Invited Editorial

Is your investment management company regulated by the US CFTC?

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ABSTRACT In February 2012, the US Commodity Futures Trading Commission (CFTC) adopted new rules amending its registration and compliance requirements for entities deemed to be 'commodity trading advisors' (CTAs) or 'commodity pool operators' (CPOs). Owing to the changes, many previously exempt investment advisers and managers of private funds that trade derivatives (directly or indirectly through funds-of-funds or other vehicles) will be required to register with the CFTC as CTAs or CPOs. This article explains the CFTC's technical rule changes, describes other remaining exemptions for US and non-US CTAs and CPOs, and summarizes some of the compliance obligations and other practical consequences of registration for managers and advisers of private funds (whether based in the United States or outside of the United States) that directly or indirectly maintain exposure to regulated derivatives contracts. In particular, this article focuses on swaps trading, in light of changes to the regulatory regime for swaps simultaneously underway in the United States.

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Whether or not based in the United States, managers and advisers of funds that trade in swaps or listed futures contracts or commodity options must now determine whether, or to what extent, they are subject to regulations

by the US Commodity Futures Trading Commission (CFTC).

In February, the CFTC published new rules toughening the regulation of so-called 'commodity pool operators' (CPOs) and

‘commodity trading advisers’ (CTAs) while subjecting a broader range of private fund managers, including non-US fund managers, to regulation as CPOs and CTAs.¹ In the past, only trading listed futures and commodity options could trigger fund managers’ treatment as CPOs and CTAs. Now, due to the sweeping financial markets reform law passed in the United States in response to the financial crisis,² fund managers trading *swap* contracts will also become subject to the CFTC’s regulatory regime.³

The CFTC has explicitly declined to provide an exemption from the new regulations to non-US advisors – there is no analog to the foreign advisors exemption under the US Investment Advisers Act of 1940 (Advisers Act).⁴ The consequences of these changes may be particularly problematic for fund managers based outside the United States.

Any fund manager or trading advisor that trades derivatives would be well advised to ascertain whether any CPO and CTA registration exemptions are available or whether it may claim relief from a subset of the compliance obligations. Even a manager that is based outside of the United States or only uses swaps or other interests incidentally or for hedging purposes may be subject to registration and compliance obligations. This article briefly describes those obligations, highlighting the changes adopted by the CFTC in February.

REGULATION OF CPOS AND CTAS

Under the US Commodity Exchange Act (CEA),⁵ a ‘commodity pool’ is an investment pool that trades in listed futures contracts, commodity options and swaps, which are collectively referred to as ‘commodity interests’

(regardless of whether such trades reference underlying commodity assets).⁶ Absent an exemption, a pool operator or a person providing commodity interest trading advice must register with the CFTC and comply with various requirements under Part 4 of the CFTC regulations. These requirements include providing detailed disclosures to pool participants and advisees and periodic reports to the CFTC, participants and advisees, as well as keeping certain books and other records. A registered CPO or CTA is also subject to the regulation and examination of the National Futures Association (NFA), the self-regulatory organization of the US futures industry.

THE RESCINDED EXEMPTION – RULE 4.13(A)(4)

CFTC regulations have long provided various exemptions from the registration requirements (and relief from related obligations). One exemption, in particular, had been widely relied upon by US and non-US fund managers alike. Specified in rule 4.13(a)(4) under the CEA, the ‘All-QEPs Exemption’ generally applied to managers of funds whose investors are ‘qualified eligible persons’ (or ‘QEPs’) or institutional ‘accredited investors’, as defined under Regulation D (Reg D) promulgated under the US Securities Act of 1933 (Securities Act).

‘QEPs’ include many types of ‘non-United States persons’,⁷ among other entities and sophisticated US investors. That meant non-US fund managers generally could sell fund participations to any non-US persons and carefully screened US investors⁸ without concern that derivatives trading could trigger US registration obligations. For funds with broader US investor involvement, the All-QEPs

Exemption had the additional benefit of overlapping with commonly used exemptions from SEC registration for managers of so-called '3(c)(7)' and '3(c)(1)' private funds.⁹

The CFTC's February rule change rescinded this exemption. Private fund managers seeking limited US regulatory exposure therefore must look for other remaining exemptions.

OTHER EXEMPTIONS

Rule 4.13(a)(3) – The 'De Minimus Exemption'

This exemption is available to any CPO operating a pool where, among other requirements:

1. the pool interests are offered only to 'accredited investors' as defined under Reg D; and
2. *either*:
 - (a) the pool's aggregate initial margin and premiums required to establish its commodity interest positions do not exceed 5 per cent of the liquidation value of the pool's portfolio (after taking account of unrealized gains or losses on such positions); or
 - (b) the aggregate net notional value of the pool's commodity interest positions does not exceed 100 per cent of the liquidation value of the pool's portfolio (after taking account of unrealized gains or losses on such positions).¹⁰

This exemption may not be as easy to use as it seems. For example, as the trading threshold prong of the exemption must be met at all times, a CPO could lose this exemption in a volatile market where the liquidation value of the pool's

portfolio drops dramatically, resulting in the registration threshold being crossed even if the initial margin or net notional value of the positions remain unchanged.

