CFTC Clarifies and Expands Relief Relating to Delegation of Commodity Pool Operator Responsibilities

U.S. Investment Management Alert

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Introduction

On October 15, 2014, the Division of Swap Dealer and Intermediary Oversight (the “Division”) of the Commodity Futures Trading Commission (“CFTC” or “Commission”) issued CFTC No-Action Letter No. 14-126 ("Letter 14-126"), which sets forth a number of conditions with which commodity pool operators (“CPOs”) that delegate their CPO responsibilities (the “Delegating CPO”) to registered CPOs (the “Designated CPO”) must comply in order to take advantage of no-action relief from the requirement to register as a CPO. The CPO community has anxiously awaited this letter because it clarifies the activities in which a Delegating CPO may engage and still qualify for relief from the requirement to register as a CPO. Essentially, the Letter makes more liberal several of the conditions set forth in CFTC Letter No. 14-69 (May 12, 2014) (“Letter 14-69” and, together with Letter 14-126, the “Letters”), with which many Delegating CPOs could not comply. In addition, Letter 14-126 makes the relief self-executing, i.e., no form requesting relief or even a notice need be filed.

As a result of Letter 14-126, the Division will no longer consider requests for CPO registration no-action relief pursuant to the streamlined no-action letter process described in Letter 14-69, and persons with pending requests should instead consult with counsel and assess whether they are entitled to the self-executing relief provided by Letter 14-126. However, any person who received a no-action letter pursuant to Letter 14-69, or any prior Staff Letter issued by the Division with respect to CPO registration relief for a Delegating CPO, may continue to rely on that relief.

The Division states that it recognizes that Letter 14-126 will eliminate the need for many, but not all, Delegating CPOs to apply for individualized no-action relief, and that it intends to continue to evaluate requests for individualized relief from persons that cannot meet the conditions in Letter 14-126.

The Modified Conditions

Letter 14-126 clarifies the permissible activities in which a Delegating CPO seeking to take advantage of registration no-action relief may engage regarding investment management.

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1 Letter 14-69 is discussed in a prior Client Alert, which may be accessed by clicking here.
2 An Attachment to Letter 14-69 provided a form no-action request letter that could be submitted to the Division. The Delegating CPO simply needed to provide identifying information regarding itself, the Designated CPO and the pools in issue, together with representations that the applicable conditions were met. The intent was for the Division to respond separately to each form request submitted.
CFTC Clarifies and Expands Relief Relating to Delegation of Commodity Pool Operator Responsibilities

solicitation and management of pool property. Accordingly, the first condition of relief ("Criterion" and, collectively, "Criteria"), which is composed of three sub-parts, reads as follows, with the clarifying text added by Letter 14-126 in bold:

1. a. Pursuant to a legally binding document, the Delegating CPO must delegate to the Designated CPO all of its investment management authority with respect to the commodity pool at issue. Letter 14-126 clarified that this condition may be satisfied if: (i) a Delegating CPO or the Designated CPO appoints one or more third parties to serve as investment manager(s) of the pool; and (ii) each such third party investment manager is registered as a commodity trading advisor ("CTA") or is exempt from such registration pursuant to the Commodity Exchange Act ("CEA") or the Commission’s regulations;

b. The Delegating CPO does not participate in the solicitation of participants for the pool. Letter 14-126 clarified that this condition may be satisfied if: the Delegating CPO: (i) is registered as an associated person ("AP") of the Designated CPO or is exempt from registration as such pursuant to the CEA or the Commission’s regulations; and (ii) participates in the solicitation of pool participants solely in its capacity as an AP of the Designated CPO;

c. The Delegating CPO does not manage any property of the pool. Letter 14-126 clarified that this condition may be satisfied if: the Delegating CPO: (i) is a principal or employee of the Designated CPO or of a CTA of the pool at issue; and (ii) has management responsibilities over pool property; provided further, however, that such Delegating CPO: (1) exercises these management responsibilities solely in the capacity of a principal or employee of the Designated CPO or as a CTA of the pool and not as the Delegating CPO of the pool; and (2) in connection with exercising these management responsibilities, is subject to supervision as a principal or an employee by either the Designated CPO or a CTA of the pool in accordance with Regulation 166.3. For purposes of this Criterion, management of pool property does not include responsibilities with respect to pool property of an administrative, clerical or ministerial nature.

