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Client Alert

Energy & Natural Resources

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Guidance on CPO and CTA Annual Affirmations Requirements Due By February 29, 2016 and General Compliance Requirements for Commodity Pools and Advisors in the US and the EU

Introduction On December 1, 2015, the National Futures Association (the NFA) issued a notice to members to remind them of certain Commodity Futures Trading Commission (CFTC) regulations that require any person claiming an exemption or exclusion under CFTC Regulation §4.5, §4.13(a)(1), §4.13(a)(2), §4.13(a)(3), §4.13(a)(5) or §4.14(a)(8) from the requirement to register as a commodity pool operator (CPO) or commodity trading advisor (CTA) to annually affirm their notice of exemption or exclusion within 60 days of the calendar year end, which is February 29, 2016 for the current affirmation cycle.

The guidance states that failure by a member to affirm such active exemption or exclusion from CPO or CTA registration by February 29, 2016 will result in the automatic withdrawal of such member's exemption or exclusion on March 1, 2016. Accordingly, by failing to reaffirm in time, a person that would otherwise be exempt or excluded from registration will be subject to the regulations applicable to CPOs or CTAs (regardless of whether the entity remains eligible for the exemption or exclusion) and to possible CFTC enforcement action for non-compliance.

Below, we (1) briefly discuss the procedural matters for making the annual NFA affirmations, (2) provide a more detailed discussion of compliance maters for CPOs and CTAs, and, (3) in conclusion, provide a brief summary of EU regulations applicable to funds and fund advisors.

What is a "Commodity Pool?" A *"commodity pool"* refers to any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity interests, including: any future, security futures product, or swap[1] (generally includes any agreement, contract or transaction based upon an exchange of payments tied to a notional amount of an asset, index, or rate); authorized commodity option or leverage transaction; or retail forex or commodity transactions as further defined in the Commodity Exchange Act ("**CEA**")[2].

In general, collective investment vehicles that engage in futures or commodity option transactions (including commodity-based swaps) are considered "commodity pools." Commodity pools include pooled investment funds that invest in multiple types of investment products, as well as funds that invest primarily in securities or other investment products and only secondarily in futures.

A *"commodity interest"* is any contract for the purchase or sale of a commodity for future delivery, security futures product, any swap as defined under CEA §1a(47) and any CFTC regulations implemented thereunder; agreement, contract or transaction described in CEA §2(c)(2)(C)(i) or 2(c)(2)(D)(i) (*i.e.*, forex transactions); commodity options authorized under CEA § 4c; or leverage transactions authorized under CEA §19, CEA §§1a(11) and (12); CFTC Regulation §1.3(yy).[3]

Accordingly, a commodity pool by definition would have positions in commodity interests (i.e., if there are no commodity interests, there is no commodity pool). Unlike under the SEC rules, the commodity pool does not register, but if there is a commodity pool, then there must be a commodity pool operator ("**CPO**") and a commodity trading adviser ("**CTA**") who must either register or file for an exemption from registration.

Who is a CPO? A CPO[4] is a person engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in "commodity interests." The CPO is most often the managing member or general partner of a fund. In a corporate structure (like a Cayman Islands exempted company), the directors are most likely the CPOs unless a delegation of management functions is made to the investment manager. If a commodity pool is identified, it must have either a registered CPO or an exempted CPO. There are several exemptions available to CPOs, as discussed below.

(a) CPO Exemption – CFTC §4.13(a)(3) CPO registration is required unless the CPO qualifies for one of the exemptions or exclusions from registration outlined in CFTC Regulations §4.5 or §4.13. If a CPO is qualified for an exemption from registration, the pool operator must electronically file a notice of exemption from CPO registration through the NFA's Electronic Exemption Filing System.

CFTC Regulation §4.13(a)(3) exemption is the one most often used by private fund managers and is referred to as the *de minimis* exemption.