Rules 30.4 and 30.5 – Exemptions for non-US market participants

If limiting its commodity interest trading to futures or options contracts listed on a non-US exchange, a CPO or CTA may rely on the registration exemptions provided under Part 30 of the CFTC regulations. Specifically, rule 30.4 includes a carve-out from registration obligations for a CPO trading such foreign contracts if (among other requirements) the pool is located outside the United States and no more than 10 per cent of the participants in the pool are, and no more than 10 per cent of pool's value is held by, US persons.

In addition, rule 30.5 allows CPOs and CTAs based outside the United States that would otherwise be required to register to apply for an exemption.¹¹ This exemption requires a non-US firm to file an 'Exempt Foreign Firm Form 7-R' through the NFA's Web site, submit background and fitness information, make certain representations to the NFA, submit to US legal jurisdiction and appoint the NFA (or certain others) as its agent for service of process. The firm can only rely on this exemption if the NFA confirms its application.

Non-US CPOs and CTAs must be mindful of the narrow scope of these exemptions: neither is available to a CPO or CTA trading futures and commodity options listed on US exchanges or any swaps. Therefore, for example, a non-US CPO or CTA that trades swaps based on indices of non-US securities would not be able to use these Part 30 exemptions.

Rules 4.14(a)(8) and 4.14(a)(10) – Exemptions for private CTAs

Fund advisors that provide commodity trading advice may be exempt from CTA registration if they undertake only limited commodity interest trading advice or few advisory relationships.

Under rule 4.14(a)(8), a CTA that is registered (or exempt from registration) as an investment adviser under the Investment Advisers Act and provides commodity interest trading advice solely *incidental* to other investment advice, without holding itself out as a CTA, will be exempt from registration provided that it maintains only tangential involvement with US investors. In particular, (i) the CTA's advice must be directed solely to commodity pools organized and operated outside of the United States, (ii) advised pools must not have been organized or be operated by a CPO for the purpose of avoiding CPO registration, (iii) the pools must not be marketed from within the United States or to US persons, (iv) only non-US persons (other than the pool's CPO, CTA or their principals) may participate in the CPO's pools, and (v) US persons who are not QEPs must own less than 10 per cent of the beneficial interest in a given pool.

In addition, rule 4.14(a)(10) under the CEA (and Section 4m(1) thereof) exempt CTAs that have not advised more than 15 clients in the past 12 months and do not hold themselves out to the general public as CTAs.

REGISTRATION AND ITS CONSEQUENCES

Filing and NFA membership

Any CPO and CTA that is not exempt must register with the CFTC and NFA by filing a

'Form 7-R' for itself and a 'Form 8-R' for each of its 'associated persons' and 'principals'.¹² In addition, associated persons and principals must submit fingerprint cards to the NFA, and associated persons generally must pass the National Commodities Futures Examination's 'Series 3' exam.¹³

A registered CPO or CTA is subject to the compliance obligations of Part 4 of the CFTC's regulations. In general, these include (i) delivery of disclosure documents with required information to prospective pool participants, (ii) delivery of account statements to pool participants, (iii) periodic reporting to pool participants and the NFA, and (iv) maintenance of specific (and broadly drawn) categories of books and records.¹⁴

In connection with the registration process, a registrant will also become a member of the NFA that is subject to the NFA's professional conduct rules (including rules regarding customer solicitation and use of promotional materials), document retention rules, internal self-examination requirements and mandatory periodic reporting. Disclosure documents generally must be submitted to the NFA for review before their public dissemination. NFA members are subject to NFA compliance audits.

Form CPO-PQR and Form CTA-PR

The CFTC's new rules also require registrants to file periodic reports on 'Form CPO-PQR' or 'Form CTA-PR' (as applicable) beginning in late 2012 or early 2013 (for large CPOs and all others, respectively).¹⁵

Form CPO-PQR must be filed quarterly for CPOs with pool assets over \$1.5 billion but only annually for all others. Three schedules set forth information required to be included in Form

CPO-PQR. Other than portions of Schedule A, Form CPO-PQR is not subject to public disclosure.

Schedule A must be completed by *all* registered CPOs. It solicits basic information about the CPO and specific information about the pools, including its pools' key relationships and investment positions. The information requested by Schedule A is not materially different from that already collected from registered CPOs by the NFA.

