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December 12, 2012

VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: CFTC Grants No-Action Relief for Managers of Hedge Funds with Indirect Exposure to Futures and Other Commodity Interests Through ETFs and Other Funds

Summary. On November 29, 2012, the Commodity Futures Trading Commission (the "CFTC") issued a no-action letter giving investment managers of funds-of-funds more time to comply with the trading limits of CFTC Rule 4.13(a)(3), an exemption from commodity pool operator ("CPO") registration. This relief is important for all managers of hedge funds that invest in other funds -- including ETFs and registered mutual funds -- that invest in futures, CFTC-regulated swaps or other commodity interests (collectively, "commodity interests"). Even if a hedge fund does not invest directly in commodity interests, the CFTC views its manager as a CPO by virtue of its indirect exposure to commodity interests through other funds (including ETFs) in which it invests. Investing even a small portion of a hedge fund's assets in a single underlying fund that trades commodity interests is sufficient to render that fund's manager a CPO. Such a manager must either comply with the trading limits of Rule 4.13(a)(3) or register as a CPO. Given the lack of transparency of ETFs and other underlying funds about their investments and notional exposures, managers of hedge funds that invest in those funds may not be able to ascertain whether they are within the Rule 4.13(a)(3) limits.

Revocation of Prior Guidance. Rule 4.13(a)(3) requires that either (i) the hedge fund's initial margin and premiums on commodity interest positions are less than 5% of the portfolio value, or (ii) the aggregate net notional value of the fund's commodity interest positions are less than 100% of the portfolio value. A hedge fund that invests in other funds generally lacks sufficient data about its indirect exposure to commodity interests to monitor its compliance with these limits. In 2003, the CFTC issued Appendix A to Part 4 of the CFTC Rules to assist funds-of-funds in applying the Rule 4.13(a)(3) trading limits to their portfolios. Appendix A described six circumstances in which a fund-of-funds would be deemed to comply with the Rule 4.13(a)(3) trading limits without using the 5% and 100% tests, based on various factors, such as percentage of its capital invested directly in commodity interests, the percentage invested in other commodity pools, and the CPO registration or exemption status of the operators of those pools.

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Effective December 31, 2012, however, the CFTC revoked Appendix A, leaving a vacuum for fund-of-funds managers seeking to comply with Rule 4.13(a)(3). Many managers are affected, because the CFTC concurrently revoked the Rule 4.13(a)(4) exemption from CPO registration on which many managers relied, and many of those managers invest in other funds, particularly ETFs, that trade futures.

The CFTC stated that it intends to issue new guidance to replace Appendix A, and that CPOs may continue to rely on Appendix A until then. When the CFTC issues new guidance, CPOs may need additional time to implement portfolio changes to comply with the new guidance or to register as CPOs.

No-Action Relief. The no-action letter provides that the CFTC will not take enforcement action against a manager of one or more funds-of-funds for failing to register as a CPO, if the manager meets the following requirements with respect to each such fund:

1. The fund's direct exposure to commodity interests does not exceed the limits of Rule 4.13(a)(3);

2. The CPO does not know and could not reasonably know that the fund's indirect exposure to commodity interests through other funds exceeds the limits of Rule 4.13(a)(3), calculated either directly or in accordance with the guidance in Appendix A; and

3. The fund complies with the other requirements of Rule 4.13(a)(3).

The CPO must file a claim electronically with the CFTC before December 31, 2012. The claim must provide identifying information specified in the no-action letter and include the CPO's signature. The no-action relief will be valid until the later of June 30, 2013 or six months after the date the CFTC issues new guidance to replace Appendix A. A CPO may claim the no-action relief with respect to some funds that it manages and concurrently rely on the 4.13(a)(3) exemption with respect to other funds, if it is able to ascertain those other funds' compliance with the 4.13(a)(3) trading limits.

Action Item. Managers of hedge funds that invest in ETFs or other funds that invest in commodity interests should contact us as soon as possible about filing a claim before year-end for the no-action relief described above.

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This letter only generally summarizes the recent CFTC no-action letter and is not intended as specific or complete advice. If you need assistance in determining your compliance obligations under the CFTC Rules, including assessing whether the no-action relief is appropriate for your funds, and if so, claiming such relief, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Jim Frolik, Joan Grant, Ellyn Roberts, Anthony Caldwell, or Christina Hamilton.

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