all annual reports for investment funds be audited.

Rule 4.7 relief is available only if interests in the relevant investment fund are offered and sold solely to investors (or the CTA clients in any managed accounts) that are "qualified eligible persons" ("QEPs") in an offering exempt from registration under the Securities Act pursuant to the "private placement exemption," Section 4(2) thereof, or pursuant to Regulation S under the Securities Act. QEPs include, for example, "qualified purchasers" and "knowledgeable employees" as defined under Investment Company Act rules. The definition also includes U.S. natural person investors that are "accredited investors" as defined in Reg D but these investors must also meet a "portfolio requirement" as do certain other types of investors. In order to claim the relief provided under Rule 4.7, a CPO or CTA must file a notice of exemptive relief with NFA.

Relief from certain CFTC requirements may also be available through other, more limited, exemptions.[10]

II. Expansion of Definition of Commodity Pool and Commodity Pool Operator

The CEA currently (before the Dodd-Frank amendments go into effect) defines a commodity pool, in relevant part, as "an investment trust, syndicate, or similar form of enterprise [operated] for the purpose of trading in any commodity for future delivery on or subject to the rules of any [regulated futures exchange.]" As of July 16, 2011, the definition will be expanded to include not only entities operated for the purpose of trading exchange-traded futures contracts, but also entities operated for the purpose of trading

security futures products, swaps, certain leveraged or dealer-financed retail foreign exchange or commodity contracts, commodity options authorized under Section 4c of the CEA and so-called "leverage transactions" subject to Section 19 of the CEA. This definitional change is automatic and does not depend on CFTC rulemaking of any kind in order to become effective.

The operators of certain pooled investment vehicles that are not currently subject to CFTC jurisdiction will be subjected to substantial new regulation, including registration as a CPO unless another exemption applies. For example, the operator of a private investment fund that exclusively trades fixed income securities, but enters into interest rate swaps for hedging purposes, would be required, barring any applicable exemption, to register as a CPO, as would the operator of a private investment fund that trades exclusively securities, offers one or more classes of interests denominated in foreign currencies and enters into OTC foreign exchange contracts to hedge exchange rate risk between currency classes.

III. Proposed Reporting Requirements

On January 26, 2011, pursuant to a mandate set forth in Section 404 and Section 406 of Dodd-Frank, the SEC proposed Rule 204(b)-1 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), jointly with the CFTC's proposed Rule 4.27(d) under the CEA that would establish new confidential information reporting requirements, set forth in new Form PF, for investment advisers registered, or required to be registered, with the SEC that advise one or more private funds and for CPOs or CTAs that are dually registered with the SEC and advise private funds.[11] Advisers that are exempt from registration with the SEC, including exempt reporting advisers, would not be required to file Form PF. The information collected on Form PF primarily would be for the use of the Financial Stability Oversight Council ("FSOC") in monitoring and assessing systemic risk in the U.S. financial system. Form PF filings would be made on a confidential basis, and the information collected through Form PF by the SEC and used by FSOC generally would be required to be kept confidential; however, the SEC may share such information with foreign regulators, other federal departments and agencies, self-regulatory organizations or pursuant to certain court orders. The SEC may also use the information collected through Form PF in its own regulatory programs, including for examinations and enforcement actions. In addition, the CFTC has proposed that all CPOs and CTAs registered with the CFTC be required to file Form CPO-PQR and/or CTA-PR,[12] as applicable, regardless of whether they also file Form PF with the SEC.

Implementation

Form PF would require substantial new periodic disclosures from all affected investment advisers that advise one or more private funds (*i.e.*, funds that rely on the exclusion from the definition of investment company provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act). Registered CPOs and CTAs dually registered with the SEC would be required to file Form PF with respect to each advised commodity pool that is a private fund. As stated in the Form PF Proposing Release, such commodity pools would be classified as "hedge funds"[13] for purposes of Form PF, so that CPOs and CTAs required to file Form PF would be required to complete only the sections of the Form applicable to hedge fund advisers.[14] If the adviser's principal office and place of business is outside the United States, the adviser could exclude any private fund that during the last fiscal year was neither a United States person nor offered to, or beneficially owned by, any United States person.[15]

Filing requirements would differ based on the size of the investment adviser (determined by assets under management) and whether the investment adviser is advising hedge funds, liquidity funds[16] or private equity funds.[17] Large Private Fund Advisers[18] that advise one or more hedge funds, in particular, would be subject to the most onerous reporting requirements.

© 2011 THOMSON REUTERS

Information Required on Form PF

Section 1 would apply to all private fund advisers required to file Form PF. Section 1a seeks identifying information about the adviser and also requires reporting of basic aggregate information about the private funds managed by the adviser, such as total and net assets under management, and the amount of those assets attributable to different types of private funds and other funds and accounts.

Section 1b elicits certain identifying and other basic information about each private fund advised by the investment adviser. The adviser generally would need to complete a separate Section 1b for each private fund it advises, including, for each fund, reporting of: (i) gross and net assets; (ii) aggregate notional value of derivative positions; (iii) breakdown of borrowings based on whether the creditor is a U.S. financial institution, foreign financial institution or non-financial institution as well as the identity of, and amount owed to, each creditor to which the fund owed an amount equal to or greater than 5% of the fund's net asset value as of the reporting date; (iv) concentration of investor base; and (v) monthly and quarterly performance information.

