

MEMORANDUM

TO: Clients and Friends of Dorsey & Whitney LLP

DATE: April 2, 2003

RE: Proposed Rules regarding CPOs and CTAs: Additional Exemptions, Confirmation of No-Action Relief and Other Regulatory Relief

On March 17, 2003, the Commodity Futures Trading Commission (the "CFTC") proposed a set of rules (each, a "Proposed Rule") designed to expand the current exclusions and exemptions from registration for commodity pool operators (each, a "CPO") and commodity trading advisors (each, a "CTA"). The CFTC also confirmed and clarified the temporary no-action relief from CPO and CTA registration pending the adoption of final rules. Furthermore, the CFTC published additional Proposed Rules with respect to bunched orders and performance data and disclosure for CTAs.

A. NEW EXEMPTIONS FROM REGISTRATION FOR CPOs: PROPOSED RULES 4.13(A)(3) AND (4)

Limited Trading Exemption

Proposed Rule 4.13(a)(3) would exempt a CPO from registration if:

(1) (a) The pool commits no more than two percent (2%) of the liquidation value of the pool's portfolio as initial margin or options premiums to establish commodity interest trading positions, whether entered into for bona fide hedging purposes or otherwise *or* (b) where the aggregate net notional value of the pool's commodity interest trading does not exceed fifty percent (50%) of the pool's liquidation value;

(2) Each participant in the pool is an "accredited investor" as that term is defined in Rule 501(a) under the Securities Act of 1933, as amended (the "Securities Act"); *and*

(3) A CPO claiming relief does not market participations in the pool as or in a vehicle for trading in the commodity futures or commodity options markets.

Compliance with this Proposed Rule is determined at the time the most recent position is established. The criterion of (1)(b) applies on a net basis, and the calculation of "notional value" includes the number of futures and options contracts and any multiplier specified in those contracts.

Sophisticated Investor Exemption

Proposed Rule 4.13(a)(4) would also exempt a person from registration as a CPO if interests in the pool for which it seeks to claim relief (1) are exempt from registration under the Securities Act and (2) are offered and sold without marketing in the United States*. In addition, the CPO must reasonably believe that (a) natural person participants are "qualified eligible persons" as that term is defined in Rule 4.7(a)(2); and (b) non-natural person participants are "qualified eligible persons" or "accredited investors."

* Although the Proposed Rules do not specifically address what is meant by "offered and sold without marketing in the United States," it is likely that a private placement of the securities of such a pool pursuant to Regulation D promulgated under Section 4(2) of the Securities Act, will be permitted under Proposed Rule 4.13(a)(4).

In order to claim either exemption, the CPO must file a notice of claim with the National Futures Association.

B. EXPANDING EXISTING CPO EXEMPTION UNDER RULE 4.13(A)(2)

Currently, Rule 4.13(a)(2) provides that a person is exempt from registration as a CPO if: (i) the total gross capital contributions it receives for units of participation in all of the pools that it operates or that it intends to operate do not in the aggregate exceed \$200,000 and (ii) none of the pools operated by it has more than fifteen (15) participants at any time, excluding the pools CPO, CTA, the principals of each and any relative, spouse or relative of the spouse of such person living in the same house as such person.

With respect to the existing exemption above the CFTC has proposed (1) to increase the total of the gross capital contributions criterion from \$200,000 to \$400,000; and (2) to expand the list of persons who are not counted when calculating the fifteen (15) participants in or capital contributions to such pool. Such expanded list of participants would include: (a) the pool's CPO, CTA and the principals thereof, (b) a child, sibling or parent of any of the persons listed in (a), above, (c) the spouse of any person listed in (a) or (b), above, and (d) any relative of a person specified in (a), (b) and (c), above, its spouse or relative of its spouse, who has the same principle residence as such person.

C. AMENDING THE DEFINITION OF CPO UNDER RULE 4.5: DELETING TRADING CRITERIA FOR EXCLUSION

Currently, Rule 4.5 excludes from the definition of a CPO registered investment companies, state-regulated insurance companies, banks and pension plans, subject to certain specific limitations on trading known as the "five-percent test." The proposed amendment would eliminate the five-percent test. Thus, the qualifying entities under Rule 4.5 would be permitted to trade any amount of futures, whether for hedging or speculative trading. Other restrictions under Rule 4.5 will remain the same.