The remaining Criteria from Letter 14-69 are carried over and reiterated in Letter 14-126 and are summarized below. Note, however, that the fifth Criterion no longer specifies (as did Letter 14-69) that the Delegating CPO’s books and records need to be maintained by the Designated CPO in accordance with Regulation 1.31, the regulation setting forth general requirements for all books and records required to be kept under the CEA and regulations.

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3 The Division stated that the legally binding document could include, without limitation, a separate delegation agreement, a document that establishes the pool, or an investment management agreement between the Delegating CPO and the Designated CPO.

4 CFTC Regulation 166.3 is the general supervisory regulation that requires CPOs, CTAs and other registrants to diligently supervise the activities of their partners, officers, employees and agents relating to their business as registrants.
CFTC Clarifies and Expands Relief Relating to Delegation of Commodity Pool Operator Responsibilities

The condition now simply requires that such records be maintained by the Designated CPO, but without any specific reference to the manner in which they must be maintained. The remaining criteria in the letter are as follows:

2. The Designated CPO must be registered as a CPO.
3. The Delegating CPO must not be subject to a statutory disqualification under Section 8a(2) or 8a(3) of the CEA.  
4. There must be a business purpose for the Designated CPO being a separate entity from the Delegating CPO that is not solely to avoid registration by the Delegating CPO under the CEA and the Commission’s regulations.
5. The books and records of the Delegating CPO with respect to the commodity pool must be maintained by the Designated CPO.
6. If the Delegating CPO and the Designated CPO are each a non-natural person, then one such CPO must control, be controlled by, or be under common control with the other CPO.
7. If a Delegating CPO is a non-natural person, then such Delegating CPO and the Designated CPO must have executed a legally binding document whereby each undertakes to be jointly and severally liable for any violation of the CEA or the Commission’s regulations by the other in connection with the operation of the commodity pool.
8. If a Delegating CPO is a natural person and is not an Unaffiliated Board Member (as defined below), then such Delegating CPO and the Designated CPO must have executed a legally binding document whereby each undertakes to be jointly and severally liable for any violation of the CEA or the Commission’s regulations by the other in connection with the operation of the commodity pool.
9. If a Delegating CPO is an Unaffiliated Board Member, then such Delegating CPO must be subject to liability as a board member in accordance with the laws under which the commodity pool is established.

Analysis and Limitations of this Relief

The Division states that it intended this relief to apply to certain fact patterns that it encounters regularly in no-action requests. For example, one criterion to qualify for relief is that, if the Delegating CPO and Designated CPO are each non-natural persons, then one CPO must control, be controlled by, or be under common control with the other CPO. Many

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5 A firm’s registration may be denied, revoked or conditioned if: a prior registration has been denied, revoked or is currently suspended; the firm has been found to have violated any provision of, or is subject to an injunction related to, the securities or commodities laws; the firm has been convicted of a felony or a misdemeanor related to futures, securities, or certain enumerated crimes, involving matters such as fraud or theft; the firm is subject to an outstanding order denying or suspending membership in a contract market or registered futures association; the firm has made willful misstatements or omissions of material facts in its application for registration; or the firm has been barred from contracting with the United States. The CFTC may also deny registration for “other good cause,” and, if a principal of a firm is subject to any of these disqualifications, the CFTC may deem the firm itself to be unfit.

