

CFTC PROPOSES TO CODIFY RELIEF FOR CPOS AND CTAS

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Investment Management Alert

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INTRODUCTION

The U.S. Commodity Futures Trading Commission (“CFTC” or “Commission”) is proposing amendments to its regulations governing commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”) to codify certain relief previously granted through an Advisory and Staff Letters (“Proposals”) [1]. The Proposals would affect not only registered CPOs and CTAs, but also persons exempt from registration as a CPO or CTA, including offshore CPOs/CTAs, business development companies (“BDCs”) and their investment advisers (“IAs”), and “family offices.” The Proposals would: (1) permit CPOs that only solicit and/or accept funds from non-U.S. investors to claim a new exemption from registration and compliance requirements with respect to such pools; (2) permit U.S.-based CPOs of offshore commodity pools with U.S. participants to maintain the pool's original books and records in the pool's offshore location; (3) provide registration relief for the CPOs and CTAs of entities qualifying as family offices and IAs of BDCs; (4) permit qualifying CPOs to engage in general solicitation with respect to their pool offerings, as contemplated by the Jumpstart Our Business Start-ups Act of 2012 (“JOBS Act”); (5) relieve certain CPOs and CTAs of the requirement to file Forms CPO-PQR and CTA-PR; and (6) require CPOs claiming exemption from registration to represent that they are not subject to statutory disqualification from registration under Sections 8a(2) or 8a(3) of the Commodity Exchange Act (“CEA”) [2]. The proposals result from an agency-wide internal review of CFTC regulations and practices to identify those areas that could be simplified to make them less burdensome that was initiated in March 2017 and is known as “Project KISS.”

OFFSHORE POOLS/NON-U.S. PERSONS

Offshore Pools

The CFTC proposes to adopt a new Regulation 4.13(a)(4) to supersede the regulatory relief provided by Advisory 18-96 (“Advisory”) [3]. The Advisory required the CPO to be registered to qualify for relief from much of the regulatory requirements applicable to CPOs.

Under the Proposals, registration would not be required to claim the relief, so long as the other conditions of the Advisory were satisfied [4]. The CFTC is proposing to provide the relief on a pool-by-pool basis so that a CPO could claim exemption for certain pools that it operates under existing Regulation 4.13(a)(3) and for others under new Regulation 4.13(a)(4), or register as a CPO and operate some pools pursuant to that registration and also claim exemption for some pools under new Regulation 4.13(a)(4). The Commission stated that it “preliminarily believes that [the Proposals], if adopted, would ultimately provide more comprehensive relief from CPO and pool regulation than the Advisory alone and more flexibility than the terms of [CFTC Regulation] 3.10(c)(3)(i).” CFTC

Regulation 3.10(c)(3) permits a person located outside of the United States and acting solely as a CPO on behalf of persons located outside of the United States to claim exemption from CPO registration, an exemption that is self-executing and thus requires no notice filing. However, it is unclear from the preamble to the Proposals whether the CFTC believes that a person can claim exemption from CPO registration for certain pools under CFTC Regulation 3.10(c)(3) and for other pools under Regulation 4.13(a)(3), if the latter had U.S. investors. It is therefore uncertain how flexible the proposed new Regulation 4.13(a)(4) is compared to the existing exemption.

Determining Exemption Eligibility

The former Regulation 4.13(a)(4), which the CFTC repealed in 2012 [5], provided that a CPO claiming exemption from registration thereunder could do so if it reasonably believed, at the time of investment (or, in the case of an existing pool, at the time of conversion to the status meeting the criteria of the exemption), that all pool participants met the criteria needed for the CPO to claim exemption. Such a “reasonable belief” provision is not included in the proposed new Regulation 4.13(a)(4), which could require a CPO claiming exemption thereunder to continuously monitor the status of its pool participants at all times, not only at the time of investment, as well as the source of investors' funds.

Non-U.S. Person Definition

Additionally, the Proposals would amend the *de minimis* commodity pool exemption in Regulation 4.13(a)(3) to explicitly permit non-U.S. person participants, regardless of their financial sophistication. The CFTC recognizes that market participants, relying on CFTC Staff Letter 04-13 [6], are generally not considering whether non-U.S. person participants meet one of the investor sophistication criteria listed in Regulation 4.13(a)(3)(iii). The CFTC appears to be using the definition of “non-United States person” in this context that is set forth in CFTC Regulation 4.7(a)(1)(iv) [7]. However, the regulatory text of the Proposals does not do so explicitly, and CFTC Regulation 4.7 states that the definitions therein are for the purposes of that regulation. Even if the CFTC were to explicitly cross-reference the definition in Regulation 4.7, that definition is not synonymous with the term's usage in the context of CFTC Regulation 3.10(c)(3), the CFTC's swaps regulations [8], Regulation S of the United States Securities and Exchange Commission (“SEC”) [9], or the regulations of the Internal Revenue Service (“IRS”). Consequently, issues could arise with respect to existing 4.13(a)(3) pools that have not explicitly referenced the non-U.S. person definition in Regulation 4.7.