All private fund advisers to hedge funds (whether or not Large Private Fund Advisers) would also be required to file Section 1c, which requires, for each hedge fund, reporting of: (i) investment strategies; (ii) percentage of assets managed using computer-driven trading algorithms; and (iii) significant trading counterparty exposures (including identity of counterparties), and trading and clearing practices.

Large Private Fund Advisers to hedge funds also would be required to complete Section 2. Section 2a requires certain aggregate information about the hedge funds advised by Large Private Fund Advisers, such as: (i) the market value of assets invested (on a short and long basis) in different types of securities and commodities (*e.g.*, different types of equities, fixed income securities, derivatives, and structured products); (ii) the duration of fixed income portfolio holdings (including asset backed securities), to indicate the assets' interest rate sensitivity; (iii) the turnover rate of the adviser's aggregate portfolios during the reporting period to provide an indication of the adviser's frequency of trading; and (iv) the geographic breakdown of investments.

Section 2b of Form PF would require Large Private Fund Advisers to report certain additional information about any hedge fund they advise with a net asset value of at least $500 million as of the close of business on any day during the reporting period (a "qualifying hedge fund").[19] Section 2b would require reporting of the same information as that requested in Section 2a regarding exposure to different types of assets, but separately with respect to each qualifying hedge fund. Section 2b also requires, for each qualifying hedge fund, reporting of: (i) portfolio liquidity; (ii) concentration of positions; (iii) collateral practices with significant counterparties; (iv) the identity of, and clearing relationships with, the three central clearing counterparties to which the fund has the greatest net counterparty credit exposure; (v) certain hedge fund risk metrics (including any value at risk metric regularly calculated by the adviser during the reporting period); (vi) impact on the portfolio from specified changes to certain identified market factors, if regularly considered in the fund's risk management, broken down by the long and short components of the qualifying hedge fund's portfolio; (vii) a monthly breakdown of secured and unsecured borrowing; (viii) derivatives exposures; (ix) the value of the collateral and letters of credit supporting secured borrowing and derivatives exposures and the types of creditors; (x) financing liquidity; (xi) side pocket and gating arrangements; and (xii) investor liquidity.

Large Private Fund Advisers to money-market and liquidity funds would be required to file Section 3. Section 3 requires, for each liquidity fund, reporting of: (i) valuation and pricing methods; (ii) whether the fund is managed in compliance with certain provisions of Rule 2a-7 under the Investment Company Act; (iii) for each month of the reporting period, net asset value, net asset value per share, market-based net asset value per share, weighted average maturity, weighted average life, 7-day gross yield, amount of daily and weekly liquid assets, and amount of assets with a maturity

© 2011 THOMSON REUTERS

greater than 397 days; (iv) the amount of assets invested in different types of instruments, broken down by the maturity of those instruments; (v) information for each open position that represents 5% or more of s net asset value; (vi) any secured or unsecured borrowing, broken down by creditor type and the maturity profile of that borrowing; (vii) committed liquidity facilities; and (viii) investor information, including concentration of investor base, percentage of fund equity purchased using securities lending collateral, gating and redemption policies, and investor liquidity.

Large Private Fund Advisers to private equity funds would be required to file Section 4. Section 4 requires, for each private equity fund, reporting of: (i) the outstanding balance of borrowings and guarantees; (ii) the leverage of portfolio companies; (iii) the weighted average debt-to-equity ratio of "controlled portfolio companies" and the range of that debt to equity ratio among these portfolio companies; (iv) the maturity profile of portfolio companies' debt, for the portion of that debt that is payment-in-kind or zero coupon; (v) debt default history during the reporting period; (vi) bridge financing to portfolio companies; (vii) additional information on "financial industry portfolio company," if applicable; (viii) whether any of the adviser's related persons co-invest in any of the fund's portfolio companies; and (ix) a breakdown of investments by industry and geography.

General Information

Small private fund advisers would be required to file Form PF on an annual basis (no later than the last day the adviser may file its annual updating amendment to Form ADV, currently 90 days after the end of the adviser's fiscal year). Large Private Fund Advisers would be required to file Form PF quarterly (no later than 15 days after the end of each quarter). A newly-registered adviser's initial Form PF would need to be filed within 15 days of the end of its next occurring calendar quarter after registering with the SEC.

Proposed Forms CPO-PQR and CTA-PR

As part of the CFTC's Proposed Compliance Rules, the CFTC proposed that private fund advisers that are dually registered with the SEC and the CFTC would satisfy certain of the proposed CFTC filing requirements by filing Form PF with the SEC. Irrespective of their filing a Form PF with the SEC, however, all private fund advisers that are also registered as CPOs and CTAs with the CFTC would be required to file Schedule A of proposed Form CPO-PQR and CTA-PR, as applicable. Additionally, CPOs and CTAs, depending on their size and that of the funds they operate or advise, will be required to file certain sections of proposed Form CPO-PQR and CTA-PR, as applicable, for any fund that is not a private fund.

IV. Proposed "Entity Definitions"

Swap and Security-Based Swap Dealers

The Dodd-Frank definitions of "swap dealer" and "security-based swap dealer" include any person that engages in any one or more of the following activities: (i) holding oneself out as a dealer in swaps or security-based swaps, respectively; (ii) making a market in swaps or security-based swaps, respectively; (iii) regularly entering into swaps or security-based swaps, as applicable, with counterparties as an ordinary course of business for one's own account; or (iv) engaging in an activity causing oneself to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps.

