



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and
Intermediary Oversight

Gary Barnett
Director

CFTC Letter No. 12-40
No-Action
December 4, 2012
Division of Swap Dealer and Intermediary Oversight

Re: No-Action Relief from the Commodity Pool Operator Registration Requirement for Commodity Pool Operators of Certain Pooled Investment Vehicles Organized as Business Development Companies

This is in response to correspondence (the “Correspondence”) received by the Division of Swap Dealer and Intermediary Oversight (“Division”) of the Commodity Futures Trading Commission (“CFTC” or the “Commission”) requesting clarification regarding CFTC Regulation 4.5¹ as applied to business development companies (“BDCs”).²

BDCs are entities created by, and subject to regulation under, the Investment Company Act of 1940 as amended (“ICA”). As a technical matter, a BDC is not “an investment company registered as such under the ICA” (“RIC”) as specified in CFTC Regulation 4.5, but instead is an entity exempt from registration under the ICA by virtue of the filing of an election to be treated as a BDC under Section 54 of the ICA. Therefore, because BDCs are not technically RICs, CFTC Regulation 4.5(a)(1) and (b)(1) as drafted do not apply to BDCs.

The Correspondence received by the Division made the following representations regarding the operation of BDCs. The Correspondence stated that BDCs are regulated like, and may employ swaps, futures contracts, or options on futures in substantially the same manner as, RICs. Further, the Correspondence also stated that BDCs qualify as “investment companies” under Section 3 of the ICA. According to the Correspondence, many BDCs have external advisers and, like advisers to RICs, such external advisers to BDCs must register with the Securities and Exchange Commission (“SEC”) as investment advisers under the Investment Advisers Act of 1940 as amended. Moreover, the Correspondence asserts that BDCs, like RICs, are subject to periodic examination by the SEC. Additionally, the Correspondence stated that

¹ 17 C.F.R. § 4.5.

² The Division received correspondence from Dechert LLP requesting interpretative guidance from the Division that Regulation 4.5 should apply to BDCs (“Dechert Letter”). Specifically, the Dechert Letter argued that relief was appropriate due to the limited use of derivatives by BDCs and the fact that BDCs are regulated in a substantially similar manner to registered investment companies, which are excluded from the definition of CPO by Regulation 4.5.

almost all BDCs are listed for trading on national securities exchanges and, thus, are subject to exchange rules governing listed companies, including investor protections. According to the Correspondence, BDCs, like RICs, must also comply with the disclosure and other requirements of the Securities Exchange Act of 1934 as amended, including filing with the SEC annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy solicitation statements in connection with annual stockholder meetings. Further, as stated in the Correspondence, BDCs must comply with the full panoply of regulations and corporate governance guidelines required under the Sarbanes-Oxley Act of 2002.

Moreover, the Correspondence stated, as a general matter, BDCs are likely to use swaps and other financial instruments (including other commodity interests) in a manner similar to, or even more closely tied to risk reduction and risk management than, RICs. The Correspondence also stated that RICs typically use derivatives as a source of leverage (to the limited extent RICs may use leverage under the ICA) to boost returns, to gain access to certain markets or assets in which they cannot invest directly, and to hedge, reduce, or manage interest rate, currency, credit, and other risks.³ Conversely, according to the Correspondence, BDCs are primarily engaged in investing in, and providing managerial assistance to, operating companies. Specifically, according to the Correspondence, BDCs are required to invest at least 70% of their assets in “eligible portfolio companies” (which are generally small or mid-sized U.S. companies that have no outstanding listed securities).⁴ The Correspondence also stated that BDCs typically limit their use of derivative instruments to interest rate and currency swaps, although they also may use credit default swaps and other commodity interests. The Correspondence also stated that, because BDCs invest primarily in private companies to which they are required to offer managerial assistance, BDCs generally use derivative instruments for the purpose of hedging, reducing, or managing investment and commercial risks.⁵ Furthermore, as stated in the Correspondence, Section 60 of the ICA⁶ requires BDCs to comply with the limitations on leverage placed upon RICs under Section 18 of the ICA,⁷ subject to certain modifications to the limitation on multiple classes of senior indebtedness securities and the asset coverage requirements.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010⁸ (“Dodd-Frank Act”) revised the definition of a commodity pool operator to include those accepting funds, securities, or property for the purpose of trading in, among other commodity interests, swaps.⁹ Based on these amendments, the CFTC determined that “any swaps activities undertaken by a CPO would result in that entity being required to register because there would

³ See *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, 76 FR 55237, 55238 (Sept. 9, 2011).

