Proskauer

Proskauer's Hedge Start: When Is CFTC Registration Necessary?

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An initial question faced by a new hedge fund manager is whether or not registration with the U.S. Commodity Futures Trading Commission (CFTC) will be required.

Limited Trading Exemption

CFTC Rule 4.13(a)(3), which is often referred to as the “limited trading exemption,” provides a basic exemption from CFTC registration as a commodity pool operator (CPO) for any manager of a fund that has only limited exposure to futures and swaps.

In order to rely on the exemption under Rule 4.13(a)(3), a fund must satisfy either one of the two tests described below:

- **Aggregate Initial Margin Test:** The aggregate amount of initial margin and premiums required to establish commodity interest positions in the fund’s portfolio is equal to 5% or less of the net asset value of the fund.
- **Aggregate Net Notional Value Test:** The aggregate net “notional value” (i.e., the principal amount or face value) of all commodity interest positions in the fund’s portfolio is equal to 100% or less of the net asset value of the fund.

Under either test, the calculation must be performed each time that a fund establishes a new commodity interest position.

For purposes of the 100% net notional value test, future contracts in the same underlying commodity may be netted across designated contract markets and foreign boards of trade. Swaps on the same underlying commodity and cleared by the same designated clearing organization also may be netted.

What is a “Commodity Interest”?

“*Commodity interest*” for this purpose includes:

- futures of any kind (agricultural futures, precious metals futures, stock index futures, interest rate futures, etc.),

- options on futures,
- security futures products (including single stock futures),
- swaps (except as described below),
- commodity options,
- OTC currency options,
- non-deliverable currency forward contracts (i.e., that are settled in U.S. dollars) (NDFs),
- retail forex transactions (which are generally off-exchange futures and options on foreign currencies, as well as certain other transactions in currencies (including virtual currencies) that are offered or entered into on a leveraged or margined basis), and
- transactions in virtual currencies on a forward basis.

"*Commodity interests*" generally do *not* include:

- options on debt or equity securities or a securities index (i.e., a stock index option is not covered, but an option on a stock index future is covered),
- traditional foreign currency forward contracts (i.e., that are settled in the relevant currencies),
- swaps (including credit default swaps) with respect to a single underlying debt or equity security,
- swaps with respect to a "narrow-based security index" (generally, an index of securities that has nine or fewer components, or with respect to which the counterparties, either directly or indirectly (e.g., through an investment adviser or a third-party index provider) have the discretionary authority to change the composition or weighting of securities in a security portfolio, but not where the composition or weighting of the index may change as a result of a predetermined self-executing formula or other predetermined criteria), and
- spot transactions in virtual currencies such as bitcoin or Ethereum.

"*Notional Value*" in the case of an option position generally means (i) the number of contracts held multiplied by (ii) the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), multiplied by (iii) the strike price per unit.

If CFTC Registration Is Required

In order to register as a CPO or commodity trading advisor (CTA), a manager must submit an application on Form 7-R to the National Futures Association (NFA) (see https://www.nfa.futures.org/nfa-registration/templates-and-forms/Form7-R-entire.pdf), and an application to register each "associated person" and "principal" of the applicant on Form 8-R (see https://www.nfa.futures.org/nfa-registration/templates-and-forms/8rFormentire.pdf). These are basic "fill-in-the-blank" forms that must be completed and submitted online.

- An "***associated person***"(AP) is an individual who "solicits orders, customers or customer funds (i.e., investors), or who supervises persons so engaged," on behalf of a CPO or CTA. This generally includes all personnel involved in marketing and, importantly, any person in the supervisory chain of command over marketing personnel, up to and including the chief executive officer.
- "***Principals***" include a person who is a director, president, chief executive officer, chief operating officer, chief financial officer or chief compliance officer; a person in charge of a business unit, division or function subject to CFTC regulation; a manager, managing member or other member with management authority for a limited liability company or limited liability partnership; or an individual who, directly or indirectly, is the owner of 10% or more of the equity of a registrant or otherwise has the power to exercise a controlling influence over a registrant's activities that are subject to regulation by the CFTC.

Series 3 National Futures Exam

Individuals applying for registration as an AP must satisfy certain proficiency requirements. Unless an AP is eligible for a waiver or for an alternative to the Series 3 examination, the AP must have completed the Series 3 examination either (i) within the two years preceding application or (ii) more than two years prior to the application date if, since the date the AP last passed the Series 3 exam (or an alternative exam, if applicable), there has been no consecutive period of two years or more during which the individual was not an AP or NFA approved principal of a CFTC registrant. Principals are not required to take any exam.

Are There Any Exemptions from CTA Registration That May Apply?

There are several exemptions from the obligation to register as a CTA that may apply, including:

- **Fewer Than 15 Clients**: Section 4m(1) of the Commodity Exchange Act (CEA) and CFTC Rule 4.14(a)(10) exempt any manager that advises less than 15 clients that trade futures or swaps, and that does not hold itself out to the public as a CTA.
  - Note that a fund operated under the Rule 4.13(a)(3) limited trading exemption counts toward the 15-client limit.

- **SEC Registered Investment Adviser**: Section 4m(3) of the CEA provides an exemption for any SEC-registered investment adviser whose business does not consist primarily of acting as a CTA, and who does not act as a CTA to any pool engaged primarily in trading in commodities.
  - Note that the exemption under Section 4m(3) can be combined with the exemption under Rule 4.14(a)(8) discussed below.

- **Limited Trading Exemption**: CFTC Rule 4.14(a)(8) exempts any manager that advises only certain limited categories of private funds, including funds operated under CFTC Rule 4.13(a)(3).
  - Note that a manager cannot rely on Rule 4.14(a)(8) if any of the funds it manages, trades, futures or swaps in excess of the Rule 4.13(a)(3) limits (such as a fund operated under CFTC Rule 4.7), or if it manages any managed accounts that trade futures or swaps. The manager must file a notice of exemption with the NFA.

The Takeaway:

Most hedge fund managers are able to avoid CFTC registration by qualifying for the limited trading exemption, typically relying on the 100% of net assets prong of the test.

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