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Commodity Pool Issues Raised by The Dodd-Frank Act

Why Should I Care About Commodity Pools?

Do you sponsor or advise an investment fund, special purpose vehicle (**SPV**), trust or similar arrangement, or work for a company that does? Does that fund, SPV, trust, or similar arrangement enter into one or more swaps? If so, please read on for a summary of important changes that are being made to the regulation of commodity pools in the United States that will affect many funds, SPVs, trusts or similar arrangements regardless of their jurisdiction, even where the connection to the United States seems limited or remote.

Summary

As a result of recent changes to the Commodity Exchange Act (**CEA**), a fund, SPV, trust or similar arrangement (**CP Entity**) that has entered, or will enter, into one or more swaps may be determined to be a commodity pool. This is an addition to the prior definition whereby a CP Entity that trades commodity interests, including futures contracts, forwards, options, forex, swaps or interests in other commodity pools, is regulated as a commodity pool. Any management of or advice in relation to a CP Entity may subject one or more of the relevant parties to regulation by the United States Commodity Futures Trading Commission (**CFTC**) and the National Futures Association (**NFA**) as commodity pool operators (**CPOs**) and/or commodity trading advisors (**CTAs**), even if the party and/or the CP Entity is formed outside of the United States. These changes will be effective as of October 12, 2012, though the CFTC has provided registration relief until December 31, 2012 for certain entities and may provide further registration relief for securitization vehicles.

Frequently Asked Questions

1. What are "commodity pools" and "commodity interests"?

A "**commodity pool**" is defined as any investment trust, syndicate or other enterprise operated for the purpose of trading any "commodity interests." A "**commodity interest**" under the CEA includes, among other things, options contracts, foreign exchange contracts and any contract for the purchase or sale of a commodity for future delivery (such as any futures or security futures product). The Dodd-Frank Act amended the definitions to include swaps within the definition of commodity interest.

2. What is a "swap" for the purposes of United States commodities law?

The recently finalized definition of "**swap**" includes interest rate, basis, equity, debt and currency swaps, as well as portfolio CDS and TRS. However, security-based swaps, such as single-name CDS and TRS referencing a single loan or security, are not included in the definition of commodity interest, as such instruments fall within the definition of "security-based swap" and thus are subject to United States Securities and Exchange Commission (**SEC**) rules, not CFTC rules. Any CP Entity that enters into swaps will likely be a commodity pool.

3. My entity holds only a single swap, option or futures contract. Will it be considered a "commodity pool"?

Yes. Historically, the CFTC has interpreted the term "commodity pool" very broadly, and would consider an entity that holds only one commodity interest, even for hedging purposes, to be covered by the definition, notwithstanding the fact that the entity does not actively "trade" commodity interests.

As a result, many entities that were not previously considered commodity pools and that would not consider themselves to be trading in swaps (or other commodity interests) will now be considered by the CFTC to be commodity pools by virtue of the fact that they hold one or more swaps (or other commodity interests). These include securitization SPVs, SPVs involved in CLO and CDO transactions, non-commodity funds (such as REITs) that hold or trade derivatives, and certain funding vehicles (including vehicles used in repackaging programs and project finance transactions).

4. My CP Entity isn't based in the United States, so why does this impact me?

Although the guidance regarding extraterritoriality is still evolving, any CP Entity operating in the United States (such as a CP Entity that has United States persons as directors or a management company operating from the United States, or a CP entity soliciting to engage in business with United States persons or firms with respect to their futures or swaps trading activities) or that has a single United States investor will likely be subject to the commodity pool regulatory regime. Therefore, even if a deal were structured so as to not have any United States investors in the first instance, any transfer or flow-back of the interests issued by the CP Entity to any United States investor after the initial offering (e.g., a purchase of equity or debt interests in the CP Entity by a United States investor in the secondary market) may subject transaction parties to CFTC regulation. It is also possible (although unclear at this stage) that a CP Entity based outside the United States that enters into a swap with a United States counterparty (which may also include a non-United States branch of a United States entity) may be subject to commodity pool regulation, even absent any other United States nexus.

5. My CP Entity currently holds one or more swaps but will never enter into any swaps in the future. Am I still caught by these changes?

