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Commodity Pool Operators and Commodity Trading Advisors

K&L Gates Investment Management Seminar Addresses Compliance Obligations for Registered CPOs and CTAs, OTC Derivatives Trading, SEC Examinations of Private Fund Managers and the JOBS Act (Part One of Two)

Jan. 30, 2014
By Jennifer Banzaca, *Hedge Fund Law Report*

K&L Gates partners and in-house counsel gathered on December 10, 2013 at the firm's annual investment management seminar to provide updates on some of the most pertinent topics impacting the private fund industry. This two-part series summarizes salient points from various sessions at the seminar. This first installment summarizes a session covering CFTC and NFA regulations impacting registered commodity pool operators (CPOs) and commodity trading advisors (CTAs) as well as U.S. and European regulations governing transactions in swaps and other over-the-counter derivatives, including discussions of swap execution facilities (SEFs) and the European Market Infrastructure Regulation (EMIR). The second installment will discuss two sessions, one addressing the newest approaches and strategies used by the SEC to examine investment managers and bring enforcement actions where necessary, and another tackling the implications of the JOBS Act for fund managers.

CPO & CTA Regulation

This panel discussion began with a discussion of CFTC and NFA regulations applicable to registered CPOs and CTAs. K&L Gates partner Cary Meer emphasized throughout the session that CPO registrants are subject to an additional layer of regulations imposed by the CFTC and the NFA, which are not harmonized with regulations promulgated by the SEC and impose significant new burdens on dual registrants. "If you are registered as a CPO or CTA, you cannot just have a compliance manual addressing SEC rules. You must update it and focus on the CFTC's rules related to CPOs and CTAs and the NFA's rules, including their interpretive notices. The most significant thing is hiring policies. You really must do due diligence on the people that you hire to make sure they do not have disqualifications. The NFA expects you to focus on that during your hiring process."

Emphasizing this point, Meer observed that while many CPO registrants operating private fund commodity pools can rely on the Rule 4.7 relief from certain CFTC obligations, they are still subject to certain CFTC requirements over and above those imposed by the SEC. "This gets you out of the fully compliant disclosure document and gets you out of most reporting and

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recordkeeping requirements. However, this rule does not work so well with the SEC's rules. For instance, if you are not a fund of funds, you have to submit your annual report with the CFTC within 90 days. The SEC's custody rule gives you 120 days. You can request an extension with the CFTC on a case-by-case basis, but there is no blanket relief." Meer also noted that managers that have to register as CPOs must submit quarterly reports to investors that contain certain specified information within 30 days of the end of each quarter. "For folks that do not have final NAVs until close to that time, this rule is also a problem." Meer indicated that the industry has requested blanket relief from these reporting deadlines, but the CFTC has not yet acted to grant such relief to address these burdens.

Meer then discussed a litany of CFTC and NFA obligations applicable to registered CPOs and CTAs, beginning with NFA Bylaw 1101. "The most significant thing that is different from the securities space is NFA Bylaw 1101. When you register as a CPO or CTA, you must become a member of the NFA and you become subject to all of its rules and bylaws. Bylaw 1101 basically says if you are an NFA member, you are not supposed to be dealing with someone else who is supposed to be an NFA member and is not. The NFA makes you look at the people you trade with (e.g., futures commission merchants), the investors in your funds, the placement agents you use and, if you are a fund of funds, the underlying managers in which you invest to see if they must be registered or if they have a valid exemption." Meer noted that this due diligence was a problem for those CPOs and CTAs that were required to register with the CFTC as of January 1, 2013 because they had to send out questionnaires to relevant parties to ascertain such parties' CFTC registration status. This created mass confusion within the industry. Meer noted that, historically, the NFA has been fairly understanding with a firm that has demonstrated good faith efforts to come into compliance with Bylaw 1101. However, Meer predicted that, in the future, the NFA will become more rigorous with respect to Bylaw 1101 compliance. See "CPO Compliance Series: Conducting Business with Non-NFA Members (NFA Bylaw 1101) (Part One of Three)," Hedge Fund Law Report, Vol. 5, No. 34 (Sep. 6, 2012).

Meer also highlighted the fact that CFTC and NFA advertising regulations differ somewhat from those contained in the Investment Advisers Act of 1940. Notably, the CFTC and NFA frown upon the use of hypothetical performance, whereas the SEC allows for the presentation of such performance results if appropriate disclosures and disclaimers are provided.

Additionally, Meer noted that managers must periodically provide training to employees, particularly people registered as associated persons. The NFA does not prescribe particular topics to be covered. However, it does prescribe methods for keeping records of the topics addressed, who was trained and when the training took place. The person providing the ethics training must hold a Series 3 license unless a waiver is obtained from the NFA.

