THE HEDGE FUND INDUSTRY

New CFTC Flexibility for Hedge Fund Managers

by Gilbert H. Davis, Esq., Raymond L. Moss, Esq. and Abdullah H. Alzuhair, Esq.

In the best of all possible worlds, investment managers would be free to employ all of the investment tools and strategies that the markets make available without incurring any added regulatory burden for taking advantage of a particular tool or strategy. Until the recent adoption of new exemptions, however, the manager of a "hedge fund"[1] with a portfolio consisting primarily of equity security investments could generally not allocate even a small amount of fund assets to commodity or financial futures contracts without accepting the burdens of registration as a commodity pool operator (CPO) and commodity trading advisor (CTA) under the Commodity Exchange Act. The compliance exemptions that were available were not complete, and CPO and CTA registration and National Futures Association (NFA) membership were still required.

Opportunities Foregone

In our experience, many excellent equity-oriented fund managers have not even considered the use of futures contracts as part of their fund investment approach for either or both of two reasons:

- the burdens of CFTC (Commodity Futures Trading Commission) registration and reporting
- the perception of many investors that "commodity pools" and futures were particularly risky investments.

Many hedge fund managers would have found the CFTC's inflexible (and not necessarily effective) disclosure requirements did not fit the way in which a securities-oriented private investment fund operated.

Foregone Benefits

Not taking advantage of the futures markets has been, at least arguably, an unfortunate forgone opportunity. For instance, many observers believe that futures contracts can be used to hedge market, sector or individual position exposure at lower cost than alternatives such as exchange-traded funds or put options.[2] If correct, fund investors and a fund's manager could have benefited if the manager had been willing to undertake the burdens of regulation and the investors had properly understood the nature of the fund's use of futures contracts.

Of course, not all futures contracts have been used by hedge funds solely for hedging purposes, and the new exemptions make it more likely that futures contracts will be used by funds for both hedging and speculative purposes. Fund managers and investors should have an appreciation for the scope of the new exemptions.

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Rulemaking in Response to Commodity Futures Modernization Act

In response to the Commodity Futures Modernization Act of 2000 and industry registration exemption proposals, the CFTC's formal rulemaking process began in October 2002.[3] After receiving interim comments and issuing a second proposal in March 2003,[4] the CFTC announced the new exemptions described below in the Federal Register on August 8, 2003 with immediate effectiveness.[5] The following discussion focuses on the new relief available for traditional hedge fund managers.

New Fund Opportunities

The new exemption provisions apply in two different circumstances. Among other requirements, new Rule 4.13(a)(3)[6] requires limitations on a fund's portfolio investments in futures contracts. In contrast, new Rule 4.13(a)(4)[7] does not restrict futures investments but does increase fund investment eligibility requirements. In either case, a manager who satisfies one of the two new rules may

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also claim an exemption from CTA registration requirements if it meets the requirements outlined below.

Requirements of Both CPO and the CTA Exemption Rules.

The following requirements will apply to any manager seeking to satisfy either of the new CPO exemptions and the related CTA exemption:[8]

1) A fund's offering of interests is exempt from registration requirements of the Securities Act of 1933.
2) The fund interests are offered without marketing to the public.
3) The manager must be registered as an investment adviser unless an exemption is available.
4) Commodity interest trading advice may only be directed to specified funds and entities (including funds that meet the new Rule requirements).
5) Commodity interest trading advisory activities are solely incidental to the business of providing securities or other investment advice to the exempt funds.
6) The fund manager does otherwise hold itself out as a CTA.
7) The fund manager signs and files notices containing specified information with the NFA claiming the applicable exemptions no later than the time it delivers subscription documents to a potential fund investor.
8) Although registration is not required, the fund manager must maintain books and records for five years and be willing to allow the books and records to be inspected.

Requirements for the Rule 4.13(a)(3) Exemption.