CFTC Regulation §4.13(a)(3) exempts CPOs operating pools that utilize a "de minimis" level of futures or swaps trading (*i.e.*, either: (1) the aggregate initial margin on futures positions and premiums on options on futures do not exceed 5% of the liquidation value of the fund's portfolio, after taking into account unrealized gains and losses (typically used for options); or (2) the aggregate notional value of such positions does not exceed 100% of the liquidation value of the pool's portfolio, after taking into account unrealized gains and losses (typically used for swaps)). It is important to note that, unlike the regulatory assets under management buffers under the Investment Advisers Act of 1940, as amended, there are no notional value buffers in respect of the de minimis exemption; if a fund manager enters into a future or swap under the CFTC's jurisdiction that causes a pool to exceed the trading limitations at any point in time, the fund manager will no longer be exempt from CPO registration under CFTC Regulation §4.13(a)(3). Accordingly, general partners of funds that use futures, but only within the defined minimum amounts, can rely on this exemption.

There are a number of additional requirements to consider in determining whether one qualifies for the *de minimis* exemption. These include the following: (a) interests in the pool must be exempt from registration under the Securities Act of 1933, (b) funds must not market themselves as trading in commodity futures, commodity options or swaps' markets[5] and (c) participants in the pool must be limited to "accredited investors" or "knowledgeable employees" as defined under Rule §3c-5 of the Investment Company Act of 1940, as amended.[6] In addition, CPOs relying on the *de minimis* exemption who have filed a notice of exemption from registration under this section must affirm on an annual basis the notice of exemption from registration, withdraw such exemption due to the cessation of activities requiring registration or exemption therefrom, or withdraw such exemption and apply for registration within 60 days of the calendar year end through NFA's electronic exemption filing system.

(b) CPO Exclusion – CFTC Regulation §4.5 Regulation §4.5 excludes from the definition of CPO "qualifying entities" that operate pools that are regulated by some other regulatory authority, such as the SEC.

A "qualifying entity" for purposes of Regulation §4.5 will include the following:

- a registered investment company under the Investment Company Act of 1940 that complies with certain trading limitations and marketing restrictions
- an insurance company with respect to the operation of a separate account

- a bank, trust company or any financial depository institution with respect to the assets of a trust, custodial or other separate unit of investment for which it is acting as a fiduciary and for which it is vested with investment discretion
- a trustee of, named fiduciary of, or an employer maintaining, a pension plan that is subject to ERISA Title I, and certain plans are not even considered pools (including Title I non-contributory plans, Title IV contributory plans, government plans, employee welfare plans, and church plans).

Who is a CTA? A CTA[7] is a person who, for pay, regularly engages in the business of advising others as to the value of commodity futures, options, or swaps or the advisability of trading in commodity interests or issues analyses or reports of the same. Providing advice also includes exercising trading authority over a customer's account as well as giving advice based upon knowledge of or tailored to a customer's particular commodity interest account, particular commodity interest trading activity, or other similar types of information.

In a fund that has no separate investment adviser, the general partner or managing member is both CPO and CTA and need not separately register as a CTA if it is already registered as a CPO. In a corporate structure, the directors are usually the CPOs unless delegation is made to the adviser, and the adviser is the CTA. In a separate account, the investment adviser is the CTA and there is no CPO.

(a) Exemption from CTA Registration There are three exemptions which will most likely apply to private fund advisers that are CTAs[8]

- **CFTC Regulation §4.14(a)(8) "de minimis exemption"** – A CTA whose CPO qualifies for the de minimis exemption can be exempt from CTA registration if such CTA (i) is registered (or exempt from registration) as an investment adviser with the Securities and Exchange Commission (the SEC), (ii) provides commodity interest trading advice solely incidental to its business on advising in securities investments, and (iii) does not hold itself out as a CTA.
- **CFTC Regulation §4.14(a)(10) "15 or less exemption"** – A CTA that has no more than 15 clients (with each fund typically counting as one client) during the prior 12 months and does not hold itself out to the public as a CTA. A fund that receives advice based on its own investment objectives and not the objectives of individual clients will count as one client. A CTA whose principal place of business is outside of the US need only count clients that are US residents.
- **CEA Section §4(m)(3) "not primarily exemption"** – A CTA that is registered with the SEC as an investment adviser is exempt from registration as a CTA if its business is not "acting primarily" as a CTA and it does not advise a commodity pool "engaged primarily"[9] in investing in commodity interests.