Some commentators have pointed out that the third prong of the dealer definition could potentially capture hedge funds, private equity funds, commodity pools, and other similar traders (collectively "Private Funds") entering into swaps and security-based swaps for their own account on a regular basis; however, the CFTC and the SEC (together, the "Commissions") noted that the third prong must be read together with the express exception from the dealer definitions for "a person that enters into swaps [or security-based swaps] for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business."[20] This exception is modeled after the definition of "dealer" in Section 3(a)(5) of the Securities Exchange Act of 1934, as

© 2011 THOMSON REUTERS

amended (the "Exchange Act"), and is likely to result in most Private Funds not being characterized as swap or security-based swap dealers.

Major Swap and Security-Based Swap Participants

The Commissions propose to define "major swap participant" and "major security-based swap participant" (together, "Major Participant") with a focus on how an entity's swap and security-based swap positions may affect the market and the risks associated with such positions. The Commissions' stated goal with respect to the Major Participant definitions is to regulate entities whose swap-related activities "do not cause them to be dealers, but could still pose a high degree of risk to the U.S. financial system."[21] In furtherance of that goal, the Commissions propose that the Major Participant definitions apply to persons that satisfy any of the following tests:

- Persons that maintain a "substantial position" in any of the "major" categories of swap and security-based swap positions excluding positions held for hedging or mitigating commercial risk and positions maintained by or contracts held by any employee benefit plan for the primary purpose of hedging or mitigating risks direction associated with the operation of the plan.
- Persons whose outstanding swaps and security-based swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."
- Any "financial entity" that is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by the appropriate Federal banking agency" and that maintains a "substantial position" in swaps or security-based swaps for any of the "major" categories of swaps or security-based swaps.

The four "major" swap categories proposed by the CFTC are:

- Rate Swaps – includes any swap that is primarily based on one or more reference rates, such as swaps of payments determined by fixed and floating interest rates, currency exchange rates, inflation rates, or other monetary rates.
- Credit Swaps – includes any swap that is primarily based on instruments of indebtedness, including but not limited to any swap primarily based on one or more indices related to debt instruments, or swap that is an index credit default swap or total return swap on one or more indices of debt instruments.
- Equity Swaps – includes any swap that is primarily based on equity securities, such as any swap primarily based on one or more indices of equity securities, or any total return swap on one or more equity indices.
- Commodity Swaps – includes any swap not included in any of the Rate Swap, Credit Swap or Equity Swap categories. For example, any swap for which the primary underlying item is a physical commodity or the price or any other aspect of a physical commodity.

The two "major" security-based swap categories proposed by the SEC are:

- Security-Based Credit Derivatives – includes any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness (including loans), or on a credit event relating to one or more issuers or securities, including but not limited to any security-based swap that is a credit default swap, total return swap on one or more debt instruments, debt swap, debt index swap, or credit spread.
- Other Security-Based Swaps – includes any security-based swap not included in the Security-Based Credit Derivatives category, including equity swaps.

© 2011 THOMSON REUTERS

Substantial Position – Current Uncollateralized Exposure Test & Future Potential Uncollateralized Exposure Test

The Commissions propose two objective tests for determining the thresholds applicable to "substantial position," one based on current uncollateralized exposure and the other based on a sum of current uncollateralized exposure and potential future exposure. The first test sets the substantial position threshold by marking swap and security-based swap positions to the market using accepted industry standards and determining the uncollateralized current exposure arising from each of the entity's positions, by counterparty, with negative value on a category-by-category basis with respect to the "major" category of swaps or security-based swaps. The second test takes into consideration both the current uncollateralized exposure and potential future exposure applicable to swap or security-based swap positions and defines potential exposure by identifying the total notional principal amount of positions in the applicable "major" category, adjusted up or down according to certain risk factors, including the type of swap or security-based swap and the remaining duration of the position. As currently written, it appears that positions held by separate private funds with different trading strategies that utilize swaps from different "major" categories would not be aggregated for the purposes of calculating either test, although there continues to be uncertainty about the extent to which positions of multiple private funds managed by the same manager may be integrated. Both tests take into consideration the risk mitigating effects of netting agreements. Mitigation of market risk associated with holding positions with multiple counterparties may not be taken into account and any positive value applied against current exposure may not be applied against any other exposure. Certain types of positions that are perceived as less risky (*e.g.*, positions that constitute the purchase of an option with no additional payment obligations) will be considered when calculating potential future exposure as will the risk mitigating effects of central clearing and mark-to-market margining.

The proposed current uncollateralized exposure thresholds for a "major swap participant" are a daily average of $1 billion for credit, equity and other commodity swaps and $3 billion for rate swaps. With respect to a "major security-based swap participant," the proposed threshold is a daily average of $1 billion in each of the major categories of security-based swaps. The proposed current uncollateralized exposure plus future potential uncollateralized exposure thresholds for a "major swap participant" are a daily average of $2 billion for credit, equity and other commodity swaps and $6 billion for rate swaps. With respect to a "major security-based swap participant," the proposed threshold is a daily average of $2 billion in each of the applicable "major" categories of swaps.

Hedging or Mitigating Commercial Risk

With respect to the first test of the Major Participant definitions, the Commissions exclude positions held for "hedging or mitigating commercial risk" from the analysis as to whether an entity holds a substantial position in a major category of swaps or security-based swaps. However, given that positions that are speculative or hedge speculative swap positions are expressly excluded, it is unlikely that any position held by a private fund would be considered to be held to hedge or mitigate commercial risk.[22] The Commissions invite comment on positions in the nature of speculating or trading as to whether it is appropriate to exclude such positions from being deemed for the purpose of hedging or mitigating commercial risk.