The following requirement will apply to any manager seeking to satisfy new Rule 4.13(a)(3):

1) At all times, the fund meets one or the other of the following tests with respect to its commodity interest positions, including positions in security futures products, whether entered into for bona fide hedging purposes or otherwise:

A) The aggregate initial margin and premiums required to establish such positions, determined at the time the most recent position was established, will not exceed percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into; provided that in the case of an option that is in-the-money at the time of purchase, the in-the-money amount may be excluded in computing such 5 percent; or

B) The aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. For the purpose of both tests, "notional value" is calculated for each futures position by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit, and for each such option position by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), by the strike price

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per unit. The manager may also net contracts with the same underlying commodity across designated contract markets, registered derivatives transaction execution facilities and foreign boards of trade.

2) The manager reasonably believes fund investors are:

A) "accredited investors," as defined in Regulation D;

B) trusts that are not accredited investors but were formed by an accredited investor for the benefit of a family member;

C) "knowledgeable employees," as defined in Investment Company Act Rule 3c-5; or

D) "qualified eligible persons," as defined pursuant to the CFTC's previously existing limited Rule 4.7 exemption.

3) Interests in the fund are not marketed as a means of investing in commodity futures.

Requirements for the Rule 4.13(a)(4) Exemption.

New Rule 4.13(a)(4) does not require limitations on the composition of the fund's portfolio. However, this rule does further limit the persons who can be investors in the fund to: A) natural person participants (including such person's self-directed employee benefit plan, if any) that are "qualified eligible persons;" and B) each non-natural person participant must be a "qualified eligible person" or an "accredited investor" under Rule 501(a)(1)-(3), (a)(7) or (a)(8) of Regulation D.

Opportunities for Multi-Manager Funds

Both of the new exemptions are available for funds that invest in other funds. However, applying the portfolio investment limitations of Rule 4.13(a)(3) in this context presents some interesting questions. Appendix A added to Part 4 of the CFTC's rules provides helpful examples for making these calculations.

Sharia Compliance

Generally, investing or trading commodities futures is acceptable in Sharia under "Sa'lim Sale" laws. In brief, "Sa'lim Sale" is selling a specific product acceptable under Sharia laws, which is not available at the time of the sale; however, probably available at a future known date. On the other hand, financial futures are unacceptable, due to the fact that they do not represent specific merchandise.[9]

Closing Words of Caution

For investors: Do remember that we do not live in the best of all possible worlds. The increased flexibility and potential for more efficient portfolio management afforded by the new CFTC exemptions also means that the CFTC and NFA will not be examining the exempt fund managers—investors will not have the option of relying on regulators (whether or not such reliance is advisable) as a substitute for conducting their own due diligence.

For managers: Keep in mind that many investors do value registered status because of the regulatory oversight. Registration may attract investors. Also, if you are currently registered, the CFTC will require some ongoing reporting if you take advantage of the new exemptions to withdraw. Finally, even though you may now be exempt from registration requirements, you will still be subject to the operational and advertising requirements of CFTC Rules 4.20, 4.30 and 4.41 and the prohibitions on fraudulent activities of the Commodity Exchange Act and relevant securities laws.

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[1] More technically, an investment fund marketed on a private placement basis that would be an investment company subject to registration under the Investment Company Act of 1940 were it not for the definitional exclusion provided by section 3(c)(1) or section 3(c)(7) of that Act. As commonly used, "hedge fund" has come to mean any private investment fund even if is does not hedge at all.

[2] See, for instance, "Managed Futures and Hedge Fund Investment for Downside Equity Risk Management ", Thomas Schneeweis, Richard Spurgin, and Mark Potter, Derivatives Quarterly, Vol. 3, No. 1 (Fall 1996), pages 62-72.

[3] 67 FR 65743 (Oct. 28, 2002) and 67 FR 68785 (Nov. 13, 2002). These Releases and the comment letters received in response may be accessed through http://www.cftc.gov/foia/fedreg02/foi021028a.htm and http://www.cftc.gov/foia/fedreg02/foi021028a.htm.

[4] 68 FR 12622 (Mar. 17, 2003). This Release may be accessed through http://www.cftc.gov/foia/fedreg03/foi030317b.htm.

[5] 68 FR 47221 (Aug. 8, 2003).

[6] 17 CFR 4.13(a)(3).

[7] 17 CFR 4.13(a)(4).

[8] See 17 CFR 4.14.

[9] Dr. Abdulrazag A. Alsanhoury, Alwaseat in the Translation of Civil Laws, p. 220.