Commodity trading advisor & Commodity Pool Operator 101

An Introduction to a vital part of the financial services industry

Managed Funds Association

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Introduction

Executive Summary:

The managed futures industry is a vital component of the financial services landscape.

Industry advisors provide important portfolio diversification and risk management tools to help investors meet their financial goals.

This presentation provides an overview of the industry, defining the roles of Commodity Trading Advisors (CTAs) and Commodity Pool Operators (CPOs) as well as the various regulatory entities and requirements shaping the marketplace.

Table of Contents:

Introduction – Managed Futures

The Managed Futures Industry:

The term managed futures describes an approximately $314* billion industry focused on investing in futures, including global bond, equity and / or commodity futures.

Futures contracts for commodities have been traded in the U.S. for more than 150 years.

- Commodity trading advisors (CTAs) invest in up to 150 global futures markets, trading in futures, forwards, and options contracts in everything from grains and gold, to currencies, stock indexes, and government bond futures.
- Collective investment vehicles that trade commodity interests (futures, options, or swaps) are known as 'commodity pools.'
- Commodity pools enable investors to diversify beyond traditional investments and gain exposure to historically non-correlated managed futures with limited risk.

*Source: Barclay Hedge

Commodity Trading Advisors and Commodity Pool Operators

What is a Commodity Trading Advisor (CTA)?

- CTAs are responsible for advising managed accounts and pooled investment vehicles, such as commodity pools.
- CTAs regularly advise investors about the value of commodity futures or options or the advisability of trading in commodity futures or options.
- A commodity pool describes an investment vehicle in which money contributed by a number of persons, investors, or entities is combined for the purpose of trading futures, swaps, contracts, or commodity options with limited liability.
- A formal definition of a CTA is provided under the Commodity Exchange Act (CEA) (P.L. 74-765).

What is a Commodity Pool Operator (CPO)?

- CPOs are the organizations managing commodity pools.
- A CPO solicits or accepts funds, securities or property from prospective investors in the commodity pool.
- CPOs can make trading decisions on behalf of the pool, or they can retain the services of a CTA to do so.
- Investments in commodity pools serve to diversify portfolios, helping to enhance portfolio returns and reduce volatility for investors.
- Public commodity pools provide retail investors with access to products that were generally available to large investors.
- CPOs are formally defined under Section 1a(5) of the CEA, 7 U.S.C. § 1a(5)

How are they Regulated?

Regulation is an important component to promote fair, transparent and efficient financial markets.

CTAs and CPOs are regulated by government entities and an industry-wide self-regulatory organization (SRO).

- **The Commodity Futures Trading Commission** (CFTC) is the government entity responsible for regulating commodity trading.
- **The National Futures Association** is the SRO responsible for regulating futures markets.

The CFTC and NFA help safeguard market integrity and protect investors through a series of regulatory requirements.

*Public pools are considered "uncovered securities" and are therefore regulated by individual state regulators, the Securities and Exchange Commission (SEC), the CFTC, the NFA and the Financial Industry Regulatory Authority (FINRA).

Regulating CTAs and CPOs - The CFTC

The Commodity Futures Trading Commission (CFTC):

The Commodity Futures Trading Commission Act of 1974 created the CFTC as an independent agency responsible for administering the CEA by regulating the commodity futures and commodity options markets in the U.S.

- The CFTC consists of five Commissioners appointed by the President with the approval of the Senate, to serve staggered five-year terms.
- The President designates one of the Commissioners to serve as Chairman.
- No more than three Commissioners at one time may be from the same political party.
- The CFTC produces "market reports" to inform traders and the general public on the status of futures and options markets.

For more information on the history of the CFTC, click here.

REGULATING CTAs AND CPOs - THE NFA

The National Futures Association (NFA):

The Commodity Futures Trading Commission Act of 1974 also authorized the creation of "registered futures associations" giving the futures industry the opportunity to create a nationwide self-regulatory organization (SRO). The NFA is the industry-wide SRO for the U.S. futures industry.

NATIONAL FUTURES ASSOCIATION®

- The NFA is comprised of a 25-member Board of Directors, which is its principal governing and policy-development body.
- Membership in NFA is mandatory and the association is financed exclusively from membership dues and assessment fees paid by the users of the futures markets.
- NFA has the authority to take disciplinary actions against any firm or individual who violates its rules.

For more information on the NFA, click here.

How Regulation Works

Commodities regulations apply to the fund's manager (CTA) or sponsor (CPO). Sometimes, the CPO and CTA are the same entity.

The process by which the CFTC regulates CTAs and CPOs includes:

- The applicants register with the CFTC.
- The CFTC monitors the market for potential manipulation.
- The agency also enforces market manipulation rules.

The process by which the NFA regulates CTAs and CPOs includes:

- All CTAs / CPOs must be registered members of the NFA.
- NFA membership stipulates that associated persons of a CTA or CPO must satisfy proficiency requirements, including passage of the National Commodity Futures Examination (known as the Series 3) prior to engaging in commodities activities.
- CTAs / CPOs must file disclosure documents with the NFA.

*These requirements are in addition to federal and state securities law requirements that apply to the fund.