Location of Books and Records

Separately, the Proposals include an amendment to CFTC Regulation 4.23 to add a new paragraph (c) thereto that would permit registered CPOs whose main business office is located in the United States and that are operating offshore pools to claim relief from the requirement in that regulation that all books and records concerning the pool and the CPO be kept at the CPO's main business office, provided that the person meets the conditions thereunder incorporated from the Advisory and enhanced to conform to other recordkeeping relief [10].

FAMILY OFFICES

The Proposals would codify registration exemptions, in proposed new Regulations 4.13(a)(8) and 4.14(a)(11), respectively, consistent with two Commission staff no-action letters that currently provide relief from CPO [11] and CTA [12] registration to qualifying family offices (“Family Offices”) with respect to investment management and advisory activities conducted on behalf of their family clients. This relief follows similar relief provided by the SEC in its Regulation 275.202(a)(11)(G)-1 under the Investment Advisers Act of 1940. Consistent with its statements in

prior rulemakings impacting Family Offices, the CFTC stated that Family Offices unable to meet the requirements of the exemptions in the Proposals may still avail themselves of the relief provided in CFTC Regulation 4.13(a)(3), if they so qualify, or they may continue to seek relief on an individual, firm-by-firm basis through requests submitted to CFTC staff.

BDCS

The Proposals would amend CFTC Regulation 4.5 to include IAs of BDCs under paragraph (a) as a type of entity that is excluded from the CPO definition with respect to the operation of a “qualifying entity” and to include BDCs as a type of “qualifying entity” under paragraph (b). Because BDCs are similarly situated to registered investment companies (“RICs”), although they are eligible for exemption from investment company registration under the Investment Company Act of 1940, the CFTC proposes that IAs of BDCs be subject to the same operational requirements as CPOs of RICs, an approach consistent with that taken by Commission staff through the BDC No-Action Letter [13]. Because the CPOs of both RICs and BDCs would be their IAs, the CFTC also proposes revising Regulation 4.5(a)(1) to refer to the registered IA, rather than the investment company itself, as the entity claiming the CPO exclusion. Because of the similarities between BDCs and RICs, the CFTC proposes that IAs of BDCs be required to reaffirm their CPO exclusion claim on an annual basis, which is consistent with the existing requirements for IAs of RICs. Finally, the CFTC concludes that the existing language in Regulation 4.6 should be sufficient to provide exclusionary relief for IAs of BDCs with respect to the CTA definition without additional proposed amendments.

JOBS ACT

The Proposals would provide additional regulatory harmonization with SEC regulations, consistent with the JOBS Act Relief Letter [14], through specific amendments to CFTC Regulations 4.7(b) [15] and 4.13(a)(3) regarding restrictions on marketing and solicitation. In Regulation 4.7, the paragraph (b) introductory text currently sets forth the eligibility requirements for registered CPOs claiming regulatory relief thereunder with respect to certain pools that they operate. The Commission proposes to remove the reference, in the provision requiring pool participation interests to be exempt from registration under the Securities Act of 1933, to “section 4(2) of the Securities Act,” to remove references to the act of “offering” the Regulation 4.7 exempt pool, and to delete the text “without marketing to the public.” The Commission intends that these amendments would permit CPOs claiming the exemptive relief in Regulation 4.7(b) to engage in general solicitation or marketing, if eligible to do so under their securities law exemptions. The Proposals would make similar amendments to the conditions related to marketing of participation interests for pools where the CPO seeks to claim exemption from registration in accordance with CFTC Regulation 4.13(a)(3).

REPORTING REQUIREMENTS

The Proposals would amend CFTC Regulation 4.27 in a manner consistent with the exemptive relief currently made available in CFTC Staff Letters 14-115 [16] and 15-47 [17]. Those letters provide that (1) CPOs that operate only pools for which they are otherwise excluded from the CPO definition under Regulation 4.5, or exempt from CPO registration in accordance with Regulation 4.13, are not required to file a Form CPO-PQR, and (2) CTAs that do not direct client accounts are not required to file a Form CTA-PR [18].