D. NEW EXEMPTIONS FROM REGISTRATION FOR CTAS

Exemptions Related to Incidental Advice Solely Directed to Certain Entities:
Proposed Rule 4.14(a)(8)

Currently, Rule 4.14(a)(8) provides an exemption from CTA registration for an investment adviser if it is registered as an investment adviser under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), or is excluded from the definition of the term "investment adviser" under the Investment Advisers Act, provided that such CTA's commodity interest trading advice is directed solely to pools operated by persons or entities excluded from the definition of CPO under Rule 4.5 and is solely incidental to its business of providing securities advice to each such entity. The CFTC has proposed to add new exemptions under this rule for the following entities: (1) state-registered investment advisers; (2) investment advisers who provide commodity interest trading advice to pools organized and operated outside of the United States (only non-U.S. persons may be pool participants, except for the pool's operator, advisor and their principals); and (3) investment advisers to commodity pools that meet the requirements of the limited trading exemption and the sophisticated investor exemption described above.

Counting Legal Organizations as a Single "Person": Proposed Rule 4.14(a)(10)

Section 4m(1) of the Commodity Exchange Act, as amended (the "Commodity Exchange Act"), provides an exemption from CTA registration for any person who, during the course of the preceding twelve months, has not furnished commodity interest trading advice to more than fifteen (15) persons and who does not hold himself out generally to the public as a CTA. Currently, the CFTC "looks through"

any pools to which a CTA relying on the above exemption provides commodity interest trading advice, counting each of the pool's participants towards the fifteen (15) person limit. Under the Proposed Rule, however, the CFTC would count a pool as a single person without "looking through" the pool to count the pool's investors individually. Interestingly, the CFTC has not provided any guidance as to what constitutes "holding oneself out generally to the public."

E. CONFIRMATION AND CLARIFICATION OF CPO CTA REGISTRATION NO-ACTION RELIEF

In November 2002, the CFTC issued temporary no-action relief from CPO and CTA registration pending the determination of a final rule. The CFTC has confirmed and further supplemented the no-action relief by clarifying issues related to the notional value test and funds of funds and adding a new trading limit test to be used alternatively with the notional value test. The provisions of the no-action relief were set forth in our memorandum dated November 18, 2002 and are restated as below:

No-Action Relief for CPOs: In General

The CFTC will not commence enforcement action against a CPO for failure to register as a CPO where each pool for which the CPO claims registration no-action relief provided that:

(1) Participation in the pool is restricted to "accredited investors", "knowledgeable employees" as that term is defined in Rule 3c-5 under the Investment Company Act of 1940, "non-U.S. persons" as defined in Rule 4.7(a)(1)(iv); and persons described in Rule 4.7(a)(2)(viii)(A); *and*

(2) One of the following criteria is met at all times:

(a) The aggregate notional initial margin and premiums required to establish such positions, determined at the time the most recent position was established, does not exceed five percent (5%) of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts 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 as defined in Rule 190.01(x) may be excluded in computing such five percent; *or*

(b) The aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts in has entered into. For this purpose, the term "notional value" should be calculated for each such futures position by multiplying 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 size of the contract, in contract units (taking into account any multiplier specified in the contract), by the strike price per unit.

CPOs Who Operate Funds of Funds

The CPO of a fund-of-funds may claim the no-action relief if the CPO of each of the investee funds in which the fund-of-funds invests has either registered with the CFTC as a CPO or claimed no-action relief with respect to such investee fund. Additionally, regardless of whether the CPO of an investee fund was an unregistered CPO that had claimed no-action relief or a registered CPO, in each case the CPO of the fund-of-fund would be entitled to rely upon a representation by each investee fund's CPO that such CPO was operating the investee fund in compliance with the requirements of the no-action relief.