Annual Affirmation of Exemption or Exclusion from CPO or CTA Registration

Any person that claims an exemption or exclusion from CPO registration or CTA registration must annually affirm the applicable notice of exemption or exclusion within 60 days of the calendar year-end.[10] The affirmations must be made online through the **NFA's Exemption System**. A new exemption filing made during the affirmation period (*i.e.*, December 1, 2015 to February 29, 2016) does not need to be affirmed until 60 days after December 31, 2016.

At the end of each year, the NFA will send out an email reminder of the affirmation period. The affirmation process can be completed by logging into the NFA Exemptions System. Once logged into the system, you will be directed to the Exemption Index, which lists all Firm Level (at the top) and Pool Level (at the bottom) exemptions on file with the NFA Exemptions requiring affirmation will be identified with an icon in the 'Affirm' column. After clicking on the icon, a pop-up box will appear requesting affirmation that the exemption continues to be effective. By clicking 'OK,' the current date will replace the 'Affirm' icon and effectively complete the exemption affirmation requirement for the year. The same process must be completed for each and every exemption on file that requires affirmation.

(a) Consequences of Failing to File the Affirmation by February 29, 2016

(i) Failure to affirm an active exemption or exclusion from CPO or CTA registration will result in the exemption or exclusion being automatically withdrawn on March 1, 2016.

(ii) For registered CPOs or CTAs, withdrawal of the exemption or exclusion will result in the entity being subject to CFTC Regulations Part 4 Requirements with respect to the pool or account for which an affirmation was not filed, regardless of whether the CPO or CTA otherwise remains eligible for the exemption or exclusion.

(iii) For non-registered entities, the withdrawal of the exemption or exclusion may subject the person or entity to enforcement action by the CFTC and the NFA.

(b) Best Practices In order to ensure that an institution receives NFA's annual reminder of the affirmation process, CPOs and CTAs are urged to ensure that the email contact information on file for the firm in the NFA's Exemption System is current and to update the information promptly if it changes. For example, if a CPO has hired a new compliance officer, the CPO will need to make sure that the NFA will have the correct contact information for that person for the purposes of receiving regulatory notices.

(c) Inactive Pools If the NFA's records reflect an exemption or exclusion for a pool that is no longer active, (i) registered CPOs can update their records by withdrawing the exemption or exclusion via the NFA's Exemption System; at the time the CPO withdraws the exemption or exclusion, the CPO will be directed to the Annual Questionnaire to delete the pool or indicate the pool has ceased operations or (ii) non-registered CPOs can update their records by notifying the NFA via email at exemptions@nfa.futures.org with specific information about the pool, including the full name of the pool and the relevant entity together with the applicable NFA ID numbers.

It is not good practice to merely ignore the filing of the annual affirmation notice with respect to those funds that have gone dormant. Rather, these CPO registrations should be withdrawn (or noted for which specific funds the registration is withdrawn if there is more than one commodity pool managed by a given CPO).

As discussed further below under "Bylaw 1101 Obligations Generally," any member of the NFA will be prohibited from doing business with a firm that is not properly registered with the NFA. In the event that a CPO or a CTA or a fund of funds makes a representation that it is compliant with the applicable laws while having missed the annual affirmation and had a filing lapse, this can be considered a misrepresentation and potentially an event of default, not to mention a violation of CFTC rules. In addition, a filing lapse (i) can impact account relationships by exposing NFA members, including their counterparties (*e.g.*, prime brokers who are registered CTAs and/or CPOs) to violations of NFA Bylaw 1101 and/or NFA Compliance Rule 2-36(d)[11] or (ii) affect the ability of any NFA member that is an investor from maintaining an investment in a fund or with a firm that does not have proper registration in place. Non-compliance with NFA rules exposes the CPO or CTA in question to penalties under Rule 3-14 of the NFA Manual. Potential penalties include the following: expulsion or suspension for a specified period from NFA membership, barring or suspension for a specified period from association with an NFA member, censure or reprimand, a monetary fine not to exceed $250,000 per violation, order to cease and desist and any other penalty or remedial action not inconsistent with Rule 3-14. The net effect of such violations is a complete ban from acting as a CPO in respect of any commodity pool.