Additional Relief

The Proposals would also expand the relief granted by Staff Letter 15-47 by exempting from the requirement to file a Form CTA-PR any CTA that is exempt from registration pursuant to CFTC Regulation 4.14(a)(4) or (a)(5). Regulation 4.14(a)(4) exempts from CTA registration a registered CPO that provides advice to pools that it operates; Regulation 4.14(a)(5) exempts from CTA registration a CPO that is exempt from registration as a CPO and that provides advice to pools that it operates. In the former case, the registered CPO is required to file Form CPO-PQR with respect to a pool that it operates, so filing a Form CTA-PR would be duplicative and inefficient. In the latter case, the exempt CPO is not required to file Form CPO-PQR with respect to a pool that it operates, so it would be incongruous to require the filing of a Form CTA-PR with respect to that pool.

STATUTORY DISQUALIFICATIONS

CEA Sections 8a(2) and (3) authorize the CFTC to deny, condition, suspend, restrict, or revoke the registration of a CPO or CTA. The more egregious grounds for adverse action are set forth in CEA Section 8a(2), which provides authority for any adverse action except revocation to be taken without a hearing [19]. Adverse action based upon CEA Section 8a(3) requires a hearing, and in practice the CFTC and NFA have provided applicants and registrants a hearing in all cases before taking adverse action.

Additional Condition to Claiming Exemption

Currently, none of the CPO registration exemptions in CFTC Regulation 4.13 prohibits being subject to a statutory disqualification as a condition of relief. In contrast, one of the requirements to obtain relief under the Advisory, which is the basis for the proposed new Regulation 4.13(a)(4), is that neither the registered CPO nor its principals are subject to any statutory disqualification under CEA Sections 8a(2) or 8a(3) unless such disqualification arises from a matter that was previously disclosed in connection with a previous registration application, if such registration was granted, or which was disclosed more than thirty days prior to the claim of this exemption. As a new requirement, the Proposals would apply the statutory disqualification condition not only to the new registration exemption based upon the Advisory, but to the other grounds for claiming exemption under CFTC Regulation 4.13, except for the new Family Office exemption. The CFTC does not further explain how such disclosure and a hearing to resolve potential disqualifications outside of the registration application process would work.

Applicable to Those Who Have Already Claimed Exemption

Accordingly, the Proposals require any person claiming a registration exemption under Regulation 4.13(a)(1), (2), (3), or (5), or proposed Regulation 4.13(a)(4), to represent that neither the claimant nor any principal is subject to statutory disqualifications under CEA Sections 8a(2) or 8a(3). The grounds for statutory disqualification under CEA Section 8a(3) include, among others, (1) any felony conviction, as well as any finding by the CFTC or another governmental body or agency to have violated the CEA, CFTC regulations, or securities laws, that is not covered by CEA Section 8a(2); (2) any misdemeanor conviction, no matter how old, involving commodity interests or securities, or embezzlement, theft, fraud, misappropriation of funds, securities or property, or gambling; and (3) "other good cause." As proposed, the prohibition would apply to current claimants under Regulation 4.13 as they renew their claims on an annual basis—i.e., existing claimants would be required to represent that neither they nor their principals are subject to statutory disqualifications under CEA Sections 8a(2) or 8a(3) when they annually reaffirm their continued reliance on a Regulation 4.13 exemption. CPOs filing new claims of a Regulation

4.13 exemption would be required to comply with this prohibition upon filing, if and when the amendments are adopted as proposed, and become effective.

COMMENT PERIOD

The comment period on the Proposals closes on December 17, 2018.

CONCLUSION

The Proposals, if adopted, could streamline and simplify regulations governing CPOs and CTAs in several ways. They would codify previously granted staff relief and require formal rulemaking to reverse the policy. Market participants and their counsel may find it easier to determine Commission rules in this area by consulting the regulations and without the need to examine numerous letters or other pronouncements, some of which are decades old. However, there are also aspects of the Proposals, such as how the new registration exemptions will interface with existing exemptions and the requirement that claimants of exemptions represent that they are not subject to any of the grounds for statutory disqualification from registration, that may yet make the regulatory framework more complex and cumbersome.

Not all of the staff relief granted to CPOs and CTAs would be codified by adoption of the proposals, and more remains to be done in areas such as harmonizing the recordkeeping requirements for CPOs and CTAs and codifying the CPO delegation relief for CPOs of private funds.

Nevertheless, it is still encouraging to read the conclusion of CFTC Chairman Giancarlo's statement on the Proposals that he expects it to be the first in a series of staff recommendations to streamline and simplify the regulation of CPOs and CTAs.