Fund managers must also identify the principals and associated persons for their firms because a CPO must list its principals on its registration application with the NFA (Form 7-R) and register its associated persons with the NFA (Form 8-R) and submit a Form 8-R for each natural person principal so that the NFA can perform a background check. Associated persons of a CPO or CTA are essentially those employees that solicit investors on behalf of the commodity pool. Meer indicated that the NFA has made this a key focus area for its audits of CPOs and CTAs. Meer explained that managers that use a broker-dealer or placement agent to solicit investments in their funds may be able to avoid having to designate people as associated persons and to register such associated persons. However, CPOs and CTAs must ensure that broker-dealers that are soliciting investors for their funds hold Series 7 and Series 6 licenses. Additionally, managers engaging broker-dealers to solicit managed account investors must ensure that such broker-dealers hold Series 31 licenses.

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Another issue fund managers must be aware of is that the CFTC requires "branch offices" to have branch office managers. Meer explained, "That's a separate registration category and the branch office managers actually have to take a test. So, you first have to determine whether you actually have a branch office. Generally, a branch office is someplace other than your main business office where you employ associated persons. If you have people that are in other offices that are soliciting investors or supervising people who are soliciting investors or managed account clients, that is a branch office and needs a branch office manager and that person must pass the Series 30 exam unless there is an exam waiver. The NFA has agreed that, if you have a supervisory procedure and people are supervised at the main office and you only have one or two employees at the branch office, you can sometimes get out of the branch office manager requirement."

The CFTC and NFA also require CPO and CTA members to conduct an annual self-examination based on an examination checklist, which is available on the NFA website. Meer explained that the checklist contains a general section for all NFA members, a section for CPOs and a section for CTAs. "It asks very different questions than those for the annual compliance review conducted pursuant to the Advisers Act," Meer explained. "It does not need to be completed in the sense that you have to fill out a form, but each year, you have to review the form and the sections that apply to you and write up a memo where you go through all of the questions and have answers to each and every one of them. It's another way of making sure you know what your compliance obligations are."

The NFA also requires that registrants complete an annual questionnaire on the NFA website that is separate from the self-examination to be completed based on the checklist. Members must complete this annual questionnaire by the anniversary of their registration, although the NFA grants members a 30-day grace period for completion of the questionnaire.

Meer also briefly addressed the confusion over which entity fund managers are required to register as CPOs for their funds operating as commodity pools. Historically, the general partner of funds organized as limited partnerships and managing members of funds organized as limited liability companies registered as CPOs with the CFTC. Meer explained that in August 2012, the CFTC issued guidance (frequently asked questions on Amendments to CPO Obligations) indicating that general partners, managing members and other operators of funds operating as commodity pools would be permitted to delegate their CFTC-related obligations to the fund's investment manager, among others. The CFTC-granted relief did not specifically require firms to file a request for no-action relief with the CFTC for each delegation arrangement. However, in March or April of 2013, the CFTC appeared to back away from its August 2012 guidance, and ultimately, managers began to flood the CFTC with no-action letter requests relating to their individual delegation arrangements. Nonetheless, the CFTC has been very slow to respond to any such requests for no-action relief and has yet to provide much more definitive guidance as to appropriate delegation arrangements.

Regulation of Swaps and OTC Derivatives

Swap Execution Facilities

The Dodd-Frank Act significantly revamped the trading of swaps and other over-the-counter derivatives, including requiring central clearing and exchange trading of such instruments in specified circumstances. Among other things, beginning on October 2, 2013, any CFTC-regulated swaps trading facility that offers "multiple-to-multiple" swap trading capabilities is no longer authorized to execute swap transactions unless it registered as a swap execution facility (SEF)

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with the CFTC, which means that many swaps that were previously executed as over-the-counter trades will now be executed through the SEF. Swaps are designed to provide additional liquidity and transparency into the swaps trading market.

Customers that wish to execute swaps on such SEFs must, among other things, enter into user agreements with the SEF and agree to abide by the rules imposed by the SEF. A swap is required to be executed on a SEF if the CFTC subjects the swap to mandatory central clearing; if it is accepted for clearing by a clearing organization; and a SEF or a designated contract market makes a "made available to trade" determination with respect to that swap. As K&L Gates partner Anthony Nolan pointed out, "The categories of swaps currently designated for mandatory central clearing by the CFTC are most interest-based swaps and a wide range of credit default swaps. This has caused some concern in the investment management industry as to whether it is possible to get best execution on a trade if there are a limited number of SEFs providing it. There are many aggregation facilities that can serve as clearing houses for SEFs. So, that might help address best execution, but it does not fully address the additional liquidity concerns. These concerns have been compounded by some uncertainty regarding whether the rulebooks for SEFs that have been provisionally registered are actually in compliance with CFTC rules."

