BARNES & THORNBURG LLP

ALERTS

CFTC Closes A Loophole For Exempt Commodity Pool Operators

September 22, 2020

Highlights

New CFTC regulation requires persons seeking exemption from Commodity Pool Operator (CPO) registration requirements to affirm that neither the CPO nor its principals have a "statutory disqualification"

The new regulation is intended to close an existing regulatory gap by eliminating the inconsistent treatment of exempt and registered CPOs

For CPOs who wish to rely on the exemptions offered under the Commodity Exchange Act – despite the new regulation – additional compliance measures may be necessary

On September 8, 2020, amendments to Commodity Futures Trading Commission (CFTC) Regulation 4.13, which sets forth exemptions to the registration requirements for Commodity Pool Operators (CPOs), went into effect. The new regulation, codified as Regulation 4.13(b)(1)(iii), requires persons seeking exemption from the usual CPO registration requirements to represent in their application for exemption that "neither the person [seeking exemption] nor any of its principals has in its background a statutory disqualification that would require disclosure

RELATED PEOPLE

David Slovick
Partner
New York, Washington, D.C.

P 646-746-2019
F 646-746-2001
dslovick@btlaw.com

Trace Schmeltz
Partner
Chicago, Washington, D.C.

P 312-214-4830
F 312-759-5646
tschmeltz@btlaw.com

RELATED PRACTICE AREAS

Financial and Regulatory Litigation
Litigation
Trial and Global Disputes

under Section 8a(2) of the [Commodity Exchange Act (CEA)] if such person sought registration" as a CPO.

The scope of the new regulation is broad; with the exception of CPOs operating as "family offices," the rule applies to all statutory persons who seek to operate as an exempt CPO and their principals.

The CFTC's CPO Registration Regime

Section 4m(1) of the CEA requires natural persons and entities to register with the CFTC as a CPO if they fall within the definition of a CPO found in Section 1a(11) of the CEA, which includes any person engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, with respect to that commodity pool, solicits, accepts, or receives from others, funds, securities or property for the purpose of trading in commodity interests. As part of the CPO registration process, the CFTC requires applicants to disclose whether they or their principals have in their background one of the disqualifications enumerated in Section 8a(2) of the CEA. If so, the CFTC typically denies the application for registration.

CFTC Regulation 4.13 provides an exemption from these CPO registration requirements for certain categories of persons and entities, including those engaged in only de minimis CPO business and certain persons acting as directors or trustees of a commodity pool. Before the new rulemaking, however, exempt CPOs were not required – as registered CPOs are – to disclose whether they or their principals had in their background one of the disqualifications enumerated in Section 8a(2). In the CFTC's words, new Regulation 4.13(b)(1)(iii) is intended to close this regulatory gap by "eliminat[ing the] inconsistent treatment between exempt and registered CPOs."

Statutory Disqualification Under CEA Section 8a(2)

As noted above, the disclosure requirements of new Regulation 4.13(b)(1)(iii) are triggered by, and limited to, the "statutory disqualification" events enumerated in Section 8a(2) of the CEA. The list includes various regulatory, civil and criminal sanctions, including:

- Suspension of a prior registration
- Refusal of an attempted registration
- Injunctions prohibiting a person from acting as a commodity pool operator
- Certain criminal convictions
- Violations of the securities laws

Before the enactment of 4.13(b)(1)(iii), it was possible for CPOs to get around the obligation to disclose such disqualifications by operating within an exemption under CFTC Rule 4.13. In its release adopting Regulation 4.13(b)(1)(iii), however, the CFTC stated that "it believes that requiring persons to attest to both their and their principals' lack of a Covered Statutory Disqualification" was necessary to "further enhance the

customer protection of exempt pool participants, and more generally, promote the public interest."

Exception and Exemption

Although the new regulation trues up the disclosure obligations of exempt and registered CPOs, it contains an exception: An exempt CPO need not represent that it and its principals have no statutory disqualification in their background if "such disqualification arises from a matter which was disclosed in connection with a previous application for registration [with the CFTC], where such registration was granted."

In addition, the CFTC provides an affirmative means for CPOs to seek relief from the effects of the new regulation. CFTC Rule 4.12(a) permits the CFTC to exempt persons from the requirements of Regulation 4.13(b)(1)(iii) if it finds "that the exemption is not contrary to the public interest and the purposes of the provisions from which exemption is sought." But the CFTC made clear that the likelihood of obtaining relief through this mechanism is small, stating explicitly that the CFTC "expects the granting of such requests to be infrequent."

What Does This Mean for CPOs?

It seems unlikely that new Regulation 4.13(b)(1)(iii) will dissuade CPOs from relying on the exemptions under Regulation 4.13 if they are determined to continue operating as a CPO, if only because there is no other option. Registering as a CPO instead of seeking an exemption would result in the same scrutiny of firm principals for past disqualifying events. A more likely result is that the new regulation will cause firms to reshuffle their roster of principals to come into compliance, or to decide that the regulatory requirements for acting as a CPO – exempt or non-exempt – are simply too onerous, in which case they will redesign their trading strategy to exclude commodity interests, thereby not operating as a CPO. Although the exemption for "family offices" found in Regulation 4.13(a)(6) is still an option for CPOs who do not wish to disclose statutory disqualifications, that exemption is narrow and will not work for CPOs who depend on external investment to fund their strategies.

For CPOs who still wish to rely on the exemptions offered by Regulation 4.13, additional compliance measures may be necessary. If they are not already doing so, compliance personnel should consider scrutinizing current and prospective principals to determine whether any of them has in his or her background any of the disqualifying events enumerated in Section 8a(2) of the CEA. This is a two-step process: first, CPOs will have to determine who qualifies as a "principal" within the meaning of CFTC Regulation 3.1(a). Second, CPOs will have to parse the various sub-sections of CEA Section 8a(2) to determine whether any of the enumerated events apply to the CPO's principals.

In many cases these questions will be easy to answer (and some CPOs may already be collecting this information about their principals), but there will be many less straightforward cases as well. The best course is to retain competent compliance counsel with experience navigating the CEA to provide an independent opinion. At a minimum, a firm's compliance program should provide for review of current and prospective principals'

disciplinary histories by an experienced in-house lawyer.

To obtain more information, please contact the Barnes & Thornburg attorney with whom you work or David Slovick at 646.746.2019 or dslovick@btlaw.com, or Trace Schmeltz at 312.214.4830 or tschmeltz@btlaw.com.