Yes. At this stage, there is no grandfathering for CP Entities or swaps established prior to the introduction of swaps as commodity interests, even if such CP Entities do not intend to undertake any future swaps activity.

6. If my CP Entity is registered as an Investment Company with the SEC, what changes may apply to it?

CFTC Regulation 4.5 exempts certain regulated entities (e.g., entities subject to the regulation of another United States regulator) from falling within the definition of a CPO. The CFTC recently repealed some of the applicable exemptions to investment companies, effectively changing the rule to its status then in existence several years ago. If an Investment Company trades in commodity interests for speculative trading purposes (rather than as a bona fide hedger), then it must make certain calculations to determine whether the exemption under CFTC Regulation 4.5 may still apply. One of the tests requires the Investment Company to calculate its initial margin requirements for futures and swaps. If the total amount of the initial margin used for speculative trading equals or exceeds 5% of its net liquidating assets, then the Investment Company would need to register as a CPO.

7. Didn't there used to be an exemption from CPO registration based on an investor sophistication standard?

There was, but in addition to the change in the definition of commodity pool, the CFTC also eliminated an exemption from CPO registration based on an investor sophistication standard that was widely used in the private funds industry, and that

previously exempted fund managers from CPO registration, disclosure, reporting, and record-keeping requirements. Fund managers had also previously relied on this exemption to provide relief from registration and other requirements as a CTA. (See CFTC Regulation 4.14(a)(5) and rescinded Regulation 4.13(a)(4).)

8. Are there any remaining exemptions that might apply to my business?

Possibly. CFTC Regulation 4.13(a)(1) continues to provide an exemption for any operator that operates only one privately offered pool for no compensation. CFTC Regulation 4.13(a)(2) provides an extreme de minimis exemption for any operator whose commodity pools have an aggregate subscription of \$400,000 or less and less than 15 participants. Finally, CFTC Regulation 4.13(a)(3) gives a two-part test, and satisfying either of the prongs could give an exemption from regulation, provided interests in the commodity pool are exempt from registration under the Securities Act of 1933, and such interests are offered and sold without marketing to the public in the United States: (1) the aggregate initial margin/premium does not exceed 5% of the liquidation value of the CP Entity; or (2) the aggregate net notional value of commodity interest positions does not exceed 100% of the liquidation value of the CP Entity.

However, there is uncertainty surrounding the calculation of aggregate initial margin/premium under the first prong of the CFTC Regulation 4.13(a)(3) exemption in the context of swap transactions (in particular because these tests were drafted for traditional commodity interests (i.e., exchange-traded futures and options) rather than swaps), and it is unclear how many CP Entities will be able to take advantage of this exemption without further guidance from the CFTC.

9. What happens if my entity is subject to commodity pool regulation and no exemption applies?

Each such commodity pool must have a CPO that is registered with the CFTC, absent an available exemption. Each commodity pool may also have a CTA that must be registered with the CFTC. The identity of these entities are factual questions:

- CPO: A CPO is defined as an entity that is engaged in a business that is of the nature of a commodity pool and that solicits, accepts, or receives from others funds, securities, or property for the purpose of trading in commodity interests. The identity of the CPO may be unclear in certain contexts (e.g., the securitization context) and it may be necessary to consider this question in detail.
- CTA: A CTA is defined as an entity who, "for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value or the advisability of trading in," or who "for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning" commodity interests (including swaps). The CFTC has interpreted this definition broadly to include a wide range of entities (but does limit the concept to entities earning specific advisory fee for their service).

Registration as a CPO or CTA requires registering both the entity (in the case of a corporate CPO or CTA) and certain individuals or entities that own or are involved in the operation of the commodity pool. In addition, certain individuals will be required to meet CFTC proficiency standards, which may involve completing an examination.

The table at the end of this document summarizes the registration, disclosure, reporting and record-keeping requirements for CPOs and CTAs.

10. Are there any other implications? What about the Volcker Rule?

Commodity pools are caught in the definition of "covered fund" under the current proposal of the Volcker Rule. Among other things, the Volcker Rule would restrict certain financial institutions from sponsoring or owning interests in "covered funds." While the CFTC is expected to provide relief from CPO registration for certain securitization and other structured finance vehicles, it is not expected that the CFTC will exclude these entities from the definition of "commodity pool" itself.