No-Action Relief for CTAs

The CFTC will not commence enforcement action against a CTA for failure to register as a CTA, where such CTA meets the following criteria:

(1) It claims relief from CPO registration under the no-action relief described above and its commodity interest trading advice is directed solely to, and for the sole use of the pool or pools that it operates: *or*

(2) It is registered as an investment adviser under the Investment Advisers Act or with the applicable state securities regulatory agency, or it is exempt from such registration, or it is excluded from the definition of “investment adviser” pursuant to Investment Advisers Act, provided that:

(a) The person’s commodity interest trading advice (i) is directed solely to, and for the sole use of, pools operated by CPOs who are eligible to claim relief from CPO registration under the no-action relief; (ii) is solely incidental to its business of providing securities advice to each such pool; (iii) is consistent with the criteria of the CPO registration no-action relief; *and*

(b) The person is not otherwise holding itself out as a CTA.

Claiming No-Action Relief

The no-action relief for CPOs and CTAs described above is not self-executing. One must file a claim to perfect the claim and must make a one-way disclosure specified in the Proposed Rule. The no-action relief will only be effective pending the CFTC’s adoption of final rules. Any final rules adopted by the CFTC will supersede the no-action relief.

F. COMMUNICATIONS WITH CLIENTS: AMENDING RULES 4.21, 4.22 AND 4.31

Permitting Communications Prior to Disclosure Document Distribution

Currently, Rule 4.21 and 4.31 prohibit CPOs and CTAs from soliciting prospective pool participants or clients prior to providing a disclosure document. The proposed amendments would allow CPOs and CTAs to solicit clients before delivering a disclosure document provided that (1) a disclosure document is delivered by such CPO or CTA no later than the time a CPO delivers a subscription agreement for the pool or the CTA delivers an advisory agreement for the trading program for which it is soliciting; and (2) any material distributed in advance of the delivery of the disclosure document is consistent with or amended by the information contained in the disclosure document.

Removing Duplicative Disclosure Requirements in the Master/Feeder Fund Context

Currently, under Rules 4.21 and 4.22, when a CPO delivers disclosure documents, account statements and annual reports to actual and prospective participants in commodity pools that it operates, if such actual or prospective participant is a commodity pool (a “Participant Pool”), the CPO must also deliver and distribute this information to each participant in each Participant Pool. Under the Proposed Rules, where the prospective or actual participant is a Participant Pool, the CPO need only deliver a disclosure document and distribute periodic account statements and annual reports to the CPO of the Participant Pool, thus eliminating the duplicative delivery of such information to each of the participants in the Participant Pool.

Distributing Account Statements Electronically; Facsimile Signatures

Additionally, the CFTC has proposed to codify staff guidance to permit electronic distribution of account statements (with the recipient's consent) and to specifically allow facsimile signatures on account statements and annual reports.

G. ACCOUNT IDENTIFICATION FOR ELIGIBLE BUNCHED ORDERS : PROPOSED RULE 1.35(A-1)

Currently, Rule 1.35(a-1)(5) allows bunching but limits eligibility to certain types of sophisticated customers. The Proposed Rule would expand the eligibility to all customers that have granted written discretion to an eligible account manager.

In addition, the current rule only permits bunching to "eligible account managers," which are investment advisers registered with the Securities Exchange Commission or CTAs registered with the CFTC. The CFTC has proposed to expand the class of account managers permitted to bunch orders to include CTAs and investment advisers who are exempt from registration or are excluded from the definition of CTA or investment advisers by operation of law or rule, and foreign advisers who exercise discretionary trading authority over the accounts of non-U.S. persons. Such eligible account managers would remain subject to the antifraud provisions of the Commodity Exchange Act and the CFTC's regulations promulgated thereunder. Further, such account managers would be subject to additional restrictions relating to disclosure, certification, allocation and recordkeeping.

H. PERFORMANCE DATA AND DISCLOSURE FOR CTAS: PROPOSED RULE 4.35(A)

The CFTC has proposed to allow CTAs to use nominal account size as the basis for calculating the CTA's past performance rather than actual funds under the CTA's control, subject to certain documentation and disclosure requirements. The CFTC has also requested comments regarding a "core principle alternative," where CTAs would be allowed to present past performance in any manner that does not run against general anti-fraud provisions. This approach is designed to achieve parity with applicable securities laws and regulations.

If you have any questions, please do not hesitate to contact Michael F. Griffin at (212) 415-9222 or griffin.michael@dorseyllp.com; J.P. Bruynes at (212) 415-9238 or bruynes.john@dorseyllp.com; or Robert E. Holton at (212) 415-9226 or holton.robert@dorseyllp.com.

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