Schedule B must be completed by a CPO with pool assets under management of at least \$150 million unless that CPO has already filed similar information for the funds it operates with the SEC (on what is known as Form PF). Schedule B solicits information regarding the investment strategy, significant borrowings, counterparty exposure and clearing entities used by the pools operated by the subject CPO.

Schedule C must be completed by CPOs with pool assets under management of at least \$1.5 billion, and like Schedule B it is not required if the covered funds' relevant data already are reported on Form PF. Schedule C solicits information about aggregate portfolios of the pools and certain risk metrics about any large pool.

The size of a pool's assets under management, which determines its reporting requirements, is measured at the close of business on each day. If a pool's assets cross any of the thresholds described above, its CPO would become subject to heightened reporting requirements for the current reporting period. This may present administrative difficulties for CPOs, as they may need to prepare additional reports on a higher frequency with little advance notice.

All CTAs are required to complete Form CTA-PR annually. Form CTA-PR requires less

information than Form CPO-PQR, collecting generally only basic demographic information related to CTA and the names of its advisees. Data supplied on Form CTA-PR is expressly subject to public disclosure, except for that portion naming pools advised by the CTA.

EFFECTIVE DATE

The CFTC's new rules largely took effect on 24 April 2012. However, for any CPO that would be exempt from registration but for its swap trading activities, the registration requirements will not take effect until after US regulators publish final definitions for the term 'swap'.¹⁶ CPOs and CTAs that have been relying on the 'All-QEPs Exemption' have until the end of 2012 to register if another exemption is not available.

CONCLUSION

The CFTC's elimination of the 'All-QEPs Exemption' likely will necessitate the registration of many fund managers and advisors. Attention to this rule change is especially important given that it coincides with the implementation of the Dodd-Frank Act's mandates subjecting swaps to CFTC regulation as commodity interests. Any manager of a fund or trading advisor that executes derivatives contracts – *even a non-US manager that uses swaps or other interests only incidentally or solely for hedging purposes* – would be well advised to review its fund's or client's trading activities (and the trading activities of any master funds in which it invests) and fund participation structure to ascertain whether any CPO and CTA registration exemptions are available or whether it may claim relief from a subset of the compliance obligations. If

registration is required, the firm will need to establish new reporting, disclosure and internal compliance procedures required under CFTC regulations. By considering US registration requirements now, managers and advisors, US and non-US alike, will be better able to structure their funds' activities with a view to avoiding US regulation or, where registration is necessary, will be better prepared to meet the compliance obligations imposed by the CFTC and the NFA.

NOTES

1. See CPOs and CTAs: Compliance Obligations, 77 Fed. Reg. 11252 (24 February 2012).
2. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203 (21 July 2010) (Dodd-Frank Act).
3. See Section 721 of the Dodd-Frank Act (adding to the US Commodity Exchange Act (CEA) a definition of 'commodity pool' and amending existing definitions of 'CPO' and 'CTA', in each case, with express references to trading 'commodity interests' including 'swaps').
4. See 77 Fed. Reg. 11252, 11263-64.
5. The CEA is the primary code governing the CFTC regulation of the US markets for commodity futures contracts, options on futures contracts, retail off-exchange forex contracts and, now, most swaps. The CFTC and US Securities and Exchange Commission (SEC) jointly regulate futures based on single securities or narrow-based indexes of securities. The SEC also generally has sole authority over *security-based* swaps, which are distinct from 'swaps' for the purposes of most CFTC regulations and this article.
6. The CFTC also views funds of funds and feeder funds as commodity pools if they invest in other, unaffiliated commodity pools.
7. A 'Non-United States person' that is a QEP includes:
 - (i) a natural person who is not a US resident;
 - (ii) a partnership, corporation or other entity, other than an entity organized principally for passive investment, organized under the laws of a foreign jurisdiction and which has a non-US principal place of business;
 - (iii) an estate or trust, the income of which is not subject to United States income tax;
 - (iv) an entity organized principally for passive investment; provided, that units of participation in the entity held by persons who do not qualify as non-United States persons or QEPs represent less than 10 per cent of the beneficial interest in the entity (and that such entity was not formed principally for the purpose of facilitating investment by persons who do not qualify as non-United States persons); and
 - (v) a pension plan for the employees, officers or principals of an entity organized and with its principal place of business outside the United States.
 See 17 C.F.R. §4.7(a)(1) (2011).
8. See 17 C.F.R. §§4.7(a)(2), (3) (2011). Notable examples of persons or entities included within the definition of 'QEP' are (in addition to non-United States persons):
 - (i) A registered futures commission merchant or retail foreign exchange dealer.
 - (ii) A registered broker dealer.
 - (iii) A registered CPO or CTA that has been registered for more than 2 years

