7 September 2016

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Recent CFTC/NFA Regulatory Actions Affecting Commodity Pool Operators and Commodity Trading Advisors

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Introduction

During August 2016, the Commodity Futures Trading Commission ("CFTC" or "Commission") and National Futures Association ("NFA") published several items that will affect commodity pool operators ("CPO") and commodity trading advisors ("CTA"). These actions (1) propose to codify previous staff letters regarding (a) CPO annual reports and (b) conditions that apply to exemptions from registration as a CPO and CTA under the U.S. Commodity Exchange Act ("CEA") for persons located outside the United States, (2) preserve the status quo regarding treatment of cross-border swaps, (3) provide guidance regarding how upcoming changes in the regulation of money market funds ("MMF") by the Securities and Exchange Commission ("SEC") will affect the ability of derivatives clearing organizations ("DCO") and futures commission merchants ("FCM") to use MMFs as permissible investments of their own and customer funds, and (4) propose changes to the CFTC's whistleblower regulations. NFA has also announced certain actions that will affect CPOs and CTAs.

CPO Annual Reports

International Accounting Standards

The CFTC requires, with some exceptions, that each registered CPO distribute to each investor in a commodity pool an annual report for the pool that has been audited by an independent public accountant within 90 calendar days after the end of the pool's fiscal year. Historically, the financial statements in the annual report were required to be presented in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"). About seven years ago, the CFTC permitted CPOs to use International Financial Reporting Standards ("IFRS") in annual reports for pools organized under non-U.S. law, subject to certain conditions.[1] The CFTC is now proposing to amend its regulations to permit a CPO to use generally accepted accounting principles, standards or practices followed in the United

[1] 74 Fed. Reg. 57585 (November 9, 2009). These conditions include: (1) the annual report includes a schedule of investments (condensed unless a full schedule is required under IFRS); (2) the use of IFRS is consistent with representations in the pool's offering memorandum; (3) any special allocations of ownership equity are reported in accordance with CFTC Regulation 4.22(e); and (4) in the event that IFRS requires consolidated financial statements for the pool (e.g., in a master-feeder fund structure), all applicable disclosures required by U.S. GAAP are provided. A CPO that wants to use IFRS in an annual report must also file a notice with NFA making the foregoing representations. A previous Client Alert discussing the use of IFRS is available by clicking here.

Kingdom, Ireland, Luxembourg, or Canada in an annual report, subject to the same conditions for using IFRS.[2]

Exemption from Audited Annual Report Requirement

The CFTC is also proposing an exemption from the audit requirement for the annual report of a pool's first fiscal year if the period from formation of the pool (which would be defined as the date the CPO first receives funds, securities or other property for the purchase of an interest in the pool) to the end of the pool's first fiscal year is three months or less. This exemption would also be subject to the conditions that, during the period from pool formation to the end of the pool's first fiscal year, the pool had no more than 15 participants and total gross capital contributions did not exceed $1.5 million.[3] In addition, the CPO must obtain a specified written waiver of the right to receive an annual report from each participant and file a notice with NFA claiming the relief and certifying that it has received the specified waivers.[4]

CPOs claiming this relief would still be required to prepare and distribute an *unaudited* annual report for the first fiscal year of three months or less, the cover page of which must prominently include this statement: ''Pursuant to an exemption from the Commodity Futures Trading Commission, this unaudited Annual Report covers the period from the date of formation of the pool to the end of the pool's first fiscal year, a period of [number] months.'' Further, the next annual report for the pool must prominently disclose the following statement on the cover page thereof: ''Pursuant to an exemption from the Commodity Futures Trading Commission, this audited Annual Report covers the period from the date of formation of the pool to the end of the pool's first 12-month fiscal year, a period of [number] months.''

The CFTC seeks to ensure that an audit is conducted at least once for each pool operated by a registered CPO, so if the CPO took advantage of the relief provided for the first short fiscal year and liquidated the pool before the end of the following full fiscal year, an audited final report would be required and the ability to claim exemption in accordance with CFTC Regulation 4.22(c)(7)(iii) would be unavailable.

