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CFTC Modernizes Offshore CPO Exemption, Aligns Regulation of Offshore Intermediaries with Global Practices and Current Commission Policies

I. Introduction and Executive Summary

At an open meeting held on October 15, 2020, the Commodity Futures Trading Commission (the "**CFTC**" or the "**Commission**") unanimously adopted amendments to Rule 3.10(c), the Commission's exemption for offshore intermediaries (the "**3.10 Exemption**" or "**Exemption**"), to modernize the conditions under which commodity pool operators ("**CPOs**") located outside of the United States ("**Non-U.S. CPOs**") acting on behalf of offshore pools whose participants are limited to persons located outside the United States ("**foreign located persons**") may rely on the Exemption.[1] The amendments become effective on February 5, 2021.

The amendments finalize a proposal published in June of 2020 (the "**2020 Proposal**"), substantially as proposed but with a number of noteworthy changes recommended by industry commenters.[2] Specifically the amendments provide for:

(1) **Pool-by-Pool Reliance**. A Non-U.S. CPO may rely on the 3.10 Exemption on a pool-by-pool basis, for pools limited to foreign located persons, while simultaneously relying on registration or on other available exemptions for operation of other pools;

(2) **Initial Seed Capital from U.S. Affiliates**. A U.S. affiliate of a Non-U.S. CPO may provide initial seed capital to an offshore pool, without jeopardizing the Non-U.S. CPO's ability to rely on the Exemption for that pool, subject to certain anti-evasion provisions; and

(3) **Safe Harbor for Inadvertent U.S. Participants**. The amendments provide a safe harbor for Non-U.S. CPOs that take specified steps designed to prevent investment by U.S. participants.

At the same time, the Commission adopted amendments to the Exemption codifying existing no-action relief, substantially as proposed in a 2016 proposal, the comment period for which was re-opened in connection with the 2020 Proposal (the "**2016 Proposal**" and together with the 2020 Proposal, the "**Proposal**").[3] The 3.10

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[1] Exemption from Registration for Certain Foreign Intermediaries, 85 Fed. Reg. 78,718 (Dec. 7, 2020), https://www.federalregister.gov/d/2020-23810. The release accompanying the final amendments is referred to as the "**Adopting Release**."

[2] *See* Exemption from Registration for Certain Foreign Persons Acting as Commodity Pool Operators of Offshore Commodity Pools, 85 Fed. Reg. 35,820 (June 12, 2020), https://www.federalregister.gov/d/2020-12034. The release accompanying the 2020 Proposal is referred to as the "**2020 Proposing Release**."

[3] Exemption From Registration for Certain Foreign Persons, 81 FR 51,824 (Aug. 5, 2016), https://www.federalregister.gov/d/2016-18210 (the "**2016 Proposing Release**").

Exemption amendments finalizing the 2016 Proposal, which are applicable to non-U.S. commodity trading advisors ("**CTAs**") and introducing brokers ("**IBs**") as well as CPOs, make two changes:

(1) **Confirmation of No Independent Clearing Requirement**. The amendments clarify that the clearing provision in the 3.10 Exemption applies only to transactions that are otherwise required to be cleared; and

(2) **Eligibility of International Financial Institutions**. Non-U.S. CPOs, CTAs, and IBs may rely on the Exemption while acting on behalf of specified international financial institutions ("**IFIs**").

