KILPATRICK TOWNSEND

November 30, 2020

New CFTC Rules Taking Effect: Investment Advisers to Registered Investment Companies (RICs) Must Claim the Rule 4.5 CPO Exclusion During First 60 Days of 2021

by Jeffrey T. Skinner , Waylon M. Bryson

On December 10, 2019, the Commodity and Futures Trading Commission ("*CFTC*") published amendments to the rules governing Commodity Pool Operators ("*CPOs*") and Commodity Trading Advisers (" *CTAs*") (the " *New Rules*"). [1] Among other provisions, the New Rules "clarify" that the exclusion from the CPO definition under CFTC Rule 4.5 that is available to a registered investment company ("*RIC*") should be claimed by the RIC's registered investment adviser, rather than by the RIC itself. This clarification has broad practical effect because prior to the New Rules it was common practice for a fund, its adviser, or both to claim the exclusion. As a result, many RICs and their advisers need to update their regulatory filings and related internal procedures and governance for the clarified approach. The Rule 4.5 exclusion must be claimed within the first 60 days of the calendar year, and the New Rules take full effect in 2021. All registered investment advisers to RICs relying on the Rule 4.5 exclusion must claim the exclusion within the first sixty days of 2021 (and in years thereafter) in order to remain compliant.

1. Background: CPO Registration and the Rule 4.5 Exemption for Registered Funds

Investment companies registered under the Investment Company Act of 1940 (the "*Investment Company Act*") fall within the definition of a "commodity pool" under the Commodity Exchange Act (" *CEA*") when they invest in futures or other instruments that are subject to CEA jurisdiction (e.g., swap agreements, commodity futures, and commodity options), even if the level of investment is minimal. [2] CFTC Rule 4.5, however, provides an exclusion from the majority of CEA requirements that would otherwise be applicable to a RIC, if the RIC limits its investing to *bona fide* hedging activities or otherwise limits its notional exposure to certain *de minimis* limits. [3] While Rule 4.5 is important to minimizing the regulatory burden on RICs, the exclusion is not self-executing. It must be claimed on an annual basis by the RIC's CPO.

Prior to the promulgation of the New Rules, it was unclear who should claim the Rule 4.5 exclusion for a RIC. Unlike the Investment Company Act, the CEA does not directly impose a registration requirement or other substantive regulation on funds themselves. Rather, the CEA indirectly regulates funds by imposing regulations on their CPOs, who are responsible for registering, or claiming an exemption on behalf of, each of their respective funds. While technical in its details, the analysis for determining who constitutes a CPO for a given commodity pool essentially distills to principles of formal control such that the board of directors would typically constitute the CPO for a corporation and the board of trustees would typically constitute the CPO for a trust. [4]

RICs are, however, an exception to this general approach. The CFTC has previously acknowledged that to require members of the governing boards of registered funds to register would raise operational concerns and could potentially pierce the limitation on liability for board members' actions. Accordingly, the CFTC had previously clarified that a RIC's adviser would be a CPO if the CFTC Rule 4.5 exclusion were unavailable. [5] But until the New Rules, it had remained unclear precisely who should claim the exclusion for a RIC where the requirements of CFTC Rule 4.5 could be met. To be on the safe side, many RICs and their advisers both claimed the exclusion. In other cases, the RIC claimed the exclusion.

2. Implementation Deadlines

Newly Formed RICs. The New Rules went into effect in December 2019. As a result, all newly formed RICs that intend to rely upon the CFTC Rule 4.5 exclusion are already required to have their registered investment advisers claim the exclusion.

Existing RICs. In adopting the New Rules, the CFTC recognized that an immediate application of the New Rules to existing registered funds would result in undue compliance burdens for RICs that currently have persons other than their advisers claiming the CPO exclusion. [6] To mitigate these concerns, the CFTC has stated that compliance with the New Rules would not require amending existing filings. [7] Rather, the requirements will be phased in. The requirement will not go into effect for advisers affected by the New Rules until the first 60 days of 2021, during which time they will need to file to claim the exclusion. [8] As a result, RICs will not need to update their public disclosure regarding CFTC Rule 4.5 until making their annual filings *following* the change.

3. Practical Steps

The CFTC has provided a long runway for compliance to funds that will need to switch to having their investment advisers claim the CFTC Rule 4.5 exclusion. RICs and their advisers should take advantage of this time by assessing which funds may be impacted by the New Rules and coordinating on timing for updating annual fund filings and related governance. Similarly, advisers to RICs should familiarize themselves with the process for claiming the CFTC Rule 4.5 exclusion from the CPO definition.

If you have any questions about these recent CFTC Rule Changes or on related matters of compliance and governance, please feel free to contact us.

By the ***Investment Management and Broker-Dealer Team*** at Kilpatrick Townsend & Stockton

Footnotes

KILPATRICK TOWNSEND

[1] CFTC, *Final Rule Adopting Release*, Registration and Compliance Requirements for Commodity Pool Operators and Commodity Trading Advisors: Registered Investment Companies, Business Development Companies, and Definition of Reporting Person, 84 Fed. Reg. 67343 available at https://www.govinfo.gov/content/pkg/FR-2019-12-10/pdf/2019-26161.pdf (hereinafter after the "Adopting Release to the New Rules").

[2] The CFTC takes an expansive view of the "commodity pool" definition, and does not recognize an inherent exclusion for de minimis trading activity. See, e.g., CPO/CTA Adopting Release, infra, note 5 at 11263 ("[O]ne swap contract would be enough to trigger the registration requirement."); CFTC Interpretative Letter No. 98-26 (Apr. 7, 1998) (stating that although commodity interest trading was only a small percentage of a fund's assets, the managing member was required to register because there is no *de minimis* exception to registration). For this reason, it is best practice for a RIC with an intention or possibility of engaging in investment activities that fall within CEA jurisdiction to claim the CFTC Rule 4.5 exclusion.

[3] The Rule, limits a RIC's transactions in instruments subject to CEA jurisdiction to those that are either used solely for "*bona fide* hedging" or that meet one of two alternative de minimis tests: either (i) 5% of initial margin or (ii) 100% of aggregate net notional test.

[4] The statutory definition of a CPO includes anyone engaged in a business that is of the nature of a commodity pool who solicits, accepts, or receives property for the purpose of trading in commodity interests. See 7 U.S.C. § 1a(11). The CFTC Staff have broadly interpreted this definition to include any person "that handles or exercises control over" commodity pool assets, regardless of whether or not they engage in solicitation. See CFTC Interpretative Letter No. 75-17 (Nov. 4, 1975) (stating that by using the words "solicit," "accept" and "receive" in the definition of commodity pool operator, "Congress clearly intended to achieve the broadest possible effect —namely, to cover all of the means by which a person can obtain control over pool participants' funds.").

[5] CFTC, *Final Rule Adopting Release*, Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11251, at 11259 available at https://www.govinfo.gov/content/pkg/FR-2012-02-24/pdf/2012-3390.pdf

[6] *See* Adopting Release to the New Rules, *supra* note 1, at 67346-47.

[7] *Id.*

[8] *Id.*