Exemption from Registration for Certain Foreign Person

CFTC Regulation 3.10(c)(3) provides an exemption from registration under the CEA for a CPO or CTA provided (1) the CPO or CTA is located outside of the United States, (2) the CPO or CTA acts only on behalf of persons located outside of the United States, and (3) any resulting commodity interest transaction is submitted for clearing through an FCM registered

[2] 81 Fed. Reg. 51828 (August 5, 2016), which is available by clicking here. The CFTC originally provided a 30-day comment period ending September 6, 2016, but announced on August 30, 2016, a two-week extension of the comment period until September 20, 2016. 81 Fed. Reg. 61147 (September 6, 2016).

[3] Various persons and their capital contributions would not count against these limits, including the CPO, any CTAs advising the pool, and any of their principals, as well as certain relatives of the foregoing persons or entities wholly-owned by such persons.

[4] Please note that this proposed relief is inconsistent with Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940. Generally, if a private fund adviser has custody of the assets of a private fund, the adviser relies on the audit exception under the Custody Rule. Under the audit exception, advisers to limited partnerships, limited liability companies, or other types of pooled investment vehicles have 120 days to distribute audited financial statements to their investors (180 days if the fund is a fund-of-funds) and there is no exemption from the audit requirement for private funds that have been in existence for three months or fewer. Accordingly, a CPO that is also a registered investment adviser with custody of the assets of a private fund that is also a commodity pool cannot avail itself of this relief if it wishes to continue to rely on the "audit exception" under the Custody Rule.

under the CEA. The CFTC is now proposing to eliminate the third condition, which would codify relief provided in CFTC Staff no-action letters.[5]

The CFTC's rationale for proposing to codify the relief is that numerous swaps are not subject to a clearing mandate and are not yet accepted for clearing by any CFTC-registered DCO, so it is impossible to comply with the third condition in the current exemption with respect to such swaps. The proposed amendments to Regulation 3.10(c) go beyond the relief granted in the Staff no-action letters in that those letters provided relief in connection with swaps not subject to a CFTC clearing mandate or where the customer is an international financial institution such as the International Monetary Fund or World Bank. The CFTC notes that persons located outside the United States will remain subject to any applicable clearing requirement for futures, options on futures and swaps, regardless of any registration exemption for a non-U.S. intermediary. However, the CFTC appears to leave open the question of whether resulting commodity interest transactions that are required to be cleared must be submitted for clearing through an FCM registered under the CEA or whether a "foreign broker" as defined in CFTC Regulation 1.3(xx) could submit the transaction for clearing, assuming the DCO permitted remote clearing members.

Cross-Border Swap Transactions

CFTC Guidance

Three years ago, the CFTC published its Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, which is commonly referred to as the "Cross-Border Guidance" or simply the "Guidance."[6] On December 4, 2013, three trade associations filed suit against the CFTC in federal court in the District of Columbia, challenging the Guidance as well as the extraterritorial application of 14 sets of regulations promulgated by the CFTC to govern swaps. The court granted summary judgment to the CFTC on most issues, but remanded without *vacatur* ten sets of regulations and directed the CFTC to address whether and to what extent the costs and benefits of the regulations as applied to cross-border swap transactions may differ from those related to domestic application of the regulations.[7]

The CFTC published its initial response to the remand order last year.[8] The CFTC supplemented its discussion of costs and benefits in the preambles of the remanded rulemakings by stating that "In the language of the district court, the Commission 'functionally considered the extraterritorial costs and benefits,' and this was because the evidence in the record did not suggest that differences existed [in the costs and benefits of the regulations in issue whether applied to domestic or cross-border transactions], with certain limited exceptions that the Commission addressed."[9]

[5] 81 Fed. Reg. 51824 (August 5, 2016), which is available by clicking here. The CFTC provided a 30-day comment period ending September 6, 2016. The Staff Letters in question are 15-37 (June 4, 2015) and 16-08 (February 12, 2016), which are available through the CFTC website, www.cftc.gov., as are other Staff Letters cited in this Alert.

[6] 78 Fed. Reg. 45291 (July 26, 2013).

[7] *Securities Industry and Financial Markets Association et al. v. United States Commodity Futures Trading Commission*, 67 F. Supp. 3d 373 (D.D.C. September 16, 2014).

[8] 80 Fed. Reg. 12555 (March 10, 2015).

[9] *Id*. at 12558 (internal citation omitted).

