

Private Equity Alert

Changes to CFTC Regulations Affecting Private Funds

By Richard Ellenbogen and Venera Ziegler

Who Is Affected?

As a result of recent changes made to the Commodity Exchange Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and new Commodity Futures Trading Commission (the CFTC) rules, private fund sponsors investing in commodity interests need to examine their portfolios and determine whether they are subject to registration with the National Futures Association (NFA) or, if available, claim an exemption from such registration.

What Is a Commodity Pool Operator and a Commodity Trading Advisor?

The CFTC considers private funds (including alternative investment vehicles and parallel investment vehicles) that have the authority to invest in commodity interests to be commodity pools. The CFTC considers a foreign domiciled commodity pool to be subject to its jurisdiction as long as such pool has one or more US investors. Absent an applicable exemption, the investment adviser of a commodity pool is subject to registration with the NFA as a commodity trading advisor (CTA) and the operator of such commodity pool (*i.e.*, the general partner or the managing member(s) of such commodity pool) is subject to registration with the NFA as a commodity pool operator (CPO). If the CPO and the CTA to a commodity pool are the same entity, then, according to the NFA, a registration only as a CPO would be sufficient.

What Are the Recent Changes to the CFTC's Regulations?

Historically, the general partners and advisers of a private fund investing in commodity interests that limited their investors to "qualified purchasers" and "knowledgeable employees" were eligible for an exemption from registration pursuant to Rule 4.13(a)(4), an exemption that was recently eliminated by the CFTC. In addition, the Dodd-Frank Act expanded the definition of commodity interest to include swaps. The CFTC rule defining a "swap" becomes effective on October 12, 2012.

How Is Swap Defined?

The term "swap" is broadly defined to include, among other things, commodity swaps, foreign exchange forwards, interest rate swaps, total return swaps, currency swaps, credit default swaps on broad-based indices, foreign currency options, commodity options, cross currency swaps, forward rate agreements, options to enter into

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- Weil advised Providence Equity Partners in connection with the C\$1.1 billion acquisition of Canadian data center operator Q9 Networks Inc. by an investor group comprised of Providence, Ontario Teachers' Pension Plan, Madison Dearborn Partners, and BCE
- Weil advised Centerbridge Partners in connection with its \$1.1 billion take private acquisition of P.F. Chang's China Bistro Inc.
- Weil advised AMC Entertainment Holdings, Inc. (a portfolio company of Apollo Global Management, Bain Capital, the Carlyle Group, CCMP Capital Advisors, and Spectrum Equity Investors) in connection with its \$2.6 billion sale to Dalian Wanda Group
- Weil advised Lion Capital in its £1.2 billion sale of a 60% interest in Weetabix Food Co. to China's Bright Food Group Ltd.
- Weil advised Thomas H. Lee Partners in connection with its acquisition of Fogo de Chao Churrascaria Holdings
- Weil advised Providence Equity Group in connection with its strategic partnership with, and investment in, The Chernin Group

swaps, swaps on broad-based security indices and swaps on two or more loans. Securities based swaps (e.g., a credit default swap on a debt instrument) are excluded from the term "swap."

Exemption from Registration Available for CPOs – CFTC Rule 4.13(a)(3) – *de minimis* exemption

A CPO is not required to register with respect to a commodity pool that (i) issues interests that are exempt from registration under the Securities Act of 1933 (the Securities Act) and are offered without marketing to the public in the United States and (ii) also meets one of the following two tests:

- **5% Test:** the aggregate initial margin and premiums (including the required minimum security deposit for retail forex transactions) required to establish its commodity interest positions (determined at the time the most recent commodity interest position was established) does not exceed 5% of the liquidation value of its portfolio (after taking into account the unrealized profits and losses on such positions); or
- **100% Test:** the aggregate net notional value of the fund's commodity interest positions (determined at the time the most recent commodity interest position was

established) does not exceed 100% of the liquidation value of its portfolio (after taking into account the unrealized profits and losses on such positions).

