Client Update
CFTC Registration Relief for Foreign CPOs and CTAs: Correct Result, Incorrect Reasoning?

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The Division of Swap Dealer and Intermediary Oversight ("DSIO") of the Commodity Futures Trading Commission ("CFTC") recently issued a no-action letter[1] to provide certain intermediaries located outside of the United States with relief from registration requirements as a commodity pool operator ("CPO"), commodity trading advisor ("CTA") or introducing broker ("IB"). The foreign intermediaries covered by the release are those that would be eligible for registration relief under CFTC Regulation 3.10(c)(3)(i) but for their failure to meet the condition that commodity interest transactions be submitted for clearing through a futures commission merchant ("FCM").

CFTC REGULATION 3.10(C)(3)(I)

With respect to commodity interest transactions executed bilaterally or made on or subject to the rules of any designated contract market ("DCM") or swap execution facility ("SEF"), CFTC Regulation 3.10(c)(3)(i) provides an exemption from registration as a CPO, CTA or IB if that intermediary and the transaction meet the following conditions:

- The intermediary is located outside the United States;
- The intermediary acts only on behalf of persons located outside the United States; and
- The commodity interest transaction is submitted for clearing at a derivatives clearing organization ("DCO") through a registered FCM.

Commodity interests include swaps, whether executed bilaterally or on or subject to the rules of a DCM or SEF, futures and retail forex transactions.

[1] Available at: http://www.cftc.gov/LawRegulation/CFTCStaffLetters/16-08.

The remainder of this memorandum refers to CPOs, CTAs and IBs who meet the first two requirements summarized above as "Foreign Intermediaries."

NO-ACTION POSITION

The DSIO states that CFTC Regulation 3.10(c)(3)(i) was not intended to impose an independent clearing requirement on commodity interest transactions involving Foreign Intermediaries that the Commodity Exchange Act and the CFTC regulations do not otherwise require to be cleared. Accordingly, it will not recommend an enforcement action against a person located outside the United States that is engaged in the activity of a CPO, CTA or IB, in connection with swaps not subject to a CFTC clearing requirement entered into only on behalf of persons located outside the United States for failure to register in such capacity.

The no-action relief will expire on the later of the effective date or compliance date of any final rule amending CFTC Regulation 3.10(c)(3)(i).

FURTHER COMMENTS

Although the no-action position taken by the CFTC is welcomed by Foreign Intermediaries, in our view, the CFTC's basis for the no-action relief is misguided. It is correct that CFTC Regulation 3.10(c)(3)(i) does not itself create a swap clearing obligation. But that does not necessarily lead to the conclusion that relief under the Regulation should be available if a Foreign Intermediary trades swaps bilaterally or on a DCM or SEF that are not required to be cleared through a DCO.

Rather, the requirement for registration should not be imposed on a Foreign Intermediary in such circumstances in light of the regulatory objective of the related registration requirement, which, in the case of a CPO, CTA or IB, is to protect customers of such CPO, CTA or IB. The United States has no regulatory interest in protecting foreign customers of a Foreign Intermediary. That would not change because a Foreign Intermediary trades uncleared swaps with U.S. counterparties or on DCMs or SEFs. Indeed, CFTC Regulation 3.10(c)(3)(i) itself grants registration relief to a Foreign Intermediary that trades futures on DCMs or swaps cleared through DCOs. There is no basis to deny relief merely because swaps are not cleared through DCOs.

From a U.S. federal securities law perspective, a foreign investment adviser's registration requirement under the Investment Advisers Act does not depend on whether it trades or invests in securities of U.S. issuers or with U.S. persons (whether securities are traded on U.S. securities exchanges or other trading venues or whether securities transactions are cleared and settled through U.S.

clearing agencies) when such foreign investment adviser has no U.S. client's money under management and has no place of business in the United States and meets the conditions for exemption from registration requirements as a 'foreign adviser' under the Investment Advisers Act.

The United States clearly has a regulatory interest in respect of foreign intermediaries' trading activities on U.S. trading venues or with U.S. persons on behalf of foreign customers of such foreign intermediaries, even if such activities are conducted solely outside the United States. For example, the U.S. federal government needs to protect the integrity of U.S. securities and commodities markets, promote price discovery and prevent market manipulation and other abuses. The Commodity Exchange Act and U.S. federal securities laws provide the CFTC and the Securities Exchange Commission with means and tools to achieve such objectives.

However, it is very difficult to justify U.S. federal regulation of a foreign CPO or CTA that operates outside the United States and has no U.S. persons as customers solely because such CPO or CTA trades (or otherwise provides investment advice in respect of) uncleared swaps with U.S. persons or on DCMs or SEFs on behalf of its customers.[2] Foreign customers of a Foreign Intermediary have no expectation for protection under the Commodity Exchange Act, and the registration of such Foreign Intermediary would not help achieve the protection of market integrity or other policy objectives.

Since the policy objective of IB regulation is to protect the IB's customers, we believe that the same reasoning should apply with respect to a foreign IB.

We also urge the CFTC in its future rule-making to provide guidance on the meaning of the phrase "persons located outside the United States" as used in CFTC Regulation 3.10(c)(3). We believe that the scope of "persons located outside the United States" may need to be different with respect to a foreign CPO, on the one hand, and a foreign CTA or IB, on the other hand. In addition, we note that occasionally, a foreign pool operated by a foreign CPO or advised by a foreign CTA will not be an eligible contract participant ("ECP") within the meaning of section 1(a)(18) of the Commodity Exchange Act and CFTC Regulation 1.3(m) in connection with a commodity transaction in foreign currency. In such case, a "swap" in foreign currency traded by such CPO or CTA for such foreign pool will be a retail forex transaction under sections 2(c)(2)(B)

[2] The CFTC has no jurisdictional basis to regulate any such foreign CPO or CTA if such CPO or CTA trades swaps only with foreign persons or on foreign swap trading facilities.

and 2(c)(2)(C) of the Commodity Exchange Act. While the CFTC has issued interpretive guidance indicating that forex pools whose participants are limited solely to non-U.S. persons (within the meaning of CFTC Regulation 4.7(a)(1)(iv) with certain modification)[3] and which are operated by CPOs located outside the United States are ECPs for purposes of CFTC Regulation 1.3(m)(5), we are aware of foreign pools which simply cannot verify the non-U.S. person status of each participant at all times. Therefore, we believe that the future rule-making should consider the interaction between the definition of ECP and CFTC Regulation 3.10(c)(3). In any case, our view is that relief under CFTC Regulation 3.10(c)(3) should not be denied because a Foreign Intermediary trades a retail forex transaction.

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Please do not hesitate to contact us with any questions.

[3] *See* Commodity Futures Trading Commission and Securities and Exchange Commission, Further Definition of "Swap Dealer," "Securities-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 FR 30596, at 30654 (May 23, 2012).