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The CFTC also solicited comments on four questions aimed at identifying differences in the costs and benefits of the extraterritorial and domestic application of any of the regulations in issue.[10] The CFTC has reviewed the comments received and recently published its final response to the court's remand order.[11] The CFTC noted that the comments identified some areas where the costs and benefits of the extraterritorial application of the remanded regulations may differ from the domestic application. However, the CFTC concluded, perhaps not surprisingly, that "the record does not establish a need to make changes in the substantive requirements of the remanded rules as originally promulgated at the present time and in the context of the [court's] remand order."[12]

Although the remanded regulations generally apply directly to swap dealers and swap execution facilities, they may have indirect effects on CPOs and CTAs and their investors and clients. Further, the CFTC appears to have no present intention to amend the Guidance, which has raised some compliance questions for CPOs located outside of the United States. One aspect of the Guidance is the "U.S. person" definition, which for these purposes includes a collective investment vehicle that is majority owned by U.S. persons, even if the adviser is located outside of the United States and the vehicle is organized under non-U.S. law. That aspect of the definition is at odds with the definition used by other U.S. financial regulators and is even at odds with the CFTC's own definition of a U.S. person in the context of the cross-border application of the CFTC's regulations governing margin on uncleared swaps, which began being phased in on September 1, 2016.[13] The CFTC appears to be content with this discrepancy, at least for the time being.

Swaps Arranged, Negotiated or Executed in the United States

One of the lingering interpretative questions resulting from the Guidance is whether U.S. law will apply to a swap between a non-U.S. entity that is registered as a swap dealer under the CEA and another non-U.S. person if the swap dealer regularly uses personnel or agents located in the United States to arrange, negotiate or execute swaps. The CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") issued an Advisory several months after the publication of the Guidance that U.S. law would apply to that transaction.[14] The Advisory generated multiple requests for relief and the CFTC responded by issuing a Staff Letter granting time limited no-action relief and publishing a notice soliciting comment on the issues raised in the Advisory.[15]

On August 4, 2016, the CFTC yet again, for the fifth time since the Staff Letter referred to in the preceding paragraph, extended the time limited no-action relief regarding these issues and the relief is now set to expire on September 30, 2017, unless the CFTC adopts additional regulations to address these issues prior to that date or the no-action relief is further extended.[16] In a statement issued to accompany the CFTC's latest actions regarding cross-border transactions, CFTC Chairman Massad said that he intends to ask the Commission to consider regulations to begin to address the "arrange, negotiate, or execute"

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[10] *Id.*
[11] 81 Fed. Reg. 54478 (August 16, 2016).
[12] *Id*. at 54496–97.
[13] 81 Fed. Reg. 34817, 34821–24, 34848 (May 31, 2016).
[14] CFTC Staff Advisory 13-69 (November 14, 2013).
[15] CFTC Staff Letter 13-71; 79 Fed. Reg. 1347 (January 8, 2014).
[16] CFTC Staff Letter 16-64 (August 4, 2016).

issues this fall. We note also that the SEC earlier this year addressed the "arrange, negotiate, or execute" issues in the context of the *de minimis* exception to the security-based swap dealer definition, stating that the terms ''arrange'' and ''negotiate'' "indicate market-facing activity of sales or trading personnel in connection with a particular transaction, including interactions with counterparties or their agents," and the term ''execute'' "refers to the market-facing act that, in connection with a particular transaction, causes the person to become irrevocably bound under the security-based swap under applicable law."[17]

Investments in MMFs

The CFTC also announced various actions in August that are intended to enhance the protection of customer funds. One of these actions relates to whether FCMs may continue to invest customer funds in MMFs in light of revisions to SEC Rule 2a-7, which become effective on October 14, 2016.[18] The CFTC's actions may affect the likelihood of full recovery of customer funds in the unlikely event of an FCM's financial failure, which could affect the funds of a CPO's or CTA's customers, or even a CPO's or CTA's proprietary funds if they trade for their own account, but the most direct operational impact will affect FCMs. However, to the extent that CPOs or CTAs are part of an enterprise with affiliated entities that may also operate MMFs, the CFTC's actions may affect how those entities choose to operate certain of their MMFs.

Historically, FCMs were only permitted to invest customer funds in obligations of the United States, general obligations of any State or of any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the United States.[19] In 2000, "[a]s part of a comprehensive regulatory reform process," and citing the CFTC's general public interest exemptive authority in CEA Section 4(c), the CFTC expanded the list of permissible investments of customer funds to include MMFs, subject to certain conditions.[20] One of these conditions is one-day liquidity, i.e., the FCM must be able to redeem all of its investment "by the business day following the request," absent certain emergency circumstances set forth in CFTC Regulation 1.25(c)(5).

