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# History of Rule 4.5

## About Rule 4.5:

- CFTC Rule 4.5 allows some market participants to be excluded from being deemed a "commodity pool operator" (CPO) under the Commodity Exchange Act (CEA).
- A CPO is an entity that pools money from investors in order to purchase commodity futures and swaps.
- If a market participant can't rely on Rule 4.5 or another exclusion or exemption, it must register with the CFTC. Registration carries with it a number of regulatory requirements, including reporting and disclosure to the CFTC and investors, recordkeeping, and segregation of investor assets. CPOs also must become members of the National Futures Association (NFA), the self-regulatory organization in charge of futures industry oversight and compliance, which has its own set of compliance rules, and requires licensing examinations.
- To claim the amended Rule 4.5 exemption, a participant must meet one of two trading tests and a marketing test, and file a notice of eligibility electronically with the NFA.

## History (significant dates in Rule 4.5 history are 1985, 2003, 2011, 2012):

<u>1985</u>

- In 1985, the CFTC adopted Rule 4.5 to exclude a variety of entities that would otherwise be subject to overlapping regulation, including registered investment companies (RICs – such as mutual funds and exchange traded funds), insurance companies, banks and pension plans.
- From 1985 to 2003, the CFTC required any entity eligible to rely on the Rule 4.5 exclusion to meet two requirements:
    - **A trading threshold** that required the entity to use commodity futures or options contracts for bona fide hedging purposes. For positions that did not meet the bona fide hedging criteria, initial margin and premiums could not exceed 5 percent of the entity's assets.
    - **A marketing restriction** that required the entity to not market participations in the pool as a vehicle for trading in commodity futures or options.

<u>2003</u>

- In 2003, after public notice and comment, the CFTC amended Rule 4.5 to exclude "otherwise regulated" entities, including RICs, from the definition of a CPO, and eliminated the trading and marketing thresholds.
- The CFTC's stated reasons for changing the rule included:
    - The fact that margin levels for certain commonly traded instruments had increased beyond the 5% threshold;
    - Market developments and changes in the current investment environment;

- Recognition that entities eligible to rely on Rule 4.5 are "otherwise regulated";
- The need to allow "greater flexibility and innovation" and to "encourage and facilitate" participation in the commodity markets by collective investment vehicles "with the added benefit of increased liquidity."

2011

- On February 11, 2011, the CFTC proposed to amend Rule 4.5 to end the general exclusion previously relied on by RICs from CPO registration and regulation. The CFTC proposed a new exclusion based on trading and marketing thresholds that are even stricter than the rules that it had eliminated in 2003.
  - The proposal also included swaps in the trading threshold requirement.
  - The proposal did not seek to impose similar restrictions on other entities that remain eligible to rely on Rule 4.5.
- On April 12, 2011 ICI filed its comment letter with the CFTC strongly objecting to the proposal. The CFTC received numerous other comment letters – most of which opposed the proposal – along with letters from two CPOs supporting it. The NFA also filed a letter generally supporting the proposal, but including a number of suggestions of how it should be revised.

2012

- On February 9, the CFTC voted 4-1 to adopt amendments to Rule 4.5 with limited changes from the 2011 proposal.
- The end result is that Rule 4.5 as amended is likely to require advisers to hundreds of RICs to register as CPOs with the CFTC.
- The amended Rule 4.5 provisions include narrow exclusions for advisers to RICs:
- **Trading threshold:** RICs can use futures, options and swaps only for narrowly defined bona fide hedging, unless either (i) the initial margins and premium for non-hedging do not exceed 5 percent of the fund's liquidation value; or (ii) the aggregate net notional value of commodity futures, options or swaps positions not used solely for bona fide hedging purposes does not exceed 100 percent of the liquidation value of the fund's portfolio.
- **Marketing threshold:** A RIC cannot market itself as a commodity pool or as a way to trade in commodity futures, options or swaps. The CFTC's adopting release enumerated seven factors – not included in the proposed rule or subject to public comment – that the CFTC states it will use to apply the marketing restriction.

## Harmonization measures:

- At the same time it released the 2012 final Rule 4.5 amendments, the CFTC acknowledged that several requirements would cause compliance conflicts between SEC and CFTC requirements. As a result, it proposed rules that it claims would harmonize some CFTC and SEC rules for dually registered advisers and their funds although it does not address many areas of conflict and inconsistent or redundant regulations.
- Comments on the Harmonization Proposal are due by April 24, 2012.

## Effective dates:

- Amendments to Rule 4.5 become effective April 24, 2012.
- The CFTC bifurcated the compliance date for its Rule 4.5 amendments.
    - *CPO registration*—Given that the rule defining the term "swap" has not yet been finalized, the CFTC indicates that advisers to RICs that must register as CPOs must do so by the later of December 31, 2012 or 60 days after the effective date of the final rulemaking further defining the term "swap" and establishing margin requirements for such instruments. *Recordkeeping and disclosure requirements*—Advisers to registered funds that will be required to register as CPOs will be subject to the CFTC's recordkeeping, reporting and disclosure requirements 60 days after the effective date of a final rule implementing the CFTC's proposed harmonization.