Substantial Counterparty Exposure

Substantial counterparty exposure as it relates to the second Major Participant definition test focuses on the counterparty risk involved with a swap or security-based swap position, analyzing whether such risk could have systemic implications. The Commissions propose the same measures of current uncollateralized exposure and potential future exposure used in the first test to be used for the second test. In essence, substantial

 © 2011 THOMSON REUTERS

counterparty exposure would be calculated by reference to all of the entity's swap or security-based swap positions instead of by reference to a "major" category of such positions. Thus, for the second Major Participant definition test an entity must aggregate its swap and security-based swap positions, respectively, across all private funds, regardless of differences in strategy, in order to calculate such entity's substantial counterparty exposure.

The Commissions propose that a "major swap participant" per the second Major Participant test will have current uncollateralized exposure of $5 billion, or a combined uncollateralized exposure and potential future exposure of $8 billion, taking into consideration all of the entity's swap positions. The Commissions propose that a "major security-based swap participant" in this context will have a current uncollateralized exposure of $2 billion, or a combined current uncollateralized exposure and potential future exposure of $4 billion, taking into consideration all the entity's security-based swap positions.

Financial Entity and Highly Leveraged

With respect to the third test in defining Major Participants, a "financial entity" includes any financial entity, including private funds, other than banking entities subject to capital requirements, that is "highly leveraged relative to the amount of capital" held by the entity, and that holds a substantial position in a "major category of swaps or security-based swaps." "Financial entity" for purposes of the third test is not defined and instead is based on the Section 723 end-user exception from mandatory clearing. Although "highly leveraged" is not defined, the Commissions reference Title I of Dodd-Frank in proposing two alternative approaches to defining this term. The Commissions propose both the ratios of 8 to 1 and 15 to 1 with respect to an entity's total liabilities to equity at the close of business on the last business day of the applicable fiscal quarter. In the Commissions view, the 15 to 1 ratio would be applied to a bank holding company or nonbank financial company when the company poses a "grave threat" to financial stability. On the other hand, the 8 to 1 ratio would be used for financial institutions subject to capital requirements given that such entities may have been excluded from the third test under the presumption that they are generally highly leveraged and would have been covered if not expressly exempted.

Application of Major Participant Definitions to Fund Managers

The Commissions do not believe that the Major Participant definitions should require fund managers to aggregate managed accounts over which they exercise trading discretion to determine if the manger itself is a Major Participant. The Commissions may, however, adopt anti-evasion rules in the event persons entering into swaps and security-based swaps attempt to allocate such positions across various accounts for the purpose of evading the Major Participant regulations. Further, multiple managed accounts with the same beneficial owner that enter into swaps or security-based swaps will be aggregated to determine if such beneficial owner is a Major Participant.

The Commissions specify that a parent company that is a majority owner of a subsidiary entity must aggregate the subsidiary's swaps or security-based swaps with the parent company's positions for calculating substantial position as it applies to the first and third tests for identifying a Major Participant. The Commissions state that attributing those positions to a parent aligns with the approach to "substantial position" and "substantial counterparty exposure" given that the parent would act as the beneficiary of the transaction.

Private Funds that fall within the Major Participant definitions will be subject to comprehensive regulation of their swap and security-based swap activities including, but not limited to, (1) registration; (2) clearing and trade execution requirements, subject to certain exceptions and (3) record keeping and real-time reporting regimes.

Eligible Contract Participant

The definition of "eligible contract participant" ("ECP") was added to the CEA by the Commodity Futures Modernization Act of 2000 ("CFMA"). Status as an ECP was intended to distinguish persons with greater financial resources or knowledge from those persons considered

© 2011 THOMSON REUTERS

"retail" counterparties, who were afforded additional protections under the futures laws. Parties that were not ECPs could not rely on any of the exemptions to the CEA created by the CFMA. Although Dodd-Frank eliminated most of the exemptions added to the CEA by the CFMA, it similarly adopts the ECP definition as the dividing line between retail and non-retail parties and as an indicator that a party requires additional protections under the commodities and securities laws. Specifically, Dodd-Frank makes it unlawful for any person, other than an ECP, to enter into a swap or security-based swap other than on or through a designated contract market or national securities exchange, respectively. ECPs, on the other hand, may enter into swaps and security-based swaps through swap execution facilities and security-based swap execution facilities or on a bi-lateral basis (to the extent that the contract is not subject to the exchange-trading requirement of Dodd-Frank).

Dodd-Frank amended the ECP definition by raising the "discretionary investments" threshold for government entities and their instrumentalities, agencies or departments from $25 million to $50 million and changing the test for individuals to qualify as ECPs such that instead of requiring them to have *total assets* exceeding $10 million ($5 million if hedging), individuals will instead need to have $10 million ($5 million if hedging) in *amounts invested on a discretionary basis*. The Commissions are proposing that swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants also be included within the ECP definition.

ECP Status of Commodity Pools and the Retail Forex Rules

Dodd-Frank also amended the ECP definition as applied to commodity pools. Prior to Dodd-Frank, the ECP definition provided that a commodity pool was an ECP if it had total assets exceeding $5 million and if it was formed and operated by a person subject to regulation under the CEA or a similar foreign person subject as such to foreign regulation (a "Pool ECP"). Dodd-Frank amended the ECP definition to require that all participants in a commodity pool that otherwise complies with the requirements of the definition must themselves be ECPs in order for the pool to be a Pool ECP, but this applies only for the purposes of entering into off-exchange foreign currency ("forex") transactions. For all other types of transactions, a commodity pool with total assets exceeding $5 million is an ECP without regard to the status of pool participants.

