

CLIENT UPDATE

CFTC STAFF ADVISORY ON COMMODITY TRADING ADVISORS AND SWAPS

NEW YORK

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd Frank Act”) imposed additional new requirements on commodity trading advisors (“CTAs”), and amended the definition of CTA in the Commodity Exchange Act (“CEA”) to include any person who engages in the business of advising others on swaps. As a result, the CEA and the regulations (the “Regulations”) of the Commodity Futures Trading Commission (the “Commission” or the “CFTC”) applicable to CTAs will generally apply to an expanded group of advisors. In addition, certain CTAs previously exempt from registration are now required to register because of the rescission of Regulation 4.13(a)(4) and amendments to Regulation 4.5.¹

The Division of Swap Dealer and Intermediary Oversight (“Division”) recently issued a staff advisory (“Staff Advisory”)² to inform the newly expanded class of CTAs and those previously exempt CTAs that are now subject to registration as to the general regulatory framework. The Division divided the Staff Advisory into three sections: the first section provides background on the CEA and the Regulations generally applicable to CTAs; the second section

¹ See our Client Update, Amendments to CFTC Part 4 Regulations Regarding Commodity Pool Operators and Commodity Trading Advisors, available at <http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=e42014f7-c21f-4106-8932-383132e8b16a>.

² Available at <http://www.cftc.gov/PressRoom/PressReleases/pr6807-13>.

addresses a CTA's advisory obligations with respect to swap risk disclosures; and the third section reviews the requirements relevant to CTAs that advise Special Entities³ on swap transactions.

CTA BACKGROUND

A CTA is any person who, for compensation or profit, whether directly or indirectly, engages in the business of advising others, or as part of a regular business issues reports or analysis, as to the value of or the advisability of trading in, among other things, any futures contract or swap.⁴

Unless an exemption is available under the CEA or the Regulations,⁵ a CTA must register with the CFTC and comply with additional regulatory requirements,⁶ such as: delivering a disclosure document to a prospective client in certain circumstances; maintaining client records; diligently supervising the activities of its officers, employees and agents; and filing an annual Form CTA-PR with the National Futures Association ("NFA"). Moreover, registered CTAs who manage or exercise discretion over customer accounts generally must be members of the NFA.

In addition, certain regulatory requirements apply to all CTAs, whether registered or unregistered. For example, a CTA may not refer to any testimonial or to any simulated or hypothetical performance of the CTA or its principals, unless certain disclosures are made. Additionally, CTAs may not represent or imply that they have been recommended or approved, or that their abilities or qualifications have been passed upon, by the Commission or the Federal government. Generally, CTAs may not solicit or accept client

³ A "Special Entity" is a Federal agency; a State, State agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State; any employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"); any governmental plan, as defined in Section 3 of ERISA; any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986; or any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying a swap dealer or major swap participant of its election prior to entering into a swap with the particular swap dealer or major swap participant. Regulation 23.401(c).

⁴ However, exclusions from the definition of a CTA apply to otherwise-regulated persons and persons engaged in certain professions whose advisory services are solely incidental to such persons' otherwise-regulated business or profession (including e.g., trust companies, regulated insurance companies, accountants).

⁵ For example, a person is not required to register as a CTA if the person does not direct client accounts and does not provide commodity trading advice based on, or tailored to, the positions or other circumstances of particular clients. In addition, a person is not required to register as a CTA if, during the course of the preceding 12 months, that person has not furnished commodity trading advice to more than 15 persons and it does not hold itself out generally to the public as a CTA.

⁶ CTAs that are exempt from registration are nonetheless subject to certain regulatory requirements that apply to all CTAs.

funds or other property (or extend credit in lieu thereof) to purchase, margin, guarantee or secure any commodity interest of a client, including a swap. The general prohibition contained in CEA section 4o(1)(B) against fraudulent or deceitful activity upon a client or prospective client is also applicable to all CTAs.

CTAS AND SWAP RISK DISCLOSURES

With respect to a swap transaction, a CTA with disclosure obligations must disclose to its clients those risks that constitute either “principal risk factors” or “material information.” Swaps regulations now make available important information regarding the material risks of certain swaps transactions. Regulation 23.431(a) requires a swap dealer or major swap participant to disclose to its counterparties (other than swap dealers and major swap participants) “material information concerning the swap” at a reasonably sufficient time prior to entering into the transaction. That “material information” includes, among other things, the “material risks of the particular swap” Additionally, prior to entering into the swap, the counterparty may “request and consult on the design of a scenario analysis to allow the counterparty to assess its potential exposure in connection with the swap,” along with other information.⁷

A CTA with disclosure obligations should assess the risks of particular swap transactions that are part of its trading program, including those disclosed in accordance with Regulation 23.431(a);⁸ the CTA must then disclose to its clients those risks that constitute either “principal risk factors” or “material information.” In certain circumstances registered CTAs have obligations to disclose the “principal risk factors” of their trading programs, and all material information, even if the information is not specifically required by Commission disclosure regulations. Additionally, if the registered CTA “knows or should know that the Disclosure Document is materially inaccurate or incomplete in any respect, it must correct that defect and must distribute the correction to” all existing clients and previously solicited prospective clients.