NOTES

[1] The Proposals were published at 83 Fed. Reg. 52902 (October 18, 2018) and are available by clicking [here](#).

[2] 7 U.S.C. 12a(2) and 12(a)(3).

[3] Advisory 18-96, "Offshore Commodity Pools – Relief for Certain Registered CPOs From Rules 4.21, 4.22 and 4.23(a)(10) and (a)(11) and From the Location of Books and Records Requirement of Rule 4.23," *reprinted in* [1994-1996 Transfer Binder] COMM. FUT. L. REP. (CCH) ¶¶26,659 (April 11, 1996). Regulations cited herein may be found in Title 17 of the Code of Federal Regulations.

[4] These conditions include: (1) the pool is, and will remain, organized and operated outside of the United States; (2) the pool will not hold meetings or conduct administrative activities within the United States; (3) no shareholder of or other participant in the pool is or will be a U.S. person; (4) the pool will not receive, hold, or invest any capital directly or indirectly contributed from sources within the United States; and (5) the person, the pool, and any person affiliated therewith will not undertake any marketing activity for the purpose, or that could reasonably be expected to have the effect, of soliciting participation in the pool from U.S. persons.

[5] *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 11252 (February 24, 2012).

[6] CFTC Staff Letter 04-13 (April 14, 2004).

[7] 83 Fed. Reg. at 52907 and n.44.

[8] See *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations*, 78 Fed. Reg. 45291, 45316–17 (July 26, 2013).

[9] 17 C.F.R. §§ 230.901–230.905 and preliminary notes.

[10] These conditions would be contained in a notice of claim for exemptive relief that must be filed with National Futures Association (“NFA”) representing that: (1) the CPO will maintain the original books and records of the pool at the pool's main office located outside the United States and states the name, title, full mailing address, telephone number, and relationship to the pool of the person who will have custody of the pool's original books and records and the location outside the United States where those books and records will be kept; (2) the CPO desires to maintain such books and records outside the United States in furtherance of compliance with IRS requirements for relief from U.S. federal income taxation; (3) the CPO will maintain duplicate books and records of the pool at a designated office in the United States; (4) the claim is electronically signed by an individual duly authorized to bind the CPO; and (5) within 72 hours after a request from a representative of the Commission, the United States Department of Justice, or NFA, the original books and records will be provided to such representative at a place located in the United States that is specified by the representative.

With respect to the second condition regarding federal income taxation, this condition relates to a tax issue that existed when the Advisory was issued in 1996. However, the Taxpayer Relief Act of 1997 included a provision intended to simplify and reduce administrative costs for offshore investment vehicles. Effective January 1, 1998, offshore investment vehicles with U.S. investment managers are exempt from federal income taxation for securities and commodity interest trading profits even if their trading activities and “principal office” and related administrative functions are conducted in the United States. Therefore, it is no longer necessary to maintain books and records outside of the United States to qualify for the tax exemption and hopefully the CFTC will remove this condition from the new rule when it is adopted.

[11] CFTC Staff Letter 12-37 (November 29, 2012).

[12] CFTC Staff Letter 14-143 (November 5, 2014).

[13] CFTC Staff Letter 12-40 (December 4, 2012).

[14] CFTC Staff Letter 14-116 (September 9, 2014).

[15] CFTC Regulation 4.7(b) provides relief to registered CPOs from certain disclosure, reporting and recordkeeping requirements that would otherwise apply, if the CPO restricts participants in a pool to investors that meet the criteria of a “Qualified Eligible Person” (“QEP”), which is generally equivalent to the SEC “accredited investor” standard.

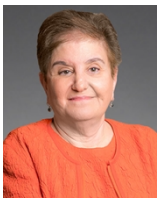
[16] CFTC Staff Letter 14-115 (September 8, 2014).

[17] CFTC Staff Letter 15-47 (July 21, 2015).

[18] The term “direct” refers to agreements whereby a CTA is authorized to cause transactions to be effected for a client's commodity interest account without the client's specific authorization.

[19] Under CEA Section 8a(2), for instance, the CFTC may refuse to register a person (1) who has been temporarily or permanently enjoined by order not to act as a registrant under the CEA, or (2) who, within ten years preceding the application for registration, (a) has been convicted of a felony for criminal activities involving commodity interests or securities or embezzlement, theft, fraud, misappropriation of funds, securities or property, or gambling, or (b) been found by the CFTC or another governmental body or agency to have violated the CEA, CFTC regulations, or securities laws, where the violation involves grounds such as embezzlement, theft, fraud, misappropriation of funds, securities or property, or gambling.

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