OUTLINE FOR PRESENTATION BEFORE FUTURES INDUSTRY ASSOCIATION

November 5, 2003

Recent Developments and Rule Changes Involving CPOs and CTAs

A. New Registration Exemptions and Exclusions Available to CPOs and CTAs.

On August 8, 2003, a wide range of CPO and CTA exemptions and rule changes became effective. I will attempt to summarize a few of these changes.

CPO Exemptions

1. Limited Trading Exemption – Rule 4.13(a)(3).

Under new Rule 4.13(a)(3), which will be applied on a pool by pool basis, the CPO of a privately offered pool will qualify for the exemption if two conditions are met:

(i) The CPO reasonably believes that participants include only persons who are accredited investors, certain family trusts formed by accredited investors, knowledgeable employees as defined under the Investment Company Act and certain other principals or family members of the CPO; and,

(ii) The pool has satisfied one of the following two portfolio tests with respect to the subject pool:

i. the net notional value of the fund's commodity positions (whether hedge or speculative) does not exceed 100% of the fund's liquidation value; or

ii. the aggregate initial futures margin and options premium required to establish the pool's commodity positions do not exceed 5% of the liquidation value of the fund.

With respect to the portfolio test, if you followed the development of this rule, in its proposed revisions published earlier in March of this year, the CFTC had proposed 50%. So the final rule was a fairly significant change.

(1) Highly Sophisticated Participant Exemption – Rule 4.13(a)(4).

This exemption will be available to a CPO of a privately offered pool if the pool participants meet a specified level of sophistication. In order to qualify, the CPO must reasonably believe that:

i. any natural person who invests in the pool is a "qualified purchaser" under the Investment Company Act of 1940, is a non-U.S. person, or a knowledgeable employee as defined under the Investment Company Act; and

ii. with respect to any non-natural person that invests in the pool, that it is either a qualified eligible person within the meaning of Rule 4.7(q) or an accredited investor.

The highly sophisticated participant exemption does not require satisfying either of the portfolio tests. It is simply an investor-based exemption. One non-qualifying investor blows the exemption.

(2) Fund of Funds Exemption.

The CPO of an Investor Fund may claim an exemption from CPO registration under new Rule 4.13(a)(3) under 3 different scenarios:

i. the CPO of each Investee Fund has either (a) claimed an exemption from CPO registration under the new Rule 4.13(a)(3) or (b) the Investee Fund is registered with the CFTC as a CPO and has operated the Investee Fund in compliance with the trading restrictions of 4.13(a)(3); or

ii. the Investor Fund has allocated no more than 50% of its assets to the Investee Fund that trades commodities, and the Investor Fund does not trade commodity interests directly, or, if it does trade commodity interests directly, the assets committed to direct trading separately meet the restrictions of new Rule 4.13(a)(3) as if such assets were a separate fund; or

iii. the CPO of the Investor Fund has actual knowledge of the commodity interest positions of the Investee Funds and the aggregate commodity positions in the Investee Funds complies with the trading restrictions of new Rule 4.13(a)(3). In the case of an affiliated Investee Fund, the standard will be actual knowledge, and in the case of an unaffiliated

Investee Fund, a CPO is able to rely on a representation from the Investee Fund.

In a number of respects, it is very difficult to describe in a rule how this rule is implemented. As a result, CFTC has included as an Appendix a question and answer section to provide further clarification.

(3) Small Pool Operator Exemption.

Prior to August 8, 2003, the *deminimus* exemption was $200k, and the exempt pool operator was restricted to not more than 15 investors in the pool. The *deminimus* exemption for small pools has been doubled or increased from $200,000 to $400,000, and the no more than 15 participants requirement now excludes family members and certain other excluded individuals. As long as contributions from outside investors do not exceed $400k, the small pool exemption provides an opportunity to include a significantly greater number of participants and significant dollars from insiders. So it has expanded substantially both the amount and the number of investors who can be involved.

B. Procedure to Claim Relief for New CPO Exemptions.

To claim relief for a pool which is in the formation stage, a CPO must:

- file a notice of exemption with NFA;
- disclose to each prospective pool participant in writing that the CPO is exempt from registration; and
- state the basis for the exemption.

With respect to a CPO involved in the operation of a pool who wants to withdraw its registration and claim an exemption based on the new rules, the CPO must first:

- notify all existing clients in writing of its intent to withdraw from registration; and
- must give clients the right to redeem their interests in the pool before claiming the exemption.

If the CPO previously filed a claim of exemption with NFA pursuant to the temporary no-action relief, he is not required to refile.