The amendments reflect an important and welcome step in a years-long process of Commission engagement with the global asset management industry on the appropriate scope of the Commission's exercise of extraterritorial jurisdiction on non-U.S. intermediaries acting on behalf of foreign located persons.[4] The Commission's actions were intended to better align its longstanding policy of focusing its customer protection activities upon domestic firms and upon firms soliciting or accepting orders from domestic participants. Commenters expressed strong support for the goals of the Proposal stated in the Proposing Releases and the Commission's initiative in undertaking a review of this area, together with recommendations for changes to further the Commission's stated goals.[5]

This Client Alert includes a **Description of the Amendments** (Part II), which includes a discussion of changes from the Proposal recommended by commenters; a section on **Regulatory Background and Rationale** (Part III), which provides a more in-depth discussion of the history and policy behind the amendments for those with a strong interest in this area, with a view to providing insight for use in further engagement with the Commission or resolution of interpretive matters that may arise in connection with global activities more generally; and a final section on **Food for Thought** (Part IV), which has three components: (1) a discussion of **Potential Open Issues**; (2) a discussion of the potential implications from the **Source of Commission Authority** for the amendments identified in the Adopting Release; and (3) suggestions for **Practical Implications and Next Steps** that market participants may wish to consider, in order to take advantage of the additional clarification and flexibility provided by the amendments. The text of the amended 3.10 Exemption, marked to indicate changes from the prior version of the Exemption, is attached as an Appendix to this Client Alert (the "**Redline Appendix**").

II. Description of the Amendments

A. New Rule 3.10(c)(5) for CPOs

The amendments create a new paragraph of the 3.10 Exemption, new Rule 3.10(c)(5), which specifically addresses CPOs.[6] As originally adopted, the 3.10 Exemption provided a combined exemption for CPOs, CTAs, and IBs in a single paragraph (former Rule 3.10(c)(3)(i)). The amendments restructure the Exemption to create a new paragraph for each category of offshore intermediaries; however, apart from amendments adopted from the 2016 Proposal, only the CPO exemption reflects substantive changes.[7]

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[4] The 2020 Proposal was an outgrowth of a previous offshore CPO exemption proposal published in 2018, as part of a broader proposal designed primarily to codify existing Part 4 no-action relief and staff guidance in a number of areas (the "**2018 Proposal**"). *See* Registration and Compliance Requirements for Commodity Pool Operators and Commodity Trading Advisors, 83 Fed. Reg. 52,902 (Oct. 18, 2018), https://www.federalregister.gov/d/2018-22324. The release accompanying the 2018 proposal will be referred to as the "**2018 Proposing Release**." The offshore CPO component of the 2018 proposal raised serious concerns among a broad range of commenters, which led the Commission to withdraw the proposal and reconsider its approach, which, in turn, led to the 2020 Proposal and ultimately the 2020 amendments. This history is described more fully in Part III.C. of this Client Alert – Background and Regulatory Goals – Publication and Withdrawal of the 18-96 Exemption Proposal.

[5] The Commission received four comment letters, including a joint letter from five asset management trade associations and a letter from a large global asset management firm. *See* Comment Letter from Alternative Investment Management Association Limited, Asset Management Group of the Securities Industry and Financial Markets Association, Investment Adviser Association, ICI Global, and Managed Funds Association (Aug. 11, 2020) (the "**Joint Industry Letter**"); Comment Letter from Vanguard Group (Aug. 11, 2020), https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62699 (the "**Vanguard Letter**").

[6] Former Rule 3.10(c)(5) has now been renumbered as Rule 3.10(c)(6). *See* the Redline Appendix.

[7] The exemptions for offshore IBs and CTAs are set forth in new paragraphs (c)(3) and (c)(4) of the Exemption, respectively. Futures commission merchants ("**FCMs**") continue to be addressed separately, in a new paragraph (c)(2).

Rule 3.10(c)(5) provides that a foreign located person engaged in the activity of a CPO in connection with a "**covered transaction**" need not register as a CPO when the covered transaction is executed on behalf of a commodity pool, the participants of which are all foreign located persons or IFIs ("**Foreign Participants**"), subject to the limited clearing and other provisions of the Exemption described below.[8]

As further described below, the Exemption is available to Non-U.S. CPOs on a pool-by-pool basis; offshore pools eligible for the exemption may accept initial capital from U.S. affiliates of the CPO; and Non-U.S. CPOs may rely on a safe harbor with respect to preventing investment by U.S. participants.