The CEA also provides that a corporation, partnership, proprietorship, organization, trust, or other entity with total assets exceeding $10 million, or that has a net worth of $1 million and is entering into transactions for certain defined hedging purposes, is an ECP (an "Entity ECP").

The Commissions are proposing to construe the ECP definition such that a commodity pool that does not qualify as an ECP for off-exchange forex transactions pursuant to the Pool ECP definition cannot alternatively qualify as an ECP for that purpose on the basis that it is an Entity ECP.

Application of the Retail Forex Rules to Commodity Pools

As a result of the Commissions' proposed construction of the ECP definition, commodity pools whose investors are not all ECPs may engage in off-exchange forex transactions only as retail customers, and cannot enter into foreign currency swaps.

Pools that satisfy the ECP definition, however, may trade foreign currency swaps. Dodd-Frank provides that foreign exchange swaps and forwards will be regulated like other swaps unless the Secretary of the Treasury makes a written determination that these instruments should not be regulated as swaps. As of the date herein, the Secretary of the Treasury has not yet made such a determination, although on October 19, 2010 the Department of the Treasury issued a notice and request for comments concerning whether the Secretary of the Treasury should make such a determination and on what conditions.[23] Any determination by the Secretary of the Treasury that foreign exchange swaps and forwards should not be regulated as swaps will not exempt such instruments from any anti-fraud or anti-manipulation rule adopted pursuant to Dodd-Frank or amendments made by Dodd-Frank. In addition,

© 2011 THOMSON REUTERS

even if the Secretary of the Treasury excludes foreign exchange swaps and forwards from full swap regulation, some requirements, such as reporting, will nevertheless apply.

The CEA includes specific provisions governing accounts and pooled investment vehicles offered for the purpose of trading or that trade foreign currency contracts that are entered into with persons that are not ECPs and that are either off-exchange futures or options, or forex transactions which are offered or entered into on a leveraged, margined, or financed basis. These currency transactions are known as retail forex. Excluded from the coverage of these new retail forex requirements are (a) securities that are not security futures products and (b) contracts of sale of foreign currency that result in actual delivery within 2 days or create an enforceable obligation to deliver between a seller and a buyer that have the ability to deliver and accept delivery, respectively, in connection with their line of business.

Retail forex may be offered only by certain designated counterparties, including U.S. financial institutions, SEC-registered brokers and dealers and their material associated persons, financial holding companies, futures commission merchants ("FCMs") and retail foreign exchange dealers ("RFEDs"). However, when Dodd-Frank goes into effect in July 2011, such counterparties with federal regulators may offer retail forex only if their regulators have issued rules for doing so, including disclosure, recordkeeping, capital, margin, reporting, business conduct and documentation requirements. So far, only the CFTC has such rules, and they apply only to FCMs, their material affiliates and RFEDs. The CFTC's rules may require registration as a retail forex CPO or retail forex CTA, as applicable.

V. Proposed CFTC Position Limits

Background

On January 13, 2011 the CFTC issued a notice of proposed rulemaking (the "Proposed Limits Rule")[25] outlining a position limits regime for 28 so-called "exempt" (*e.g.* metal and energy contracts) and agricultural commodity derivatives, futures and option contracts[26] and their "economically equivalent" swaps (the "Covered Contracts").[27]

The most significant departure from current practice is the expansion of CFTC's authority to impose position limits on swaps. Title VII, Section 737(a), of Dodd-Frank expands the CFTC's mandate to set position limits beyond futures and option contracts to include: (1) swaps traded on a DCM or swap execution facility ("SEF"); (2) swaps that are economically equivalent to DCM futures and option contracts with position limits; and (3) swaps not traded on a DCM or SEF that perform or affect a significant price discovery function with respect to regulated entities.

In addition to outlining position limits for the Covered Contracts, the Proposed Limits Rule narrows the definition of a *bona fide* hedging transaction, sets forth revised standards for the aggregation of positions and establishes visibility reporting requirements for certain exempt commodities.

Dodd-Frank requires the CFTC to impose position limits on exempt commodities by no later than January 17, 2011 and on agricultural commodities by no later than April 17, 2011. Since the Proposed Limits Rule is not final and does not yet impose any position limits, the CFTC has already missed the January deadline and it seems likely that it will miss the April deadline as well.

The CFTC will adopt current spot month position limits currently set by the regulated futures exchanges (designated contract markets ("DCM")) as well as standards pertaining to *bona fide* hedging and account aggregation. These interim position limits will remain effective until the enactment of the second phase.

In a second implementation phase, the CFTC will establish spot-month limits (using the DCM estimates or its own estimates) and non-spot-month limits consisting of aggregate single-month and all-months-combined limits that apply across classes as well as separately for each class (futures/options being one class and swaps the other class). These limits will be determined using data collected in the upcoming months and such limits will be set annually by January 31st of each calendar year. The CFTC will publish position limits

on its website (http://www.cftc.gov) prior to making such limits effective on March 1st of each calendar year. In the release that accompanied the Proposed Limits Rule, the CFTC set forth formulaic methods for determining the various limits.