⁷ These new disclosure obligations of swap dealers and major swap participants do not apply to transactions made available for trading on a designated contract market or swap execution facility.

⁸ The Division notes that there may be circumstances where disclosures in accordance with Regulation 23.431(a) are delivered directly to the client, rather than to the CTA. In situations where the CTA has disclosure obligations, the CTA may well desire to obtain that information in order to assess the risks of such swaps in the context of its trading program. Even where the CTA does not have disclosure obligations, however, it may be appropriate, depending on the nature of the advisory relationship, for the CTA to advise its client regarding the availability of the disclosures and scenario analyses under Regulation 23.431, and request a copy of such information from the client.

CTAS THAT ADVISE SPECIAL ENTITIES ON SWAPS

A CTA that acts as an independent representative to a Special Entity in connection with a swap transaction where the counterparty is a swap dealer or major swap participant must satisfy certain qualifications, and must undertake a duty to act in the “best interests” of the Special Entity.⁹ Moreover, by virtue of its role advising the Special Entity with respect to the swap, the independent representative must also be registered as a CTA, unless otherwise excluded from the CTA definition or exempt from registration, as discussed above.

Special Entities Should Be Independently Represented in Connection with Swap Transactions where Their Counterparties Are Swap Dealers or Major Swap Participants

Whenever a swap dealer or major swap participant offers to enter or enters into a swap with a “Special Entity,” that swap dealer or major swap participant must have a reasonable basis to believe that Special Entity is being advised by an independent representative that has certain qualifications specified by Congress and the Commission.

Qualifications of an Independent Representative to a Special Entity

The qualifications of the independent representative are set forth both in CEA Section 4s(h)(5) and Regulation 23.450(b)(1) and (b)(2), and include having sufficient knowledge to evaluate the transaction and risks; not being subject to a statutory disqualification; being independent of the swap dealer or major swap participant; undertaking a duty to act in the “best interests” of the Special Entity; making appropriate and timely disclosures; evaluating and providing written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction; and in the case of an ERISA plan, being an ERISA fiduciary.

How an Independent Representative to a Special Entity May Satisfy Its “Best Interests” Duty

The “best interests” duty is “the duty to act in good faith, make full and fair disclosure of all material facts and conflicts of interest, and to employ reasonable care to advance the Special Entity’s stated objectives.”

⁹ For both registered CTAs and exempt CTAs, the person acting as an independent representative of a Special Entity has a duty to act in the “best interests” of the Special Entity and must satisfy the other requirements applicable to independent representatives.

A representative should establish and comply in good faith with written policies and procedures that identify, manage and mitigate material conflicts of interest including, where appropriate, those arising from (1) compensation or incentives for employees that carry out the representative's obligations to the Special Entity, and (2) lines of business, functions and types of activities conducted by the representative for the swap dealer or major swap participant.

In satisfying the duty to employ reasonable care to advance the Special Entity's stated objectives, an independent representative should make reasonable efforts to obtain a range of information such as: the financial status, future funding needs, and tax status of the Special Entity; hedging, investment, financing, or other objectives of the Special Entity; the experience of the Special Entity with respect to entering into swaps generally, and swaps of the type and complexity being recommended; and whether the Special Entity has the financial capability to withstand changes in market conditions during the term of the swap. In addition, the independent representative should endeavor to obtain such other information as is relevant to the particular facts and circumstances of the Special Entity, market conditions, or type of swap or trading strategy being recommended.

CTA Registration Requirements for an Independent Representative of a Special Entity

An independent representative under CEA Section 4s(h)(5) that advises State and municipal Special Entities will be subject to registration with the Commission as a CTA, except for those independent representatives who are employees of such entity or otherwise excluded or exempt under the CEA or Commission rules.

Situations where a CTA Might Owe a Heightened Duty to a Special Entity

Even though the "best interest" regime established under CEA Section 4s(h)(5) is limited to situations where the CTA advises a Special Entity in connection with a swap transaction where the counterparty is a swap dealer or major swap participant, a CTA might assume fiduciary duties under common law with respect to an entity it advises, including Special Entities, under any number of circumstances, depending on the nature of their relationship.

Registered CTAs that Provide Advice to Special Entities that Are Municipalities Fall within the Commission's Jurisdiction

Under the Securities Exchange Act of 1934 ("Exchange Act") Section 78o-4(e)(4)(C), any commodity trading advisor registered under the CEA or persons associated with a trading advisor who are providing advice related to swaps are expressly excluded from the

definition of “municipal advisor.” Nonetheless, the Commission notes that to the extent that a registered CTA engages in any municipal advisory activities other than advice related to swaps, registration may still be required with the SEC.¹⁰ The Division advises CTAs in such situations to consult with the appropriate agencies and self-regulatory organizations.

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Please do not hesitate to contact us with any questions.

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¹⁰ Adopting Release, 77 Fed. Reg. 9734, 9739 n.67.