B. Pool-by-Pool Reliance on the Exemption – the "Stacking Provisions"

1. Summary of Final Provision

A Non-U.S. CPO may rely on the Exemption on a pool-by-pool basis, with respect to offshore pools whose participants are limited to Foreign Participants (we refer to this condition as the "**Foreign Participant Condition**").[9] Accordingly, a Non-U.S. CPO may rely on the Exemption for its operation of offshore pools that meet the Foreign Participant Condition, while concurrently relying on other exemptions or on CPO registration with respect to pools that accept U.S. participants or otherwise do not qualify for the Exemption (these provisions together are referred to as the "**stacking provisions**").[10]

In adopting the stacking provisions, the Commission recognized (i) the increasing globalization of the commodity pool industry and (ii) the development of an integrated international investment environment, in which large Non-U.S. CPOs typically operate many different commodity pools simultaneously, including some pools for U.S. investors and other pools for investors outside of the United States. The Commission also found that the clarity and flexibility resulting from incorporating express stacking provisions into the Exemption for CPOs could lead to a range of beneficial results, including:

- more Non-U.S. CPOs undertaking to design and offer pools for persons in the United States, leading to greater diversity of commodity pools offered and/or sold to persons in the United States;
- increased competition amongst commodity pools and their CPOs, leading to additional innovation in the commodity pool space, leading to the promotion of vibrancy of the U.S. commodity interest markets; and
- enabling the Commission to focus its resources on the oversight of CPOs operating pools offered and sold to participants located in the U.S., *i.e.,* the Commission's primary customary protection mandate.

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8 The term "**covered transaction**" is defined in new Rule 3.10(c)(1)(i) as a commodity interest transaction, as defined in Rule 1.3, executed bilaterally or made on or subject to the rules of any designated contract market or registered swap execution facility. The term "**foreign located person**" is defined in new Rule 3.10(c)(1)(ii) as a person located outside the United States, its territories or possessions. The term "**foreign participant**," which we use in this Client Alert to refer to foreign located person participants and IFIs, collectively, is not used in the Exemption. The amended clearing provision, which is included for each category of intermediaries in slightly different form, is set forth for CPOs in Rule 3.10(c)(5)(i) as follows: "provided, that if any such covered transaction is required or intended to be cleared on a registered derivatives clearing organization and the commodity pool that is party to the covered transaction is not a clearing member of such registered derivatives clearing organization, the covered transaction is submitted for clearing through a futures commission merchant registered in accordance with section 4d of the Act."

9 *See* Rule 3.10I(5)(i). For the text of this provision, *see* the Redline Appendix.

10 The stacking provisions are reflected both in the general language of Rule 3.10(c)(5)(i) and in the specific language of Rule 3.10(c)(5)(iv). For the text of these new provisions, *see* the Redline Appendix.

2. Comments and Response

Commenters strongly supported the Commission's proposal to incorporate stacking provisions into the 3.10 Exemption, in order to expressly provide for reliance on the Exemption on a pool-by-pool basis and thus align with both widespread global practices and Commission regulatory policy.[11] The Commission adopted the stacking provisions as proposed, with technical adjustments to the text of the Exemption suggested by commenters, in order to make clear (a) that the other exemptions on which a Non-U.S. CPO may rely (for pools that do not meet the requirements of Rule 3.10(c)(5)) are not limited to Rule 4.13(a) and Rule 4.5, and (b) that a Non-U.S. CPO may register with the CFTC as a CPO for some pools, while simultaneously relying on the 3.10 Exemption for pools that meet the requirements of the Exemption.[12]

C. Initial Capital Contributions (Seed Money) from U.S. Affiliates Permitted

1. Summary of Final Provision

A U.S. affiliate of a Non-U.S. CPO may contribute initial capital to an offshore pool without affecting the CPO's ability to meet the Foreign Participant Condition for that pool, subject to conditions designed (a) to prevent evasion of Part 4 of the Commission's regulations and (b) to prevent contributions by persons barred from the U.S. commodity interest markets (the "**Affiliate Contribution Exception**").[13] In effect, the U.S. affiliate contributing initial capital is not considered a U.S. participant for purposes of the Foreign Participant Condition.