In addition to positions executed on U.S. exchanges and trading facilities, Proposed Limits Rule Section 151.8 specifies that aggregate position limits will apply to a trader's positions in Covered Contracts executed on, or pursuant to the rules of a foreign board of trade, provided that there is a direct connection to the US markets.[28]

Proposed Position Limits

Spot-Month Position Limits

Spot-month limits are determined as a function of deliverable supply. Under the Proposed Limits Rule, each DCM must submit to the CFTC an estimate of deliverable supply by December 31st of each year for each physical delivery referenced contract that is subject to a spot-month position limit and listed or executed pursuant to the rules of the DCM. In phase 1, the CFTC will adopt the DCM spot-month limits. In phase 2, however, the CFTC has the discretion to rely on the DCM's estimate, or alternatively, the CFTC can use its own estimate of deliverable supply when setting position limits.

For physical delivery contracts, the Proposed Limits Rule sets spot-month position limits at 25% of estimated deliverable supply. The limit for cash-settled contracts is the same as for physical delivery contracts, however, Section 151.4 of the Proposed Limits Rule incorporates a conditional spot-month limit that permits traders without a hedge exemption to acquire position levels equal to five times the spot-month limit if such positions are exclusively in cash-settled contracts and the trader holds physical commodity positions that are less than or equal to 25% of the estimated deliverable supply.

The proposed limits will be enforced on an aggregate basis, subjecting economically equivalent derivatives to the same spot-month limits whether or not they are listed for trading on a DCM, cleared or uncleared. The Proposed Limits Rule applies spot-month position limits separately for physically-delivered contracts and cash-settled contracts, including cash-settled futures and swaps, unless the cash-settled contract positions are held pursuant to the conditional-spot-month-position limit described above. Therefore, under most circumstances, a trader may have up to the spot-month position limit in both the physically-delivered and cash-settled contracts.

Class and Aggregate Single-Month and All-Months-Combined Position Limits

The proposed class and aggregate single-month and all-months-combined position limits will be tied to a specific percentage of overall open interest for a particular Covered Contract in the aggregate or on a per class basis. The Proposed Limits Rule creates two classes of contracts for non-spot month limits: (1) futures and options on futures contracts and (2) swaps.

In addition to the aggregate position limits that will apply across classes, the Proposed Limits Rule applies single-month and all-months-combined position limits to each class separately. Within a contract class, the limits will be set at an amount equal to 10% of the first 25,000 contracts of average all-months-combined aggregate open interest in the contract, and 2.5% of the open interest for any amounts above 25,000 contracts. The aggregate all-months-combined limits across contract classes will be set at 10% of the first 25,000 contracts of average all-months-combined aggregated open interests, and 2.5% of the open interest thereafter. The average all-months-combined aggregate open interest, which is the basis of these calculations, is determined annually by adding the all-months futures open interest and the all-month swaps open interest for each of the 12 months prior to the effective date and dividing that amount by 12. Each trader's positions would be netted for the purpose of determining compliance with position limits.

Under the Proposed Limits Rule there are a total of six possible non-spot-month position limits: (1) futures/options class single-month limit; (2) futures/options class all-months-combined limit; (3) swap class single-month limit; (4) swap class all-months-combined limit; (5) aggregate single-

© 2011 THOMSON REUTERS

month limit; and (6) aggregate all-months-combined limit.

Exemptions From Proposed Position Limits

The Bona Fide Hedging Transactions Exemption

The CFTC, in the Proposed Limits Rule, sets forth a revised narrower definition of a "*bona fide* hedging transaction" for the purpose of obtaining an exemption from position limits. Unlike the current definition, the proposed definition provides an exemption for *bona fide* hedging transactions only if such transactions represent a substitute for a physical market transaction. Notably, the proposed definition will not provide an exemption to swap dealers offering risk management products to market participants seeking to hedge financial risk unrelated to physical market exposure.

Proposed Limits Rule Section 151.5(a) establishes an exemption from compliance with the proposed position limits for any transaction or position in a Covered Contract that: (1) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel; (2) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (3) arises from the potential change in value of assets that a person owns, produces, manufactures, processes, or merchandises (or anticipates owning, producing, manufacturing, processing or merchandising), liabilities that a person owns or anticipates incurring or services that a person provides or purchases, or anticipates providing or purchasing. Also exempt are positions in Covered Contracts that reduce risks attendant to a position from a swap that was executed opposite a counterparty for which the transaction would qualify as a *bona fide* hedging transaction pursuant to (1), (2) and (3) above or meeting the requirements of (1), (2) and (3) above. This exemption would especially be relevant for swap dealers. Proposed Limits Rule Section 151.5(a)(2) lists several specific transactions and positions that would qualify as *bona fide* hedging under the rules.

Pre-Existing Position Exemption

The Proposed Limits Rule provides a limited exemption for futures or option contracts in excess of position limits, provided that such positions were established in good faith prior to the effective date of enacted position limits. Persons with such positions on futures and options contracts would not be permitted to enter into new, additional contracts in the same direction, however they could take offsetting positions to reduce their total combined net position. Persons with an established net position below the speculative limit for a contract for future delivery (prior to the enactment of position limits) would be allowed to acquire new positions, however the CFTC will calculate the combined position based on any position established prior to enactment plus any new position.

The Proposed Limits Rule does not apply position limits to swaps effective prior to the enactment of Dodd-Frank. The CFTC will allow pre-effective date swaps to be netted with post effective date swaps for the purpose of complying with position limits.

New Standards for Aggregation of Positions

Under the CFTC's current standards for agricultural commodities, eligible entities[29] are permitted to disaggregate positions pursuant to a self-executing independent account controller framework (the "independent account controller exemption"). The current rules also provide for extensive disaggregation provisions for CPOs, limited partners, other pool participant and futures commission merchants ("FCMs"). For example, under the current procedure, for a commodity pool whose trading is managed by three independent unaffiliated managers pursuant to an information firewall and appropriate written procedures, the positions carried by each independent manager are not aggregated at the pool level.

