CFTC Expands Exemptive Relief for Certain Non-U.S. Commodity Pool Operators

November 19, 2020

On October 15, 2020, the Commodity Futures Trading Commission (the "CFTC") adopted a final rule (the "Final Rule")[1] expanding the exemptive relief available to non-U.S. commodity pool operators ("CPOs") of certain non-U.S. commodity pools that have only foreign located persons and international financial institutions as participants.

For CPOs, three key amendments adopted by the Final Rule are:

- *Pool-by-Pool Exemption*: A non-U.S. CPO can rely on the exemptive relief in respect of a qualifying pool even if it serves as a CPO to other pools in which U.S. persons are invested;

- *Permitted Seed Investments by U.S. Affiliates*: Initial capital contributions to a pool made by U.S. affiliates of a non-U.S. CPO may be disregarded in determining whether participation in that pool is limited to only foreign located persons; and

- *Safe Harbor*: A non-U.S. CPO that satisfies certain conditions with respect to its marketing, sale and administration of a non-U.S. pool may rely on a safe harbor mechanism by which the pool will be deemed to satisfy the "foreign located persons" requirement.

In addition to adopting the foregoing changes in respect of CPOs, the Final Rule also implements or formalizes certain additional relief for non-U.S. CPOs, as well as for other non-U.S. persons acting as a futures commission merchant ("FCM"), introducing broker ("IB") or commodity trading advisor ("CTA", and collectively, "Foreign Intermediaries").

The rule amendments pursuant to the Final Rule take effect 60 days following publication in the Federal Register.

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[1] The CFTC "voting draft" containing the text and description of the Final Rule is *available at*: https://www.cftc.gov/media/5061/votingdraft101520Part3/download.

Exemptive Relief for a CPO Operating in Multiple Jurisdictions

Background and Generally Applicable Rule Amendments

Prior to the adoption of the Final Rule, CFTC regulation 3.10(c)(3) granted an exemption from registration as a CPO, CTA or IB to a person located outside the United States that engaged in such activity in connection with any commodity interest transactions if such transactions were:

- executed only on behalf of persons located outside the United States, its territories or possessions; and
- submitted for clearing through a registered FCM.

For all Foreign Intermediaries, the amendments adopted by the Final Rule:

- provide that the requirements of the exemption can be met if the Foreign Intermediary's clients or pool participants, as applicable, are limited to certain "international financial institutions,"[2] as well as "foreign located persons";[3] and
- ease the prior requirement that all transactions in commodity interests be submitted for clearing through a registered FCM, such that only futures and clearable swaps must be so cleared.

In each case, the exemption is self-executing and does not require that any claim for exemptive relief be filed with the CFTC or the National Futures Association (the "NFA").

Key Rule Amendments for CPOs

The Final Rule implements three key changes for CPOs relying on the exemptive relief provided by CFTC regulation 3.10 (the "3.10 Exemption").

Pool-by-Pool Exemption

The exemptive relief available to non-U.S. CPOs under former CFTC regulation 3.10(c)(3) was not available to a CPO that engaged in activities on behalf of *any* U.S. person, even if such U.S. person was in a separate pool from a non-U.S. pool with only

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[2] The term "international financial institution" is defined to include certain international organizations and their agencies and pension plans (including, for example, the International Monetary Fund, the International Bank for Reconstruction and Redevelopment, the United Nations and other identified or similar organizations).

[3] A "foreign located person" is defined as a person located outside the United States, its territories or possessions.

non-U.S. participants. In addition, a registered CPO could not rely on the exemption in respect of its non-U.S. pools.[4]

As amended by the Final Rule, CFTC regulation 3.10(c)(5)(i) permits a non-U.S. CPO to apply the 3.10 Exemption on a pool-by-pool basis. As such, a non-U.S. CPO may rely on the 3.10 Exemption in respect of a particular non-U.S. commodity pool if all of the participants in such pool are foreign located persons or international financial institutions, even if such CPO operates other commodity pools that do not meet the requirements for the 3.10 Exemption.[5]

In addition, CFTC regulation 3.10(c)(5)(iv) expressly indicates that utilizing the 3.10 Exemption in respect of a qualifying pool will not preclude a CPO from registering with the CFTC as a CPO or relying upon or claiming other available exemptive or exclusionary relief for other pools. Thus, for example, a non-U.S. CPO claiming the 3.10 Exemption for a qualifying pool can also claim another exemption or exclusion, such as the *de minimis* exemption provided by CFTC regulation 4.13(a)(3), in respect of one or more other commodity pools. Further, a registered non-U.S. CPO can rely on the 3.10 Exemption in respect of qualifying pools and thereby avoid any reporting requirements, such as those pursuant to Form CPO-PQR filings, in respect of such pools.[6]

Permitted Seed Investments by U.S. Affiliates

Amended CFTC regulation 3.10(c)(5)(ii) incorporates an exception for initial capital contributions made by U.S. affiliates of a non-U.S. CPO. Such affiliates are not viewed as participants in the relevant pool for purposes of determining whether all participants are foreign located persons pursuant to the 3.10 Exemption. Although the Final Rule does not explicitly define "initial" for this purpose, the discussion in the CFTC's voting

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[4] Note, however, that CFTC Staff Advisory 18-96 permits a qualifying registered CPO operating offshore commodity pools to claim relief from certain disclosure, reporting and recordkeeping requirements with regard to its offshore commodity pools, subject to certain conditions. Advisory 18-96 also permits a qualifying registered CPO, as an alternative, to claim relief solely from the books and records location requirement in CFTC regulation 4.23, allowing such CPO to maintain its offshore pool's original books and records at the pool's offshore location, subject to certain conditions.