Initial capital, as used in the Exemption, refers to capital contributed at or near the pool's inception.[14] The Exemption does not impose any limit on the amount of time the initial capital contributed can remain in the pool.

The additional conditions imposed by the Affiliate Contribution Exception are that: (a) the affiliate may not be a natural person; (b) the affiliate and its principals are not barred or suspended from participating in commodity interest markets in the United States, its territories or possessions; and (c) interests in the affiliate are not marketed as providing access to trading in commodity interest markets in the United States, its territories or possessions.[15]

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11 *See* Joint Industry Letter and Vanguard Letter.

12 As proposed, the express stacking provision referred specifically to exemptions available under Rule 4.5 and Rule 4.13(a)(3). The Joint Industry Letter pointed out that this language was inconsistent with the intent of the Proposal. The Commission agreed and the final amendments remove the references to specific exemptions; the Adopting Release states that "[a]lthough the relief provided by [Rules] 4.5 and 4.13(a)(3) is the predominant means by which commodity pools are operated without the registration of a CPO, those provisions are not the sole source of such relief available to CPOs for their pools. Therefore, the Final Rule adopts the provision permitting the 'stacking' of the 3.10 Exemption with either registration or other available relief from CPO regulation by the Commission, without the specific references to [Rules] 4.5 and 4.13." Adopting Release at 78,726.

13 *See* Rule 3.10(c)(5)(ii). The term "**affiliate**" for this purpose is defined in CFTC Rule 4.7(a)(1)(i) as a person that directly or indirectly through one or more persons, controls, is controlled by, or is under common control with the specified person. For the full text of Rule 3.10(c)(5)(ii), *see* the Redline Appendix.

14 Adopting Release at 78,727.

15 *Id.* at 78,740.

2. Comments and Response

This aspect of the 2020 Proposal received the most attention from commenters. Commenters strongly supported the adoption of an affiliate contribution exemption but recommended three changes from the exemption as proposed, two of which the Commission accepted.

a. Elimination of Proposed "Controlling" Affiliate Limitation

In the most significant change from the Proposal, the Affiliate Contribution Exception as adopted is available with respect to contributions of initial capital from any non-natural person affiliate, as defined in CFTC Rule 4.7(a)(1)(i), of the Non-U.S. CPO. As proposed, the exemption would have been limited to contributions from "controlling" affiliates.[16]

Commenters urged that affiliate capital contributions are not investments made for the purpose of seeking returns from a pooled vehicle, but rather reflect commercial business decisions to further the business goals of the enterprise and support the CPO's innovation and offering of investment opportunities.[17] For this reason, there is no need to provide Part 4 investor protections to affiliates making these contributions, regardless of whether or not they are "controlling" affiliates.[18] The Commission was persuaded by commenters that such a limitation was not necessary to ensure that the contributing affiliate has sufficient visibility into the operations of the Non-U.S. CPO and the pool, and thus has access to the information it needs to make properly informed decisions for the relevant purposes, without the need for Part 4 protections.[19] Accordingly, the, final Affiliate Contribution Exception is not limited to capital contributed by controlling affiliates.

b. Retention of Limitation to Initial Capital

As proposed, the Affiliate Contribution Exception was limited to contributions of initial capital, referring to capital contributed at or near the time of launch.[20] The Commission explained this proposed limitation by stating that such initial capital contributions generally result from commercial decisions by the affiliate, typically in conjunction and coordination with the Non-U.S. CPO, to support the offshore pool until such time as it has an established performance history for solicitation purposes, notwithstanding that the affiliate's capital may remain invested for the life of the offshore pool.[21]