⁴ You note that swaps and other commodity interests do not qualify as securities of eligible portfolio companies.

⁵ A BDC must offer significant managerial assistance to its portfolio companies and is operated for the purpose of making investments in securities of eligible portfolio companies. See ICA §2(a)(48). The BDC must keep at least 70% of its investments in eligible assets. See ICA §55(a).

⁶ 15 U.S.C. 80a-60.

⁷ 15 U.S.C. 80a-18.

⁸ Pub. L. 111-203, 124 Stat. 1376-2223 (2010).

⁹ See Section 721(a) of the Dodd-Frank Act.

be no de minimis exclusion for such activity. As a result, one swap contract would be enough to trigger the registration requirement.”¹⁰

The Division believes that BDCs are properly considered commodity pools and, absent relief from the Division, a BDC’s operator would be required to register as a CPO.¹¹ Based on the foregoing representations submitted to the Division, however, the Division will not recommend that the Commission take an enforcement action against the operator of a BDC provided that the BDC satisfies the following criteria:

- The BDC has elected to be treated as a BDC under Section 54 of the Investment Company Act of 1940 with the SEC, and continues to be regulated by the SEC as a BDC; and:
- The BDC will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options, or swaps markets; and
- Either:
 - The BDC uses commodity futures or commodity options contracts, or swaps solely for bona fide hedging purposes within the meaning and intent of Rules 1.3(z)(1) and 151.5 (17 CFR 1.3(z)(1) and 151.5); provided, however, that in addition, with respect to positions in commodity futures or commodity option contracts, or swaps which do not come within the meaning and intent of Rules 1.3(z)(1) and 151.5, the aggregate initial margin and premiums required to establish such positions do not exceed five percent of the liquidation value of the BDC’s portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; and, provided further, 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) (17 CFR 190.01(x)) may be excluded in computing such five percent; or
 - The aggregate net notional value of commodity futures, commodity options contracts, or swaps positions not used solely for bona fide hedging purposes within the meaning and intent of Rules 1.3(z)(1) and 151.5 (17 CFR 1.3(z)(1) and 151.5), determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the BDC’s portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into.

¹⁰ Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11263, 11258 (Feb. 24, 2012) (corrected for unrelated reasons by 77 FR 17328 (Mar. 26, 2012)).

¹¹ Cf. Dechert Letter at 2 (“[B]ecause BDCs are not technically RICs, Regulation 4.5(a)(1) and (b)(1) as drafted do not apply to BDCs.”).

In granting CPOs the relief described herein, the Division seeks to strike the appropriate balance between the Commission's regulatory objectives and the operational circumstances facing certain specialized funds.

This no-action relief is not self-executing. Rather, a CPO that is eligible for the relief must file a claim to perfect the use of the relief. A claim submitted by a CPO will be effective upon filing, so long as the claim is materially complete. Specifically, the claim of no-action relief must:

- a. State the name, main business address, and main business telephone number of the BDCs for which the relief is being claimed;
- b. Be signed by a person authorized to bind the BDC;¹² and
- c. Be filed with the Division using the email address *dsionoaction@cftc.gov*, with "BDC" in the subject line of such email, prior to December 31, 2012 (for a BDC in operation as of December 1, 2012) or, for a BDC that begins to operate after December 1, 2012, within 30 days after it begins to operate as a BDC.

The position we have taken herein is based upon the representations that have been made to us. Any different, changed, or omitted facts or conditions might require us to reach different conclusions. In this connection, we request that you notify us immediately in the event any facts change in any way from those represented to us. This letter, and the positions taken herein, represent the view of this Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the CFTC.

Should you have any questions, please do not hesitate to contact Amanda Olear, Special Counsel, at 202-418-5283, or Ellie Jester, Special Counsel, at 202-418-5874.

Very truly yours,

Gary Barnett
Director,
Division of Swap Dealer
and Intermediary Oversight

cc: Regina Thoele, Compliance
National Futures Association, Chicago

¹² This may be accomplished through attaching a signed PDF statement from the CPO.