(d) Confirmation The NFA's Background Affiliation Status Information Center (BASIC) will indicate whether a CPO or CTA exemption or exclusion has been successfully affirmed, along with the date of affirmation, or a withdrawal date will be reflected for any exemption that was not affirmed for a given CPO or CTA. NFA members may access a spreadsheet that includes a list of all entities with exemptions that must be affirmed on an annual basis. Such a spreadsheet is updated nightly and includes all entities with an exemption that requires affirmation, as well as the affirmation date, if applicable; if the spreadsheet does not reflect an affirmation date, the exemption has not been affirmed. The spreadsheet can be found in the member's annual questionnaire available at http://www.nfa.futures.org/nfa-electronic-filings/annual-questionnaire.html.

Registration with the NFA On September 14, 2015, the CFTC published Rule 170.17 requiring all registered introducing brokers ("**IBs**"), CPOs, and most CTAs[12] to become members of a registered futures association ("**RFA**").[13] The NFA is currently the only registered futures association in the United States.

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, additional IBs, CPOs and CTAs that facilitate swaps but not futures transactions have been required to register with the CFTC, due to swaps being added to the definition of a "commodity interest." While these new IBs, CPOs and CTAs have registered with the CFTC through the NFA, they are not subject to NFA Bylaw 1101, which only applies to transacting in futures and not swaps. Accordingly, registered IBs, CPOs and CTAs that transact in swaps but not futures to date have not been required to become NFA members. Under the final rule, all registered IBs and CPOs and almost all registered CTAs now will be required to become members of the NFA.

All persons subject to the regulation will be required to become members of the NFA by **December 31, 2015**. To comply with the requirement, each registered IB, CPO, and CTA (subject to the limited exception for CTAs) must update its existing registration forms on the NFA's online registration system and pay the NFA membership dues.

(a) Bylaw 1101 Obligations Generally Bylaw 1101 prohibits NFA members, such as CPOs, from doing business with or on behalf of any non-member of the NFA, or suspended member of the NFA, that is otherwise required to be registered with the CFTC, pursuant to the CEA. The most common CFTC registration categories are for a futures commission merchant, introducing broker, CTA and CPO.

(b) Application of Bylaw 1101 The fundamental determinations necessary for complying with Bylaw 1101 are: (1) whether you are doing business with or on behalf of a person that is required to be registered with the CFTC (and is otherwise compliant with CEA and CFTC's regulations) and (2) if such registration is required, whether such person is also an NFA member.

You can review the NFA's BASIC system at https://www.nfa.futures.org/basicnet/welcome.aspx to verify whether the person is CFTC-registered and an NFA member. If the NFA's BASIC system indicates that a person is CFTC-registered and an NFA member, your initial Bylaw 1101 compliance obligation is satisfied (although you will have an ongoing obligation in light of new facts). If a person is not registered, however, your obligation will continue such that you will need to ascertain why CFTC registration is not required, such as due to an exemption, exclusion or otherwise. Similarly, if a person is CFTC registered but not an NFA member, you will need to determine why that person is not an NFA member. As part of this process, you should always remember to document your diligence review in coming to such conclusions.

The NFA expects a member to use reasonable steps to identify those persons who currently claim an exemption from CPO or CTA registration with whom the NFA member transacts customer business. This process is fairly simple where the CPO or CTA at issue has made a notice filing of its exemption or exclusion with the NFA. For instance, if a CPO or CTA is claiming an exemption from CPO registration under CFTC Regulations §4.13(a)(1), §4.13(a)(2), §4.13(a)(3) or §4.13(a)(5), an exclusion from CPO registration under Regulation §4.5 or an exemption from CTA registration under §4.14(a)(8), you can check to determine that this party has properly affirmed its exemption or exclusion on the NFA's BASIC system. If the NFA's BASIC system indicates that the person is exempt or excluded from registration as indicated, your initial Bylaw 1101 compliance obligation is satisfied (although the obligation is ongoing).