Commenters strongly opposed this limitation, urging that the Commission's stated policy rationale for the exception equally supported extension of the exception to contributions made for a similar purpose at any time during the pool's life cycle, and that limiting the exception to initial capital would thus reduce the effectiveness of the exemption without serving any U.S. investor protection purpose.[22] Commenters stated that there are "many situations in the life of an offshore pool, after the initial startup period, where it is beneficial, and may be essential, to the pool's viability and to its participants for the CPO or its affiliates to provide additional support for the pool."[23] These include matters beyond a CPO's control "such as shareholder redemption activity

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16 The proposed limitation on contributions by controlling affiliates would have excluded contributions by affiliates controlled by or under common control with the Non-U.S. CPO.

17 Adopting Release at 78,722.

18 *Id.*

19 *Id.* at 78,728-29.

20 *Id.* at 78,727.

21 *Id.* at 78,729.

22 *See* Joint Industry Letter and Vanguard Letter.

23 *See* Joint Industry Letter.

and market disruptions" that make it important for the offshore pool to have continued access to affiliate capital support.[24] Commenters suggested that the Commission's concerns could be met by introducing a "purpose" requirement, to ensure that the exception for contributions after the initial phase would be available only for contributions made in good faith for the purpose of establishing, or providing ongoing support to, the offshore pool to attract or retain non-U.S. investors, and would not be used as a mechanism for the U.S. affiliate to generate returns for its own investors.[25]

The Commission was not persuaded, and the final Affiliate Contribution Exception remains limited to initial capital. The Commission stated that its rationale applies specifically to generating a performance history for innovative or new strategies, so that Non-U.S. CPOs can "test novel trading programs or otherwise engage in proof of concept testing in the collective investment industry that might otherwise not be possible due to a lack of a performance history for the offshore pool."[26] This rationale would not apply to contributions made for other reasons after launch of the fund.[27]

Moreover, the Commission expressed concerns that contributions to facilitate ongoing operations in times of distress, or to attract and retain participants at times later in the offshore pool's lifecycle, well beyond its inception, "could result in a U.S. affiliate being used by its affiliated [N]on-U.S. CPO to financially support an otherwise poorly performing or even failing offshore pool, which could, in turn, adversely affect the financial condition of (and potentially result in the failure of) the U.S. affiliate, and ultimately, cause harm to the U.S. financial system and investors."[28] Finally, the Commission believed it would be difficult to craft a regulatory provision that would appropriately expand the time frame and/or circumstances under which U.S. affiliates would be permitted to make capital contributions to an offshore pool, without rendering the Affiliate Contribution Exception overbroad or impermissibly vague.[29]

c. Disqualified Affiliates

As proposed, the Affiliate Support Exception would have been unavailable for contributions by affiliates that are "subject to a statutory disqualification." The purpose of this provision, as explained in the 2020 Adopting Release, was to "mitigat[e] the risk that persons no longer permitted to participate in the U.S. commodity interest markets directly use the Affiliate Contribution Exception to access such markets through indirect means."[30]

Commenters urged that the proposed "subject to a statutory disqualification" limitation was overly broad relative to the purpose of the condition as stated in the Proposing Release. The Commission agreed, and in the final rule narrowed the condition to specifically address persons barred from participation in the U.S. commodity interest markets.[31]

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[24] *Id.*

[25] Adopting Release at 78,730.

[26] *Id.*

[27] The Adopting Release notes that a non-U.S. CPO contemplating accepting additional capital contributions for an offshore pool from one or more of its U.S. affiliates outside the period of initial capitalization would have to separately qualify for, rely upon, or claim other relief from registration as a CPO with the Commission, as such investment would not be eligible for the Affiliate Contribution Exception. *Id.* at 78,731 n. 174.

[28] *Id.*

[29] *Id.*

[30] *Id.* at 78,732.

[31] *Id.* at 78,731-32.