The Proposed Limits Rule's approach eliminates the independent account controller exemption and many of the existing provisions for dis-

aggregation. Proposed Limits Rule Section 151.7 contemplates both ownership and control and calls for account aggregation of position limits where any trader, directly or indirectly, has an ownership or equity interest of 10% or greater, or by power of attorney or otherwise, controls trading. The Proposed Limits Rule treats positions held by two or more traders acting pursuant to an express or implied agreement or understanding the same as if the positions were held by a single trader. Additionally, unlike the current rule, Section 151.7 requires a trader to aggregate positions in multiple accounts or pools, including passively managed index funds, if those accounts or pools have identical trading strategies.

There are three limited exemptions from the new aggregation standards. With respect to passive investments, the Proposed Limits Rule offers a limited exemption for positions in pools where a trader that is a limited partner, shareholder or similar person has an ownership or equity interest of between 10 and 25%, if such trader lacks control over or knowledge of the pool's trading and the pool operator has obtained an exemption from the CFTC. However, this exemption does not apply to CPOs, who must aggregate accounts or positions in which they hold an equity interest of 10% or more as a limited partner or similar type of pool participant with all other accounts or positions they own or control. Other exemptions relate to certain positions held by FCMs and certain positions held by traders that are passive pool participants.

VI. Change in Accredited Investor Standard

Section 413(a) of Dodd-Frank mandated that the SEC adjust the $1,000,000 net worth standard for individuals to qualify as "accredited investors" pursuant to SEC rules enacted under the Securities Act to require that an individual exclude the value of his or her primary residence when calculating his or her net worth. An individual investor was previously allowed to count any net equity in his or her home in calculating his or her net worth. This change was effective immediately upon enactment of Dodd-Frank on July 21, 2010. Section 413 also froze the $1,000,000 net worth threshold for individuals in place for four years following enactment of Dodd-Frank, but beginning as of such date and every four years thereafter the SEC will be required to undertake a review of the definition of "accredited investor," as applied to natural persons, and determine whether any modifications are appropriate.

Dodd-Frank did not address how a natural person investor should treat mortgage debt and other indebtedness secured by his or her primary residence when determining the value of the residence to be excluded from his or her net worth. On July 23, 2010, the SEC's Division of Corporation Finance issued a Compliance and Disclosure Interpretation (the "AI CDI") in which the staff expressed its view that "the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth."[30]

At an SEC open meeting on January 25, 2011, the SEC released a notice of proposed rulemaking on the "Net Worth Standard for Accredited Investors"[31] (the "Proposed AI Rules"). The Proposed AI Rules would implement Section 413(a) by amending the "accredited investor" definitions in SEC Rules 501 and 215 by requiring that an individual exclude the value of his or her primary residence when calculating net worth. The Proposed AI Rules would also codify the AI CDI by requiring that an individual's net worth be "calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property." Any indebtedness secured by the primary residence in amounts exceeding the fair market value of the residence should be counted as a liability in calculating an investor's net worth (*i.e.*, an investor who is "under water" in his or her primary residence will have his or her net worth reduced by the amount by which he or she is underwater). Notably, the Proposed AI Rules do not make a distinction with respect to whether the relevant indebtedness gives the lender personal recourse against the debtor in

© 2011 THOMSON REUTERS

the event of default. This is an area in which the SEC may provide clarification in its final rules.

The SEC specifically requested comment on whether an investor who previously qualified as an accredited investor before the enactment of Dodd-Frank should continue to qualify as such for the purposes of making subsequent investments in their existing investments.

NOTES

1 The authors practice in the Investment Products and Derivatives group of the Chicago and New York offices of Sidley Austin LLP. The authors thank James B. Biery, William D. Kerr, Lauren B. Kleiman, Jonathan B. Miller, James C. Munsell, William J. Nissen and Michael S. Sackheim, Partners at Sidley Austin LLP, for their assistance in the preparation of this article.

2 Comments for the proposed rules discussed in this article were due on the following dates: Proposed Compliance Rules (discussed in Section I) and Proposed Reporting Rules (discussed in Section III)—April 12, 2011; Proposed "Entity Definitions" (discussed in Section IV)—February 22, 2011. Proposed Limits Rule (discussed in Section V)—March 28, 2011; and Proposed AI Rules (discussed in Section VI)—March 11, 2011.

3 *See* Sidley Client Updates: Dodd-Frank Requirements for Private Fund Advisers (http://www.sidley.com/sidleyupdates/Detail.aspx?news=4625); FINRA Rule 5131 (http://www.sidley.com/sidleyupdates/Detail.aspx?news=4650); CFTC Rules Regarding Retail Forex (http://www.sidley.com/sidleyupdates/Detail.aspx?news=4579); Registration Regime for Municipal Advisors (http://www.sidley.com/sidleyupdates/Detail.aspx?news=4685); Lobbyist Regulations' Impact on Investment Managers (http://www.sidley.com/sidleyupdates/Detail.aspx?news=4708); and Massachusetts Information Security Regulations (http://www.sidley.com/sidleyupdates/Detail.aspx?news=4267).

4 *See Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Proposed Rule*, 76 FR 7976 (February 11, 2011), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-2437a.pdf.