The SEC's revised Rule 2a-7 requires an MMF to retain the authority under defined conditions to impose "liquidity fees" or suspend participant redemptions. These provisions are mandatory for MMFs that invest primarily in corporate debt securities ("Prime MMF") and the provisions may be voluntarily adopted by MMFs that invest primarily in U.S. government securities ("Government MMF"). In Staff Letter 16-68, DSIO stated that "[c]onsequently, when the revisions to SEC Rule 2a-7 take effect on October 14, 2016, FCMs will no longer be permitted to invest customer funds in Prime MMFs, or in Government MMFs that voluntarily elect to be subject to liquidity fees or redemption restrictions ('Electing Government MMFs')."[21]

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[17] 81 Fed. Reg. 8597, 8622 (February 19, 2016).

[18] 79 Fed. Reg. 47735, 47932 (August 14, 2014).

[19] CEA Section 4d(a)(2).

[20] 65 Fed. Reg. 77993, 78001–04, 78007 (December 13, 2000).

[21] CFTC Staff Letter 16-68 (August 8, 2016). The CFTC's Division of Clearing and Risk issued a similar letter stating that it would be inconsistent with CFTC regulations for a DCO to accept or hold initial margin in MMFs, or to invest funds belonging to the DCO, its clearing members, or clearing members' customers in MMFs that retain authority to impose redemption restrictions. CFTC Staff Letter 16-69 (August 8, 2016).

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That letter further provided certain no-action relief. Generally, investments of customer funds are subject to various concentration limits, e.g., a limit on the percentage of the total assets held in a segregated account for customers that may be invested in a particular category of permissible investment. However, there is no percentage concentration limit on the investment of customer funds in an MMF comprised only of U.S. government securities, provided the MMF has $1 billion or more in assets and the management company for the MMF has $25 billion or more in assets under management. DSIO noted that "[SEC] Rule 2a-7 defines a Government MMF as a fund that invests at least 99.5 percent of its total assets in U.S. government securities, cash, or repurchase agreements that are fully collateralized," which differs slightly from the requirement in CFTC regulations that, to qualify for no concentration limit, an MMF must be comprised solely (i.e., 100 percent) of U.S. government securities. Nevertheless, DSIO provided no-action relief such that no percentage concentration limit would apply to an MMF that (1) meets the SEC definition of a Government MMF, (2) does not impose liquidity fees or redemption restrictions, and (3) has more than $5 billion in assets (rather than the $1 billion required by the CFTC's regulations).

The other no-action relief provided by DSIO relates to that portion of funds in an account holding customer segregated funds, a secured amount account (which holds funds related to foreign futures and options) or a cleared swaps account that represents a residual interest of the FCM's own funds in excess of the targeted residual interest amount for each such account. The targeted residual interest amount represents funds of the FCM that are intended to provide a buffer to withstand market fluctuations and reasonably ensure that the FCM remains in compliance with requirements for safeguarding customer funds at all times.[22] DSIO provided no-action relief to "an FCM that continues to invest, on or after October 14, 2016, its own funds held in customer segregated, secured and cleared swaps accounts in Prime MMFs and Electing Government MMFs provided that the funds invested in such MMFs represent the FCM's residual interest that is in excess of the targeted residual interest amount for each such account."

Whistleblower Regulations

The CFTC is proposing various amendments to its whistleblower regulations as well as its interpretation of its own authority.[23] Reversing an interpretation announced when the CFTC adopted its whistleblower regulations,[24] the CFTC now proposes to interpret its authority so that it can bring an enforcement action against any entity that retaliates against a whistleblower. This enforcement authority will be in addition to the private right of action that is available to the whistleblower.

The CFTC is also proposing to add new provisions to its regulations to prohibit (1) the enforcement of confidentiality and pre-dispute arbitration clauses against potential whistleblowers in any pre-employment, employment or post-employment agreements, and (2) employers from threatening, harassing or retaliating against individuals who participate in the CFTC's whistleblower program, irrespective of whether those individuals qualify for an award or report internally before providing the CFTC with information. The CFTC views the

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[22] *See* CFTC Regulations 1.23(a), 22.2(e) and 30.7(g).

[23] 81 Fed. Reg. 59551 (August 30, 2016), which is available by clicking here. The CFTC provided a 30-day comment period ending September 29, 2016.