D. Safe Harbor for Inadvertent U.S. Participants

1. Summary of Final Provision

The Amendments establish a safe harbor, pursuant to which a Non-U.S. CPO may rely upon the Exemption if it satisfies certain enumerated factors relating to its operation of the offshore pool, including specified due diligence procedures for preventing investment by U.S. participants.[32] Under the safe harbor, a commodity pool operated by a Non-U.S. CPO will be considered to be operated in accordance with the 3.10 Exemption, including the Foreign Participant Condition, if:

a. The commodity pool is organized and operated outside of the United States, its territories or possessions;

b. 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;

c. The commodity pool's constitutional documents and offering materials:

   (1) are reasonably designed to preclude persons located in the United States from participating therein; and

   (2) include mechanisms reasonably designed to enable its operator to exclude any persons located in the United States that attempt to participate in the offshore pool, notwithstanding those prohibitions;

d. The commodity pool operator exclusively uses non-U.S. intermediaries for the distribution of participations in the commodity pool;[33]

e. The commodity pool operator 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

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

As explained in the Adopting Release, the safe harbor is designed to permit reliance on the Exemption by Non-U.S. CPOs that have taken reasonable actions designed to minimize the possibility that participation units in the operated offshore pool are being offered or sold to persons located in the United States. The Commission recognized that Non-U.S. CPOs "may not be able to represent with absolute certainty that they are acting only on behalf of foreign located persons invested in their offshore pools, as such [N]on-U.S. CPOs may not have complete visibility into the ultimate beneficial ownership of their offshore pool participation units."[34] The Commission also recognized the benefits that could follow from the ability of Non-U.S. CPOs to rely on the safe harbor, which include:

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[32] *See* Rule 3.10(c)(5)(iii).

[33] The Adopting Release states that "[w]ith respect to this proposed safe harbor, the Commission stated its preliminary expectation that a non-U.S. intermediary would include a non-U.S. branch or office of a U.S. entity, or a non-U.S. affiliate of a U.S. entity, provided that the distribution takes place exclusively outside of the United States." Adopting Release at 78,726.

[34] *Id.*

- The promotion of responsible economic or financial innovation and fair competition in the U.S. commodity interest markets generally, thereby increasing the vibrancy and liquidity of these markets;

- Placing Non-U.S. CPO on an equal footing with those domestic CPOs solely regulated by the Commission, because each is generally subject to a single, appropriate regulatory regime with respect to the operation of its commodity pools;

- Creating a diversity of viewpoint in the U.S. commodity interest markets, through the offshore development of trading strategies that could encourage innovation and competition by domestic CPOs as well; and

- Encouraging trading by Non-U.S. CPOs and their offshore pools in the U.S. commodity interest markets, thus adding liquidity to those markets and thereby promoting more efficient price discovery therein.

2. Comments and Response

Commenters supported the safe harbor, and it was adopted as proposed.[35]

E. Codification of No-Action Relief with Respect to Clearing and International Financial Institutions (the 2016 Proposal)

The Commission adopted amendments to the 3.10 Exemption for all three categories of non-U.S. intermediaries previously covered by Rule 3.10(c)(3)(i) (CPOs, CTAs, and IBs) that codify relief provided in prior no-action letters, largely as proposed in the 2016 Proposal.

1. No Independent Clearing Requirement

a. Summary of Final Provision

These amendments clarify that the 3.10 Exemption is not limited to cleared transactions. Rather, Covered Transaction for which the non-U.S. intermediary seeks to rely on the Exemption must be submitted for clearing through a registered FCM only if (i) the Covered Transaction is required or intended to be cleared on a registered derivatives clearing organization (a "**DCO**") and (ii) the pool (or other customer) that is party to the Covered Transaction is not itself a clearing member of the DCO.[36]

By way of background, amendments to the Rule 3.10 Exemption in 2012 had led to uncertainty as to whether only transactions that were submitted for clearing through an FCM would qualify for the Exemption.[37] In 2016, in response to an industry request for clarification, the staff of the Commission's Division of Swap Dealer and Intermediary Oversight ("**DSIO**") granted no-action relief to address this uncertainty, stating the Division's belief that "[the 3.10 Exemption] was not intended to impose an independent clearing requirement on commodity interest transactions involving Foreign Intermediaries that the CEA and Commission regulations do not otherwise

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35 *Id.*

36 *See* Rule 3.10(c)(5)(i). For the text of this provision, *see* the Redline Appendix.