5 The definition of "qualified purchaser" is set forth in Section 2(a)(51)(A) of the Investment Company Act. In general, a natural person who owns not less than $5,000,000 in investments is a qualified purchaser.

6 Proposed as new Rule 4.5(c)(2)(iii).

7 *See* Rule 4.14(a)(8)(ii).

8 Rule 4.13(a)(1) provides an exemption for a CPO that, among other things, operates only one pool and does not receive any compensation for doing so. Rule 4.13(a)(2) generally exempts from registration a CPO that has 15 or fewer participants in each of its pools at any time and receives $400,000 or less in capital contributions to all pools it operates in the aggregate.

9 Section 4m of the CEA exempts from registration any CTA that, during the course of the preceding 12 months, has not furnished commodity trading advice to more than 15 clients and does not hold itself out to the public generally as a CTA. In addition, Section 4m, as amended by Dodd-Frank, exempts any SEC registered investment adviser whose business does not consist primarily of acting as a CTA, and that does not act as a CTA to a commodity pool that is primarily engaged in trading commodity interests (which now include swaps).

10 With respect to offshore investment funds, CFTC Advisory No. 18-96 (April 11, 1996) has not been rescinded by the CFTC and provides relief similar to the disclosure, recordkeeping and reporting exemptions under Rule 4.7 for such funds meeting certain requirements such as not having any U.S. investors. Registered CPOs currently operating funds exempt pursuant to Rule 4.13(a)(3) or excluded pursuant to Rule 4.5, and that cannot otherwise claim exemptive relief under Rule 4.7 as described above, may be able to claim the more limited relief from certain CFTC requirements provided in Rule 4.12(b). Rule 4.12(b) requires, among other things, that the relevant fund not enter into commodity futures and commodity options contracts for which the aggregate initial margin and premiums exceed 10% of the pool's assets and that the trading of such commodity interests be done in a manner solely incidental to its securities trading.

11 *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF*, 76 FR 8068 (February 11, 2011) ("Form PF Proposing Release"), *available at* http://www.sec.gov/rules/proposed/2011/ia-3145fr.pdf.

12 Registered CPOs and CTAs that file Form PF are only required to file Schedule A of Form CPO-PQR and/or Form CTA-PR, as applicable.

© 2011 THOMSON REUTERS

13 Any private fund that (1) has a performance fee or allocation calculated by taking into account unrealized gains; (2) may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (3) may sell securities or other assets short.

14 *See* the Form PF Proposing Release at 14.

15 "United States person" would have the meaning provided in proposed Rule 203(m)-1 under the Advisers Act, and "principal office and place of business" would have the same meaning as in Form ADV.

16 Any private fund that seeks to generate income by investing in a portfolio of short term obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors.

17 Any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course.

18 "Large Private Fund Advisers" are defined as those that manage hedge fund assets of at least $1 billion determined as of the close of any day during the reporting quarter, liquidity fund and money-market fund assets of at least $1 billion determined as of the close of any day during the reporting quarter or private equity fund assets of at least $1 billion determined as of the close of the last day of the quarterly reporting period. For these purposes, advisers must aggregate assets of (i) all managed accounts that pursue substantially the same investment strategy and invest in substantially the same positions as the private fund and (ii) private funds that are advised by affiliates or related persons of the investment adviser.

19 For purposes of determining whether a private fund is a qualifying hedge fund, the adviser would have to aggregate any parallel managed accounts, parallel funds, and funds that are part of the same master-feeder arrangement, and would have to treat any private funds managed by its related person as if they were managed by the filing adviser.

20 *See* CEA § 1a(49)(C); Exchange Act § 3(a)(71)(D).

21 *See* 75 FR at 80185.

22 There may be some ambiguity as to whether a swap that hedges a non-swap may be considered to be held to hedge or mitigate commercial risk.

23 *See* 75 FR 66426 (October 28, 2010).

24 *See* http://www.sidley.com/sidleyupdates/Detail.aspx?news=4579.

25 *Position Limits for Derivatives*, 76 FR 4752 (January 26, 2011), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-1154a.pdf.

26 The covered exempt commodities under the Proposed Limits Rule are: copper grade 1, gold, palladium, platinum, silver, light sweet crude oil, gasoline, natural gas, and no. 2 heating oil. The covered agricultural contracts under the Proposed Limits Rule are: cocoa, coffee, corn, cotton no. 2, feeder cattle, frozen concentrated orange juice, lean hogs, live cattle, milk class III, oats, rough rice, soybeans, soybean meal, soybean oil, sugar no. 11, sugar no. 15, CBOT wheat, hard red spring wheat, and hard winter wheat.

27 A swap is considered "economically equivalent" to a futures contract under the Proposed Limits Rule if either: (1) the price of the swap refers to a covered futures contract settlement price; or (2) the swap is priced on the same commodity delivered at the same location, or at locations with substantially the same supply and demand characteristics, as that of any of the Covered Contracts.

28 The foreign board of trade contract, agreement or transaction must settle against the price of a contract executed or cleared pursuant to the rules of a CFTC- regulated entity and the foreign board of trade must make such linked contracts available to its members or other participants located in the U.S. by direct access to its electronic trading and order matching system.

29 Including banks, insurance companies, mutual funds, CPOs and CTAs.

30 Securities Act Rules, Compliance and Disclosure Interpretations, Questions 179.01 and 255.47 (July 23, 2010).

31 76 FR 5307 (January 31, 2011), *available at* http://www.sec.gov/rules/proposed/2011/33-9177fr.pdf.

 © 2011 THOMSON REUTERS