[5] It is important to note, however, that the definition of "foreign located persons" is somewhat vague and leaves open some questions as to what factors are determinative when concluding that a particular person (individual or entity) is "foreign located", and the CFTC has not provided guidance that is relevant for this purpose. For an individual, the determination might be based on citizenship or residence (though the stronger view is likely residence). Making a determination for an entity is potentially a bigger challenge. Almost certainly, such an entity should be formed outside of the United States. But it isn't necessarily clear whether an entity formed in an offshore jurisdiction (*e.g.*, the Cayman Islands) but managed solely by officers or principals located in the United States would qualify as "foreign located" for purposes of the Final Rule. As such, a determination generally needs to be made on a case-by-case basis and taking all relevant factors into account.

[6] Prior to the effectiveness of the Final Rule, registered CPOs that operated offshore commodity pools, as well as other commodity pools with U.S. participants, were still required (pursuant to CFTC Staff Advisory 18-96) to identify and report certain information regarding the offshore pools in their Form CPO-PQR filings with the NFA.

draft of the Final Rule (the "Voting Draft") indicates that qualifying contributions must be made at or near inception of the pool.

In addition, this exception is not available with respect to capital contributions made by affiliates who are natural persons, and is further conditioned upon interests in the affiliate not being marketed as providing access (*i.e.*, indirectly through the capital contribution to the relevant pool) to trading in commodity market interests in the United States, its territories or possessions. Finally, use of this exception is conditioned upon the U.S. affiliate and its principals not being barred or suspended from participating in commodity interest markets in the United States, its territories or possessions.

Safe Harbor

In the Voting Draft, the CFTC acknowledged that some non-U.S. CPOs may not have full visibility into the beneficial ownership of pool interests and may not be able to represent with certainty that they are acting only on behalf of foreign located persons participating in their offshore pools. As such, the Final Rule incorporates a "safe harbor" with respect to inadvertent U.S. participants in offshore pools.

As amended, CFTC regulation 3.10(c)(5)(iii) indicates that a commodity pool operated by a foreign located CPO will be considered to be operated in accordance with the requirements of the 3.10 Exemption if:

- the commodity pool is organized and operated outside the United States, its territories or possessions;
- the commodity pool's offering materials and any underwriting or distribution agreements include clear, written prohibitions on the commodity pool's offering to participants located in the United States and on U.S. ownership of the commodity pool's participation units;
- the commodity pool's constitutional documents and offering materials are reasonably designed to preclude persons located in the United States from participating therein, and include mechanisms reasonably designed to enable its CPO to exclude any persons located in the United States that attempt to participate in the commodity pool notwithstanding such prohibitions;
- the CPO exclusively uses non-U.S. intermediaries for the distribution of participations in the commodity pool;

- the CPO uses reasonable investor due diligence methods at the time of sale to preclude persons located in the United States from participating in the commodity pool; and

- the commodity pool's participation units are directed and distributed to participants located outside the United States, including by means of listing and trading such units on secondary markets organized and operated outside the United States, and in which the CPO has reasonably determined participation by persons located in the United States is unlikely.

CTAs Do Not Currently Benefit from Pool-by-Pool Exemptive Relief

In the Voting Draft, the CFTC indicates that it is expressly declining at this time to adopt further expanded exemptive relief for CTAs. The CFTC notes that several commentators on the proposed rules argued in favor of extending similar concepts as those adopted for non-U.S. CPOs (*e.g.*, pool-by-pool exemptive relief) to non-U.S. CTAs. Although the CFTC does not rule out this possibility for the future, at this time non-U.S. CTAs that wish to rely on this exemption remain subject to the requirement that all of their commodity trading advice be provided solely to persons that are either foreign located persons or international financial institutions.

Concluding Thoughts

The Final Rule may provide more expansive exemptive relief to non-U.S. CPOs. An unregistered non-U.S. CPO that meets the conditions for the relief with respect to particular offshore pools may be able to rely on the exemption without the need for monitoring compliance with the requirements of other available exemptive relief (*e.g.*, the *de minimis* exemption). A registered non-U.S. CPO that meets the conditions for the relief with respect to certain pools may have the option to delist qualifying offshore pools or not list new pools in the first instance, and would no longer need to file notices regarding such pools with the NFA (pursuant to CFTC Staff Advisory 18-96) or include such pools in their Form CPO-PQR filings with the NFA.

There are potential risks, however, if a CPO does not have a clear view of the ownership composition of its non-U.S. commodity pools. The safe harbor discussed above may provide some benefit in this regard, but the requirements of the safe harbor are fairly extensive and subject to some interpretation. At a minimum, a non-U.S. CPO that seeks to rely on the 3.10 Exemption with respect to a given non-U.S. pool should not solicit or accept investments in such pool from persons who it knows or suspects to be U.S. persons. In addition, relevant constitutive and offering documents for the pool should

clearly indicate that interests in the pool may only be acquired and held by and on behalf of foreign located persons or international financial institutions.

For many unregistered non-U.S. CPOs that believe they are eligible to claim the *de minimis* exemption under CFTC regulation 4.13(a)(3), doing so may be simpler and safer in practice.

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Please do not hesitate to contact us with any questions.

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