If a person is not listed as exempt or excluded from registration, your obligation will continue such that you will need to ascertain whether a self-executing exemption or exclusion applies. "Self-executing" exemptions or exclusions mean that no filing with the NFA is necessary for the CPO or CTA to operate under the desired exemption or exclusion. By consequence, self-executing exemptions and exclusions are harder to verify. Under your Bylaw 1101 obligations, at a minimum, you are required to take notice and conduct additional due diligence if the facts tend to be contrary to the claimed exemption or exclusion status. In all cases, we recommend that you obtain the CTA or CPO's written confirmation that the claimed exemption or exclusion is applicable to their facts.

Other Compliance Matters for Commodity Pools, CPOs and CTAs In addition to compliance with the regulations applicable to matters unique to commodity pools (*e.g.*, registration of CPOs and CTAs and providing of required disclosures), these entities should also note general requirements under the CEA and CFTC Rules and Regulations applicable to any counterparty to a swap or a person trading futures contracts on a designated contract market. For example, commodity pools must: (i) have capacity to contract *(i.e.*, the requirement of qualifying as an eligible contract participant), (ii) have conducted due diligence regarding contract determination (i.e., whether the traded contracts qualify as futures, swaps or options), (iii) ensure these transactions are properly documented, (iv) ascertain if these contracts must be cleared, and (v) ensure that they comply with recordkeeping and reporting requirements, as well as any cross-border requirements.

Given that the CFTC recently finalized its OTC margin rules and is likely to finalize its position limits rules in the near future, it is imperative that parties review existing collateral management arrangements in place and conduct an analysis of its aggregation of positions.

Even though exempt CPOs and CTAs are not required to have a chief compliance officer on staff, they are required to ensure compliance with the law for the firm and its associated persons. Accordingly, it is good practice to annually conduct compliance training and evaluate the firm's policies and procedures to ensure that they are in good order.

CFTC's Cross-Border Guidance Applicable to Funds and the EU Regulations

(a) US Cross-Border Regulations Many commodity pools are organized outside of the United States (*e.g.*, the Cayman Islands), even though they may be open to US participants and are managed by US-based CPOs and advised by US-based CTAs. Because there could be many variations on how these pools may be organized and marketed, questions often arise about their treatment under the CFTC's cross-border guidance (the "Cross Border Guidance") with respect to swap regulations.[14] The Cross Border Guidance will affect the regulatory treatment of a pool's swaps and a pool will have to make representations about its status under the Cross Border Guidance to its swap counterparties. Generally, if a pool is organized or incorporated in the United States or has its principal place of business in the United States, it would be treated as a US person.[15] Also, if a pool is directly, and in some circumstances indirectly, majority owned (*i.e.*, more than 50%) by a US person or US persons, such pool may also be recognized as a US person unless it is publicly offered to only non-US persons and is not offered to US persons. Finally, in some circumstances a pool may be recognized as an affiliate conduit of a US person. In any of these scenarios various levels of CFTC regulations will apply on the pools themselves as well as their counterparties and accordingly, it is imperative to conduct the relevant analysis to determine whether a given pool is subject to CFTC's regulation.

(b) European Regulations The principal means by which managers of funds of this nature are regulated in the European Union is through the Alternative Investment Fund Managers Directive (AIFMD). EU Directives are required to be implemented by each EU member state, so there are divergences in how AIFMD applies in each state. However, the fundamental principle is that the manager of an alternative investment fund (AIF) (as distinct from the fund itself) is required to be licensed by the regulatory authority of the member state in which it carries out activities. Licensing obligations apply even where both the manager and the fund are located outside of the EU, if the fund is to be marketed within the EU. By way of example, there are exemptions available for holding companies, pension schemes and certain joint ventures. There are partial exemptions available where the total assets under management of the fund do not exceed certain thresholds. Some EU member states operate additional funds regulations alongside AIFMD. In the UK, for example, the operator of a collective investment scheme must be licensed.