37 The language that created the uncertainty stated that registration is not required in connection with any commodity interest transaction executed bilaterally or made on or subject to the rules of any designated contract market or swap execution facility only on behalf of foreign located persons, "provided that any such commodity interest transaction is submitted for clearing through a futures commission merchant registered in accordance with section 4d of the [CEA]."

require to be cleared."[38] The relief effectively permitted non-U.S. intermediaries to rely on the Exemption in connection with swaps not subject to a Commission clearing requirement. The Commission subsequently proposed to codify this no-action relief as part of the 2016 Proposal. The Commission did not finalize the 2016 Proposal at that time, and it remained pending at the time of the 2020 Proposal, in connection with which the Commission sought comments on the 2016 Proposal as well.

b. Comments and Response

Commenters on the 2016 Proposal strongly supported codification of the relief provided in the 2016 Letter, both during the original 2016 comment period and during the re-opened comment period in 2020. Commenters supported both the rationale underlying the relief (removing uncertainty about a potential unintended interpretation of the Exemption) and the superiority of rulemaking over no-action relief as a means of clarifying the Commission's intent.

The Commission agreed with the comments supporting the proposed codification of the 2016 Letter, but modified the text of the Exemption designed to implement the codification. While the codification text originally proposed would have eliminated the clearing requirement altogether, the final text adopted reiterates that those transactions that are required to be cleared must be cleared by a clearing member of the relevant DCO. As explained in the Adopting Release, this modification is designed to avoid the inadvertent consequence of leading some market participants to believe, incorrectly, that the Commission intended to permit unregistered foreign located persons to become clearing members on a DCO to clear commodity interest transactions on behalf of customers that were also foreign located persons.[39]

2. International Financial Institutions

a. Summary of Final Provision

The amendments permit non-U.S. intermediaries to rely on the Exemption while acting on behalf of IFIs, as defined in new paragraph (c)(1)(iii) of Rule 3.10, in addition to acting on behalf of foreign located persons.[40] In effect, the Exemption treats IFIs, such as the World Bank, the International Monetary Fund, and various regional development banks, as the equivalent of foreign located persons for purpose of the Exemption, even though they have headquarters or a significant presence in the United States. Thus, for example, IFIs may invest in offshore pools without violating the foreign participation condition of Rule 3.10(c)(5).

By way of background, amendments to permit reliance on the Exemption with respect to transactions on behalf of certain international financial institutions were proposed in 2016, in order to codify relief provided by DSIO in a 2015 no-action letter.[41] That relief was predicated on DSIO's recognition that "the unique attributes and multinational status of these institutions did not warrant treating them as domestic persons" for purposes of the 3.10 Exemption.[42]

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[38] CFTC No-Action Letter 16-08 (Feb. 12, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/16-08.pdf (the "**2016 Letter**"). In October 2020, DSIO was merged with the CFTC's Office of Customer Education and Outreach to form the Market Participants Division (known as "MPD").

[39] Adopting Release at 78,723.

[40] The complete list of IFIs is set forth in the definition (Rule 3.10(c)(1)(iii)), and can be found in the Redline Appendix. As explained below, the definition includes all institutions included in the U.S. person definition in the cross-border rules, plus two additional institutions identified in the CFTC staff no-action letters, and a catch-all for similar institutions.

[41] CFTC No-Action Letter 15-37 (June 4, 2015), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/15-37.pdf (the "**2015 Letter**").