Swap trading on SEFs is anticipated to begin in February 2014. For trades that are required to be executed on a SEF, there are requirements on how trades may be executed, whether through an order book system or a request for quote system. If a market participant wishes to engage in a swap transaction that is required to be centrally cleared, the swap must be submitted to a clearinghouse for clearing unless an exception applies. Additionally, all OTC derivatives are now reported to swaps data repositories. Typically, the reporting obligation will fall not on the fund manager, but on the swap dealer counterparty. As such, fund managers must ensure that such counterparties are registered as broker-dealers. See "A Practical Guide to the Implications of Derivatives Reforms for Hedge Fund Managers," Hedge Fund Law Report, Vol. 6, No. 29 (Jul. 25, 2013).

Nolan highlighted the concern that foreign multiple-to-multiple trading facilities may be concerned about taking on U.S. customers because such customers could potentially subject the trading facility to SEF regulation, which could ultimately result in the availability of fewer trading facilities for U.S. fund managers. "The CFTC said that any multiple-to-multiple trading facility is required to register with a SEF regardless of whether the trades are actually subject to mandatory clearing. This creates an issue for trading platforms that are outside of the U.S. From the point of view of a U.S. investment manager, you can have a situation in which you are trading on an offshore trading platform, but you will be bounced out of the platform if it does not want to register as a SEF or, alternatively, be put into a separate sub-platform so that U.S. regulated customers will be segregated and only permitted to trade cleared products."

Another requirement to be aware of is the separate recordkeeping requirement for SEF participants. Nolan explained that there is a requirement to keep all written records and oral records. "This is similar to the general swap clearing records requirements, but different in significant detail; there is an exemption for certain market participants from having to maintain oral records, including registered CPOs," Nolan stated. "The relief does not apply to standalone CTAs."

K&L Gates partner Sean Donovan-Smith then turned to a discussion of the EMIR cross-border interpretation, which imposes three overarching obligations on those who trade OTC derivatives, which include:

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- To clear OTC derivatives that have been declared subject to the clearing obligation through a central counterparty (CCP);
- To put in place certain risk management procedures for OTC derivatives transactions that are not cleared; and
- To report derivatives to a trade repository.

EMIR imposes central clearing for OTC derivative contracts and also imposes trade reporting requirements. Those who trade derivatives must apply risk mitigation techniques, such as using timely confirmations, regular portfolio reconciliation, implementing dispute resolution procedures and using mark-to-market values where possible. See "Comparing and Contrasting EMIR and Dodd-Frank OTC Derivatives Reforms and Their Impact on Hedge Fund Managers," Hedge Fund Law Report, Vol. 6, No. 36 (Sep. 19, 2013).

According to Donovan-Smith, EMIR's cross-border interpretations are similar to CFTC regulations addressing OTC derivatives reforms. "If you are dealing with any EU counterparties for OTC derivative contracts, they are likely to ask you to make certain representations or to sign up under various protocols under ISDA. So, you should get a sense of what these regulations are."

Donovan-Smith explained that EMIR is only relevant to managers that deal with EU counterparties. However, it introduces central clearing and risk-mitigation elements to derivatives trading. EMIR also introduces regulation similar to that applicable to SEFs. EMIR requires counterparties to report details of all derivatives contracts, whether cleared or not cleared, and traded on an exchange or over the counter, to trade repositories.

"To what extent you are exposed to central clearing obligations or risk mitigation techniques depends on how you are characterized as a counterparty," Donovan-Smith explained. "There are EU financial counterparties, EU non-financial counterparties and third country entities. A financial counterparty is an EU-based counterparty that could include banks, insurers, broker-dealers, investment firms, credit institutions and alternative investment funds. A non-financial counterparty is defined as an EU-based undertaking other than a central counterparty or a financial counterparty. A third-party country entity is an OTC derivatives counterparty that is not based in the EU.

Donovan-Smith highlighted new margin requirements with respect to uncleared OTC derivatives trades. For instance, counterparties are required to collect and post initial margin on non-centrally cleared trades and to exchange variation margin. These requirements will be phased in over the next few years.

EMIR also addresses extraterritorial questions, stating that where one party to the contract is established in a third country, the party would not be subject to EMIR obligations provided that the non-EU state has an equivalent regulatory framework.

EMIR also requires counterparties to establish a dispute resolution process. Parties should have procedures in place for identifying, recording and monitoring disputes relating to recognition and valuation of the contract or the collateral. These procedures should, at a minimum, record the length of the dispute, the counterparty and the disputed amount; provide for the resolution of disputes in a timely manner (specifically, process unresolved disputes within five business days); and provide for counterparty reporting to their relevant authority any disputes relating to an OTC derivative contract for which the valuation or the exchange of collateral is greater than €15 million and the dispute has lasted at least 15 days.

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