Absent such an exclusion, financial institutions would be restricted from sponsoring or owning interests in any entity or arrangement considered to be a commodity pool.

11. So this means I have to register as a CPO and/or a CTA?

Possibly; however, there is also a "registration light" option available to both CPOs and CTAs that provides relief from certain disclosure, reporting, and record-keeping requirements for commodity pools for which interests are offered exclusively to "qualified eligible persons" in transactions that are exempt from registration under Section 4(2) of or Regulation S under the Securities Act of 1933 (as amended). (See CFTC Regulation 4.7.)

This is not an exemption from registration, and CPOs and CTAs remain subject to some disclosure, reporting, and record-keeping requirements, and will also need to make a filing with the CFTC claiming "registration light."

The table at the end of this document summarizes the registration, disclosure, reporting and record-keeping requirements for CPOs and CTAs taking advantage of "registration light."

12. If I have to register, what is the deadline for doing so?

Possibly as early as October 12, 2012. The CFTC is of the view that the changes based on the inclusion of the word "swap" in the definition of commodity pool will be effective as of October 12, 2012 (which is when the definition of "swap" becomes effective). However, the CFTC has indicated that it may provide some form of registration relief for certain securitization SPVs prior to this date; the scope of this is not yet clear.

CP Entities that are currently relying on the exemption from CPO and/or CTA registration as a result of the sophisticated investor exemption that has been repealed must register by December 31, 2012 (rather than October 12, 2012). In addition, certain new CP Entities launched after July 10, 2012 (but before December 31, 2012) that could have relied on the repealed exemption do not need to register until December 31, 2012, provided they comply with certain requirements specified by the CFTC in no-action relief issued earlier this year.

13. What will happen to me if I am required to register but don't?

The CFTC may take enforcement action against you, or you may face criminal prosecution by the United States Department of Justice. In addition, it is possible that an investor could sue you based on a private cause of action under the CEA and/or state law.

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Registration and Compliance Requirements: A Comparison of General Registration and Registration Light

	General Registration	Registration Light
REGISTRATION AND FILING REQUIREMENTS		
Filing Requirements	Form 7-R must be filed with the NFA.	<i>The requirements are the same.</i> In addition, a Notice of Claim for Exemption must be filed to gain relief from subsequent disclosure, record-keeping, and reporting requirements.
Registration of Certain Individuals and Entities Involved in Commodity Pools	Certain individuals and entities must register with the NFA under Form 8-R and be listed on the registration application.	<i>The requirements are the same.</i>
Examination Requirements	Certain individuals deemed "associated persons" must take the Series 3 exam. (This requirement does not apply to individuals deemed an "associated person" solely because of a connection to swaps trading.)	<i>The requirements are the same.</i>
DISCLOSURE REQUIREMENTS		
Disclosure Documents	A detailed disclosure document must be provided to pool investors prior to or when it delivers a pool subscription agreement. The disclosure document must be filed with the NFA.	No detailed disclosure document is required, but offering memorandums (if any) must fulfill certain requirements. (CTAs are required to obtain consent from their clients.)
Signed Acknowledgement from Investors	A signed acknowledgement of receipt of the disclosure document is required.	No signed acknowledgement required.
REPORTING REQUIREMENTS		
Periodic Account Statements	A detailed periodic account statement must be distributed to each investor in a commodity pool.	No periodic account statement required, provided that a less-burdensome quarterly statement is provided.
Annual Reports	An annual report certified by an independent public accountant and prepared in accordance with U.S. GAAP (or IFRS if certain conditions are met) must be provided to each investor and the NFA. (CTAs not required to provide annual reports.)	Only an abbreviated annual report is required to be provided to each investor and the NFA. The abbreviated annual report must be prepared in accordance with U.S. GAAP (or IFRS if certain conditions are met).
Other Reporting Requirements	Form CPO-PQR (for CPOs) and/or Form CTA-PR (for CTAs) must be filed with the CFTC.	<i>The requirements are the same.</i>
RECORD-KEEPING REQUIREMENTS		
General Record-keeping Requirements	Extensive and detailed books and records relating to the commodity pool and operations of the entity must be kept for at least five years (the first two of which must be readily accessible).	Entity generally exempt from detailed record-keeping requirements provided certain documents are kept on file. (CTAs are required to obtain consent from their clients.)

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