Most private equity funds using swaps to hedge currency or interest rate risk should be able to fall within this *de minimis* exemption. The CFTC stated that a fund manager may rely on CFTC Rule 4.13(a)(3) with respect to a fund that will predominantly invest in non-derivatives even when its first position is a swap. The CFTC has acknowledged that a fund manager should be afforded a "reasonable time" to comply with the limitations set forth in CFTC Rule 4.13(a)(3). The CFTC did not clarify what constitutes "reasonable time."¹

Exemptions Available for CTAs

There are three exemptions which will most likely apply to private equity fund advisers that are CTAs:

- **Rule 4.14(a)(8) "de minimis exemption"** – A CTA whose CPO qualifies for the *de minimis* exemption can be exempt from CTA registration if such CTA (i) is registered (or exempt from registration) as an investment adviser with the SEC, (ii) provides commodity interest trading advice solely incidentally to its business, and (iii) does not hold itself out as a CTA.

- **Rule 4.14(a)(10) “15 or less exemption”** – A CTA that has no more than 15 clients (with each fund typically counting as one client) during the prior 12 months and does not hold itself out to the public as a CTA. A fund that receives advice based on its own investment objectives and not the objectives of individual clients will count as one client. A CTA whose principal place of business is outside of the US need only count clients that are US residents.
- **Section 4(m)(3) “Not primarily exemption”** – CTAs that are registered with the SEC as investment advisers are exempt from registration as CTAs if their business is not “acting primarily” as a CTA and they do not advise a commodity pool “engaged primarily”² in investing in commodity interests.

How to Claim an Exemption?

CPO and CTA exemption claims (other than CTA exemptions under Section 4m(3) and Rule 4.14(a)(10) which are self-executing, and for which no further action is required) have to be filed with the NFA electronically and need to be updated annually within 60 days of the end of each calendar year. There is no fee for filing for an exemption. A CPO needs to file

a claim for an exemption for each fund that is deemed to be a commodity pool.

Deadlines

December 31, 2012:

- CPOs and CTAs that rely on Rule 4.13(a)(4) can continue relying on it until December 31, 2012.
- Swaps are included in the threshold calculations for the CFTC Rule 4.13(a)(3) *de minimis* exemption.

October 12, 2012:

- For CPOs and CTAs that are currently not relying on CFTC Rule 4.13(a)(4), the deadline for *de minimis* exemption filing or registration, unless further guidance is issued by the CFTC, is October 12, 2012.

Register as a CPO or a CTA / Claim Rule 4.7 Relief³

A sponsor and an investment adviser that are required to register as a CPO and a CTA, respectively, must submit Form 7-R and Form 8-R for their principals and associated persons. Principals and associated persons must also submit fingerprint cards (for background checks by the FBI, and Interpol in the case of non-US individuals) with Form 8-R, and most associated persons

must take and pass a proficiency examination (the Series 3 or 31). Once registered, the CPO may claim some reporting and recordkeeping relief on a pool by pool basis pursuant to Rule 4.7 if the interests in such pool are offered only to “qualified eligible persons” (*i.e.*, qualified purchasers, knowledgeable employees and accredited investors that meet additional portfolio standards).

Open Issues

Private funds managers intending to engage in general solicitation and general advertising to raise capital after the implementation of the newly proposed SEC’s amendments to Rule 506 of the Securities Act should note that CFTC Rule 4.13(a)(3) includes a restriction against “marketing to the public.” In addition, in order to qualify for the exemption under Rule 4.7, the offering of the interests of the commodity pool would have to be done in a manner consistent with the initial marketing limitations applicable to a private offering under Section 4(a)(2) of the Securities Act. Therefore, it appears that, absent future guidance from the CFTC and the SEC to the contrary, private funds which intend to claim a Rule 4.13(a)(3) or Rule 4.7 exemption may not be able to use general solicitation

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and general advertising pursuant to proposed Rule 506(c).

- 1 A copy of the CFTC's guidance released on August 14, 2012 is available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq_cpocta.pdf.
- 2 A CTA or a commodity pool shall be considered to be "engaged primarily" in the business of being a commodity trading advisor or commodity pool if, respectively it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding, or trading in commodity interests. CEA § 4m(3)(B).
- 3 Exempt reporting advisers who are not currently required to file a Form PF with the SEC but have to register with the CFTC as CTAs have to file an equivalent to Form PF with the CFTC.

If you would like more information about the contents of this issue, or about Weil's Private Equity practice, please speak to your regular contact at Weil or to the editors or authors.

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