- or which operates a pool, or advises commodity accounts, having total assets in excess of \$5 000 000.
- (iv) A registered investment adviser that has been registered for more than 2 years or advises securities account having total assets in excess of \$5 000 000.
 - (v) A 'qualified purchaser' as defined under the Investment Company Act.
 - (vi) A 'knowledgeable employee' as defined in Rule 3c-5 under the US Investment Company Act of 1940 (Investment Company Act).
 - (vii) The CPO, CTA or investment adviser of the pool offered or sold, a principal thereof, his or her immediate family members.
 - (viii) A trust or an organization such as a foundation, if the trustee or other person making the investment decision, and each person establishing the trust or organization, is a QEP.
 - (ix) An entity in which all of the unit owners or participants are QEPs.
9. These private funds (including many hedge funds) are investment vehicles that are exempt from registration as investment companies under Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Before the implementation of the Dodd-Frank Act, many investment advisers of these private funds were also exempt from SEC registration under the 'private adviser exemption' of Section 203(b)(3) of the Advisers Act. (Section 403 of the Dodd-Frank Act has since mandated the rescission of this private fund adviser exemption.)
A fund qualifies as a 3(c)(7) private fund only if all investors are 'qualified purchasers' under Section 2 of the Investment Company Act. As qualified purchasers are 'QEPs' per rule 4.7 under the CEA, a 3(c)(7) fund adviser would be an exempt CPO with respect to that fund under the All-QEPs Exemption.
A fund qualifies as a 3(c)(1) private fund if it is sold to natural and non-natural persons that are 'accredited investors' (as defined under Reg D). This is a lower qualification threshold than the 'qualified purchaser' requirement, and it therefore allows such a fund access to a broader universe of potential fund investors. The 'All-QEPs Exemption' allowed 'accredited investors', but only to the extent they were institutions and *not* natural persons.
- 10. See 17 C.F.R. §4.13(a)(3) (2011). CFTC commentary provides additional guidance as to the application of the 'net notional test' of its rule 4.13(a)(3)(ii)(B) and the permissibility of netting swaps cleared by the same clearing house. See 77 Fed. Reg. 11252, 11262-3.
 - 11. A CPO or CTA exempt from registration under rule 30.5 under the CEA nonetheless must provide US pool participants or clients with certain minimum risk disclosures. See 17 C.F.R. §30.6.
 - 12. An CPO associated person is broadly defined to include any person who 'solicit[s] funds, securities, or property for participation in a commodity pool' and anyone in the line of supervisory authority over such a person. A CTA associated person is any person who 'solicit[s] a client's or prospective client's discretionary account' and persons in the line of supervisory authority. See 17 C.F.R. §§1.3(aa)(3), (4). The NFA provides an extensive list on Form 8-R of persons who are principals based on

their economic or control rights or job titles and capacities at a CPO or CTA.

13. A person registered or licensed to solicit customer business in the United Kingdom or Canada may take the Series 32 exam rather than the Series 3 exam. The NFA's securities-related counterpart, the Financial Industry Regulatory Authority, administers these exams in several major financial centers outside of the United States. United States embassies and sometimes local law enforcement agencies are usually able to assist with the preparation of fingerprint cards.

14. Relief from some, but not all, of these compliance obligations, may be available to registered CPOs or CTAs with eligible pools or clients. For example:

- (i) If a pool's participants are all QEPs, its CPO may be eligible for rule 4.7's 'lite touch' regime, which provides relief from most disclosure and record-keeping requirements and less formal financial reporting requirements.
- (ii) If a pool's commodity interest trading is incidental to its securities trading activities, and the aggregate value of initial margin, premiums and security deposits posted does not exceed 10 per cent of the fair market value of the pool assets, its CPO may be able to use alternative disclosure documents and

financial reports under rule 12(b) under the CEA.

- (iii) For non-US pools with no US investors, a CPO may be relieved from certain disclosure, periodic reporting and financial statements production obligations under long-standing CFTC advisory relief. *See* CFTC Advisory 18-96, Offshore Commodity Pools Relief for Certain Registered CPOs (11 April 1996).

15. *See* 17 C.F.R. §4.27.

16. Many of the Dodd-Frank Act's requirements addressing 'swaps' are unlikely to take effect until the effective date of any final CFTC rule defining the term 'swap'. *See* CFTC Final Order, Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (19 July 2011) and CFTC Final Order, Amendment to 14 July 2011 Order for Swap Regulation, 76 Fed. Reg. 80233 (23 December 2011). However, the CFTC's February rule change did not directly address this absence of definitions for 'swaps'. As a result, there is some ambiguity as to whether, in the near term, swaps trading should be considered for determining whether CPO and CTA definitional requirements are met and whether registration exemptions that are contingent on a pool's limited use of commodity interests should include swaps as commodity interests.

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