[24] 76 Fed. Reg. 53172, at 53182 (August 25, 2011).

proposed new interpretation of its authority and new regulations as making the CFTC's whistleblower provisions consistent with those of the SEC.

NFA Actions

More than two years ago, NFA issued a request for comment regarding whether to impose minimum capital requirements on CPOs and CTAs and/or institute certain other measures intended to protect customers.[25] After receiving substantial negative comment, NFA has formally abandoned these proposals. In their stead, however, NFA's Board, at its August meeting, adopted rules revising NFA Forms PQR and PR, which must be filed quarterly by CPOs and CTAs, respectively, to require reporting of two financial ratios related to the firm's financial condition: (1) current assets/current liabilities ("CA/CL") as of the reporting quarter end, where current assets include cash or any asset that can be readily converted to cash within one year and current liabilities are those obligations that are reasonably expected to be paid within one year or normal operating cycle, whichever is longer; and (2) total revenue/total expenses ("TR/TE"), which is intended to measure a firm's operating margin and must be reported quarterly using the accrual method of accounting and reflect the total revenue earned and total expenses incurred during the prior 12 months. NFA did not establish any minimum ratio percentages that a firm must meet but indicated that it will incorporate the financial information collected on Forms PQR and PR into its oversight program and use it to identify trends that indicate that a firm may be facing financial difficulties that could impair its ability to act in the best interests of its customers. Each CPO and CTA must be able to demonstrate to NFA how it calculated the ratios reported on Form PQR or PR, and, therefore, must maintain financial records supporting the calculation of these ratios and make those records available to NFA during an examination or otherwise upon request. NFA submitted these rules to the CFTC on September 6, 2016, for approval and expects the changes to be implemented in June 2017.

NFA announced previously that, beginning with filings as of September 30, 2016, CPOs and CTAs that submit Forms PQR and PR after the due date will be assessed a late fee of $200 per business day.[26]

We note three other recent NFA actions. The Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Treasury Department whose mission is to prevent money laundering, recently issued final rules relating to customer due diligence requirements that are applicable to FCMs and introducing brokers ("IB"), which will require them to identify and verify the identity of beneficial owners of "legal entity customers." FinCEN's rules exclude, among others, CPOs, CTAs, and pooled investment vehicles operated by these entities from the definition of legal entity customer. Accordingly, FCMs and IBs are *not* required to apply the beneficial ownership requirements to new accounts opened for commodity pools advised or operated by CPOs or CTAs.[27]

[25] NFA Notice to Members I-14-03 (January 23, 2014). NFA Notices to Members are accessible through the NFA website, www.nfa.futures.org.

[26] NFA Notice to Members I-16-16 (June 21, 2016). NFA Form PQR is due within 60 days after the end of the quarters ending March, June and September, and a year-end report must be filed within 90 days of the calendar year end. All NFA Forms PR are due within 45 days of the calendar quarter end, including the year-end report.

[27] NFA Notice to Members I-16-17 (August 12, 2016).

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Secondly, as of August 2016, NFA amended the self-examination questionnaire, required to be completed annually by CPOs and CTAs, to add technical clarifications to the Financial section of the Supplemental Questionnaire for CPOs.

Finally, at the direction of CFTC staff, NFA has stopped granting waivers to CPOs of commodity pools that are also investment companies registered under the Investment Company Act of 1940 ("registered investment companies" or "RICs") from the requirement to file with NFA and distribute to pool participants a final audited report when such a pool ceases operations. The operators of such pools had understood that the requirement to prepare a final audited report could be waived and that such waivers were consistent with the "harmonization" of compliance obligations for operators of pools that were also RICs.[28] We understand that CFTC staff is considering issuing an Advisory on this topic and that trade associations are seeking to meet with CFTC staff to discuss the issues involved.

Conclusion

This Alert reflects the fact that regulators may take action at any time that can affect the obligations of a regulated entity, even during the relatively quiet month of August. Some of these actions, such as the new NFA ratio reporting requirements, will require operational changes by CPOs and CTAs. Some of the other actions may not break new policy ground but do confirm and even extend previous staff positions and obviate the need to apply for individualized relief. CPOs and CTAs should review all of these recent regulatory actions and determine which ones may affect their particular circumstances and are encouraged to contact us to discuss any of these items in greater detail.

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[28] 78 Fed. Reg. 52308, 52325, 52331 (August 22, 2013).