6 Some appropriate reasons that the Division referred to in Letter 14-69 include for separate asset management purposes, tax-related reasons, to account for different ownership and compensation arrangements, or to comply with licensing requirements in other jurisdictions.
CFTC Clarifies and Expands Relief Relating to Delegation of Commodity Pool Operator Responsibilities

pools utilize separate, but affiliated, investment advisers and general partners or managing members, and will readily meet this condition.7 The Division also requires that these affiliated entities enter into a legally binding document whereby each undertakes to be jointly and severally liable for any violation of the CEA or the CFTC’s regulations thereunder by the other in connection with the operation of such pool, which should be a fairly noncontroversial requirement for affiliated entities.

The Division similarly states that it intended this relief to apply to a Delegating CPO who is a natural person and an “Unaffiliated Board Member,” which the Division defined in the Letter as a natural person who is a voting member of a board of directors or an equivalent governing body of the commodity pool who: (i) is not a member of the management or an employee of the Designated CPO, or any affiliate thereof; (ii) is not a substantial8 beneficial owner of the Designated CPO, or any affiliate thereof, or of any company holding more than 5% of such Designated CPO’s beneficial ownership interests, or any affiliate thereof; and (iii) has no other interest or relationship that could interfere with his/her ability to act independently of management of the Designated CPO or any affiliate thereof or of any company holding more than 5% of such Designated CPO’s beneficial ownership interests or any affiliate thereof.9 For Delegating CPOs who are Unaffiliated Board Members, the Division does not require the Delegating CPO to be jointly and severally liable with the Designated CPO, although the Delegating CPO will remain subject to liability as a board member in accordance with the laws under which the pool is established.10 Given that certain facts relevant to the independence analysis may not be readily determined, Designated CPOs would be well-advised to request certificates from their Unaffiliated Board Members confirming their independence.

Conclusion

The Division, by issuing Letter 14-126, has provided welcome clarifications regarding activities of Delegating CPOs that take into account the operations of many private funds. Designated CPOs that are also registered or exempt as APs of the Designated CPO can continue to solicit in accordance with such registration or exemption, and to manage pool property in accordance with the status of being an employee or principal of the Designated CPO or of the pool’s CTA and, thereby, subject to supervision by such entity. The elimination of the specific reference to Regulation 1.31 regarding the maintenance of the Designated CPO’s records should also address concerns of Designated CPOs. The Division

7 However, neither of the Letters addresses circumstances where a Delegating CPO that is an entity, such as a corporate trustee of a Delaware statutory trust or a Cayman Islands unit trust, is not affiliated with the Designated CPO.
8 The Division did not provide any guidance in the Letters as to what threshold would constitute “substantial” beneficial ownership.
9 The Division provided the following guidance in the Letters with respect to this requirement:
[W]hether a director has an interest or relationship under clause (iii) will be based on the relevant facts and circumstances. For example, interests or relationships that are indicative of an affiliation with the Designated CPO that could trigger clause (iii) may include: the director being a material service provider or investment counterparty to the Designated CPO or any of its affiliates, or is, or within the past three years was, employed in an executive capacity by, or was a principal or employee of, a material service provider or investment counterparty to, the Designated CPO or any of its affiliates.
10 Care must be taken to determine whether directors work for an entity that is a service provider to the Designated CPO or one of its affiliates, or whether the director only works for an affiliated company of the service provider. In addition, board members who (i) are not Unaffiliated Board Members (i.e., they are affiliated with the Designated CPO) and (ii) do not engage in the prohibited activities described above, are required to enter into a legally binding document with the Designated CPO whereby each undertakes to be jointly and severally liable for any violation of the CEA or the CFTC’s regulations thereunder by the other in connection with the operation of such pool.
CFTC Clarifies and Expands Relief Relating to Delegation of Commodity Pool Operator Responsibilities

has now also eliminated the need for the filing of separate form request letters and conserved its own resources by obviating the need for separate responses to such requests. Nevertheless, not all circumstances have been addressed (see note 7 above), so CPOs that cannot meet the conditions in Letter 14-126 may be required to seek individualized no-action relief from the registration requirement, although there is no assurance that such individualized relief will be granted.

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