C. CPO Exclusion – Rule 4.5 - Expansion of the Scope of Qualifying Entities Excluded from the Definition of a CPO.

- The old Rule 4.5 excluded from the definition of CPO certain qualifying entities such as mutual funds, pension plans, insurance companies, bank trust funds and similar regulated institutional investors. The old exclusion was conditioned on the requirement that the qualifying entity limit its commodity trading to 50% of its overall portfolio trading. Under the new rule, there is no limit to the amount of commodity interest trading by any of these entities. Thus, 100% of the trading can be devoted to commodity trading and the exclusion is nonetheless available.

- The new rule also lets a qualifying entity market itself as a commodity pool. The old rule did not.

- In order to utilize this expanded exclusion, a qualifying entity must provide written notice to each of its participants that it has claimed the exclusion from the definition of a CPO, and is therefore not subject to registration.

D. New Registration Exemptions for CTAs Under Rule 4.14(a)(8).

The new rules also include new exemptions from registration as a CTA.

1. <u>SEC and State Registered Investment Advisers</u>.

The old regulation 4.14(a)(8) provided an exemption from CTA registration for investment advisers registered with the SEC, and to certain unregistered investment advisers that qualified for one of two narrow exemptions from SEC registration requirements.

The new rule exempts a much larger category of investment advisers – it exempts all federally registered investment advisers, all state registered investment advisers and all exempt investment advisers (exempt from both the SEC's and the state's investment adviser registration requirements). In order to utilize the exemption, however, the investment adviser cannot hold itself out as a CTA.

2. The second new exemption under the new rules permits a CTA to claim exemption from registration <u>if the advice it provides is provided to a pool that is organized and operated outside the U.S. and the pool does not have any U.S. participants</u>.

3. A third exemption permits a CTA to claim exemption from registration if it is rendering advice to pools that meet the requirements of the new exemptions contained in new Rule 4.13(a)(3) (Limited Trading) and (4) (Highly Sophisticated Participant Exemption).

<u>Procedure to Claim Relief</u> - Similar to CPOs, to claim relief from the CTA exemption under 4.14(a)(8), a CTA must file a notice of exemption with the NFA. Any registered CTA who now desires to withdraw its registration pursuant to these new exemptions must first notify existing clients of the right to terminate their advisory agreement with the CTA.

4. **<u>Another Significant Change Involves the Expansion of an Existing Exemption Under 4m(1) - Section 4m Exemption - Fifteen (15) or Fewer Restriction</u>.**

   Section 4(m) provided that a CTA is not required to register if during the preceding 12 months it has not provided commodity trading to more than 15 persons and has not held itself out to the public as a CTA. Since its inception, the CFTC has always looked through an organization or legal entity and counted, for example, the number of partners in a partnership that were advised by the CTA for purposes of calculating the 15 or fewer client restriction. Under the new rule (4.14(a)(10)), certain organizations will now be counted as one client. This will conform with the treatment of an investment adviser under the Advisers Act of 1940.

E. Other Noteworthy Changes.

1. **<u>Solicitation of Clients and Delivery of Disclosure Document</u>.**

   The old rule 4.21 and 4.31 prohibited CPOs and CTAs from soliciting prospective clients prior to providing a disclosure document. The new rules allow solicitation prior to delivering a disclosure document. CPOs are now only required to deliver the disclosure document no later than the delivery of a subscription agreement, or in the case of a CTA, no later than the delivery of an advisory or management agreement.

   The new rules also do away with the need to require that visitors to a CTA or CPO website view a summary risk disclosure statement before accessing performance information.

2. **<u>Master Feeder Reporting Obligations – Rule 4.22</u>.**

   Under Rule 4.22, a CPO of a master feeder fund is no longer required to provide a disclosure document, periodic account statements or any reports of the master feeder to its affiliated Investee Feeder funds.

3. **<u>Computation and Presentation of Notional Funds Performance Disclosure</u>.**

The new rules change how notional performance is presented by CPOs and CTAs. In the final release, CFTC has indicated that it will return to a fundamental core principle – you cannot defraud your investor – effectively punted and asked NFA to adopt final rules regarding presentation of notional performance disclosure. Even though effective September 8, 2003, NFA has not issued any new guidelines.

4. <u>Electronic Delivery of Periodic Account Statements and Annual Reports Permitted by CPOs to Fund Participants</u>.

F. Conclusion.

In summary, perhaps the most significant impact for CPOs and CTAs utilizing the new exemptions is the ease with which they will be able to operate. Persons who qualify will no longer be required to register, will no longer be required to be NFA members, will not be subject to NFA audits, and will no longer be required to prepare and file disclosure documents and maintain and disclose performance information. One industry source speculates that up to as many as one half of all pool operators will be able to drop their registration. At the same time, and as I think David Matteson will soon point out, it is ironic that the SEC is increasing regulatory burdens for those same money managers who are involved in the hedge fund business and trade futures.