A distinction is made in AIFMD between EU and non-EU AIFs, as well as EU and non-EU managers. There are significant differences as to the ongoing requirements that apply to EU-based managers/AIFs as compared to those that apply to non-EU based managers/AIFs. Generally speaking, a non-EU manager of a non-EU AIF is subject to the least onerous set of obligations. For example, being an EU manager carries with it obligations with respect to regulatory capital, remuneration and the need to appoint a depository to hold the assets of the fund. A non-EU manager is only required to comply with certain disclosure and reporting requirements. There are no particular reporting requirements that apply with respect to the end of the calendar year, though managers must produce an annual report which must be made available to relevant national authorities and investors upon request no later than six months following the end of the party's financial year. The annual report must include, *inter alia*, information on remuneration paid by the manager and AIF. There is also information that an AIFM needs to provide periodically to national authorities, including trading information, risk management information and details of leverage employed.

There are also detailed marketing provisions in AIFMD which must be complied with. The drawback of either the fund or the manager being located outside of the EU is that the EU marketing "passport" will not be available. The passport enables a manager licensed in one EU member state to market an EU AIF in other member states without the need to be separately licensed in that other member state. Where the passport is unavailable, marketing must comply with the national rules of each member state where marketing is to take place. There are discussions taking place amongst the EU authorities regarding extending the marketing passport to non-EU managers and funds. However, at least with respect to the United States, there are still some obstacles to be overcome before this will come into effect, if it ever does come into effect.

Conclusion There are consequences for failing to comply with relevant CEA, CFTC and European rules that apply to you in this space or for failing to take steps to meet or affirm relevant exceptions and exceptions. The end of the calendar year is a good time for parties to review and assess its compliance program and the applicable rules, including any updates thereto.

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1 *See* CEA §1a(47);

2 *See* CEA §1a(10); CFTC Regulation 4.10(d).

3 *Note*, there is separate definition of "commodity interest" for commodity trading adviser purposes under CEA §4m(3)(C). *See also* Lincoln-Dodd Colloquy (July 16, 2010).

4 *See* CEA §1a(11).

5 *Note*, that on September 9, 2014, the CFTC Division of Swap Dealer and Intermediary Oversight published CFTC Exemptive Letter No. 14-116 that facilitates the use of the JOBS Act general solicitation provisions (provided certain conditions are satisfied) by private fund managers that are relying on exemptive relief under CFTC Regulations §4.7(b) or 4.13(a)(3).

6 *See* CFTC Regulation 4.13(a)(3).

7 *See* CEA §1a(12).

8 Section 1.3(ggg)(4)(i) of the CEA provides a *de minimis* exception from swap dealer and/or CTA registration for certain persons engaged in a *de minimis* level of swap dealing provided certain thresholds are satisfied.

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[9] A CTA or a commodity pool shall be considered to be "engaged primarily" in the business of being a commodity trading advisor or commodity pool if, respectively, it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding, or trading in commodity interests. See CEA, Section 4m(3)(B).

[10] For those CPOs and CTAs who are CFTC Registrants and NFA Members, they are required to report to the NFA and their investors with regard to different areas of their CPO and CTA business activities. These reporting requirements include periodic investor statements, annual certified pool financial statements, and Forms CPO-PQR and CTA-PR. These filing requirements are beyond the scope of this client update.

[11] See NFA Notice I-12-10 "Guidance to Members Carrying Accounts for, or Transacting Business with Persons Exempt from Registration" (June 25, 2012), available at http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4055.

[12] A limited exception to this requirement applies to CTAs that qualify for an exemption from registration under CFTC Regulation 4.14(a)(9) (*i.e.*, those who do not direct client accounts or provide advice tailored to a particular client) but who nonetheless chose to register.

[13] *See* CFTC Release PR7225-15.

[14] Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45293 *et seq*. (July 26, 2013).

[15] *Id* at 45316-17.

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