CFTC Exemptions

The CFTC offers exemptions for CTAs and CPOs whose pools meet certain qualifications, including:

Exclusion from CPO Definition	CFTC Regulation 4.5 offers an exclusion from the definition of the term "commodity pool operator" for certain regulated persons. Managers wishing to claim an exclusion must file a notice of eligibility with the NFA. Regulation 4.5 also offers automatic exclusion from the CPO definition to operators of certain employee benefit plans.
Exemption from CPO Registration	CFTC Regulation 4.13 offers an exemption from CPO registration for operators of smaller pools and pools that trade at a *de minimis* level, as defined, of commodity interests in regulation. Any person claiming this exemption must also file a notice of eligibility with the NFA.
Exemption from CTA Registration	The Commodity Exchange Act provides certain exemptions from CTA registration for qualifying individuals. A list of the qualifications can be found here. Exempted parties must file with the NFA, however the relief is considered "self-executing" with the CFTC and does not require notification to the Commission.
Other Exemptions	CFTC Regulation 4.12(b) and CFTC Regulation 4.7 also provide exemptions to a registered CPO from certain requirements for funds with certain trading positions and to pools whose participants are limited to "qualified eligible persons" (sophisticated investors). Exempted parties must file notification with the NFA.

NFA Registration Exemptions

As the SRO for the futures industry, all registered CTAs and CPOs are required to be members of the NFA.

However, the NFA does provide certain exemptions to qualifying individuals based on certain criteria and in coordination with CFTC regulations:

CTAs	CTAs are required to register with the NFA unless they meet certain criteria pertaining to the size and scope of services offered. All registered CTAs who manage customer accounts must be NFA members. A summary of the registration exemptions and membership requirements can be found here.
CPOs	CPOs are required to register with the NFA unless they meet one of the requirements for exemption outlined by the CFTC. All registered CPOs must be members of the NFA in order to conduct business with the public. A summary of the registration exemptions and requirements for membership can be found here.

NFA's website also offers an Easy Reference Guide outlining registration exemptions.

Dodd-Frank and CTAs / CPOs

Changes under the Dodd-Frank Act:

The Dodd-Frank Act expanded the definition of CPO and CTA in the CEA to include entities operating pooled investment vehicles and managing commodity trading accounts that enter into swaps.

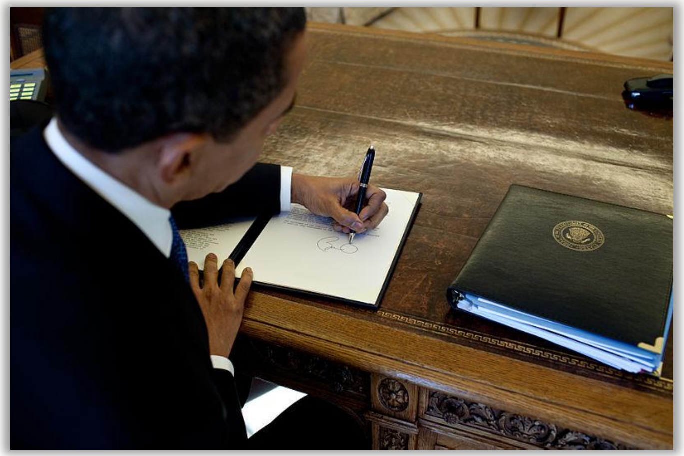
The Act also amended the definition of "commodity pool" to include pooled investment vehicles that trade commodities - including pools that enter into non-security-based swaps.

- As a result of these changes, many funds and investment managers will now be required to register as CPOs or CTAs.

On February 9, 2012, the CFTC issued final rules under the Dodd-Frank Act removing certain registration and compliance exemptions for CPOs and CTAs.

- The rules also adopt new data collection rules for CPOs and CTAs and include new risk disclosure requirements for CPO and CTA swap transactions.
- The purpose of the rules is to increase transparency in CPOs and CTAs that participate in the futures and swaps markets and enhance protections for their customers.

Once finalized, these rules will impose Dodd-Frank swap-related obligations on many funds, fund managers and investment managers, regardless of whether or not their swap activities are for client accounts or for their own investment or risk-mitigation activities.



Are Exempt CTAs / CPOs Still Regulated?

Yes. Individuals who qualify for one of the exemptions described above are still generally subject to the following requirements either under CFTC or Securities and Exchange Commission (SEC) rules:

Exempt parties **must file a publicly available notice** disclosing the fund's existence and exempt status.

- These notices are generally available for viewing electronically on a public website such as the CFTC or NFA website, or otherwise made available for public viewing.

Exempt parties **must provide investors with an offering memorandum** containing information such as:

- Fees, transferability of fund interests, conflicts of interest and other matters

Exempt parties **must provide investors with quarterly account statements** disclosing:

- The fund's net asset value (NAV) at quarter end,
- the change in NAV from the previous quarter end,
- and the value of the investor's interest at quarter end.

Exempt parties **must provide investors with a form of annual report**.

Exempt parties are **subject to the anti-fraud provisions of the CEA**.

Exempt parties are **subject to CFTC rules with respect to market manipulation**.

Exempt parties are **subject to federal securities laws** with respect to the offering of fund interests and investment activities involving securities.

Exempt parties are **subject to certain "special call" provisions**, including the requirement to file special reports with the CFTC, used for market surveillance and in connection with investigations or litigation.

International Regulation of CTAs / CPOs

Within the European Union, regulation of CTAs and CPOs falls under the purview of prudential regulators from individual Member States, including the following:

United Kingdom
The Financial Services Authority

France
Autorité des marchés financiers

Germany
Bundesanstalt für Finanzdienstleistungsaufsicht

Belgium
Autoriteit voor Financiële Diensten en Markten

Italy
Commissione Nazionale per le Società e la Borsa

Sweden
Finansinspektionen

The Netherlands
Autoriteit Financiële Markten

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