[42] 2016 Proposing Release at 51,825.

b. Comments and Response

Commenters supported codification of the relief permitting reliance on the rule for transactions on behalf of international financial institutions, with suggestions for inclusion of additional entities in the definition of IFI. The Commission adopted amendments implementing the proposal, with modifications to the definition. In the final amendments, the definition of IFI was modified to be consistent with the definition of U.S. person recently adopted by the Commission in its final cross-border rules for swap dealers and major swap participants, which generally excludes IFIs from the definition of U.S. person, and adds two additional institutions to the IFIs identified in the 2015 Letter – ESM and the North American Development Bank.[43]

The IFI definition also includes a catch-all for "any other similar international organizations, and their agencies and pension plans," which the Commission intends to extend the definition to any of the entities discussed above that are not explicitly listed in the definition.[44]

As the Commission recognized in the 2016 Proposal, IFIs are operated to satisfy public purposes and have as their members sovereign nations from around the world. Although such institutions may have headquarters or another significant presence in the United States, the Commission recognizes that the unique attributes and multinational status of these institutions do not warrant treating them as domestic persons for purposes of the intermediary registration exemptions in Commission regulation 3.10(c).[45]

III. Background and Regulatory Goals

A. Overview

As noted above, the Amendments are the culmination of a lengthy re-evaluation by the Commission with respect to its global regulation of CPOs that spans several years and three separate rule proposals. Approval of the Amendments was unanimous, as was agreement with the underlying goals. As described in the concurring statement by Commissioner Dan Berkovitz:

> Regulation 3.10(c) provides an exemption from registration to foreign persons who operate commodity pools ("CPOs") located outside of the United States. The Final Rule makes pragmatic adjustments to certain conditions for claiming the exemption that will allow the Commission to focus its limited resources on protecting U.S. persons who participate in commodity pools, rather than on commodity pools operated outside the U.S. in which non-U.S. persons participate.
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> A fundamental goal of the Commission's registration and regulation of CPOs is the protection of U.S. customers. The CFTC has long held that CPOs trading commodity interests in our markets are not required to register as CPOs if they are located offshore and only operate pools for non-U.S. persons. In 2007, the Commission codified the exemption in regulation 3.10(c).[46]

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[43] *See* Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants, 85 Fed. Reg. 56,924 (Sept. 14, 2020), https://www.federalregister.gov/d/2020-16489.

[44] Adopting Release at 78,724.

[45] *Id.*

[46] *Id.* at 78,741 (statement of Commissioner Dan M. Berkovitz) (footnotes omitted).

Commissioner Rostin Behnam expressed similar views and acknowledged the long process and industry agreement:

> The amendments to the 3.10 Exemption stem from two separate rulemaking proposals that spanned a roughly four-year period and, among other things, address policy positions that were ripe for consideration. As amended, the 3.10 Exemption will further reflect the increasingly global nature of this space and clarify the Commission's approach with respect to its oversight of foreign intermediaries that are not engaged in commodity interest activities on behalf of U.S. customers.
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> This final rule is brief in its delivery—less than one tenth the length of the final rule on position limits, but it reflects many years of staff experience and familiarity with the Commission's historical positions and reasoning in addressing material policy issues raised by appropriately balancing the financial interests of foreign intermediaries and their customers with our commitment to the financial integrity of U.S. markets and U.S. customer protection.[47]

B. Public Interest Findings under Section 4(c) of the Commodity Exchange Act

In adopting the Amendments, the Commission relied primarily on the authority granted in Section 4(c) of the Commodity Exchange Act ("**CEA**"), which gives the Commission broad authority to provide exemptive relief in order to promote responsible economic or financial innovation and fair competition, after notice and opportunity for a hearing, and based on certain required determinations. In accordance with the requirements of Section 4(c), the Commission determined, for each of the components of the Amendments, that the Exemption (1) would involve transactions entered into solely by appropriate persons, (2) would not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act, and (3) would be consistent with the public interest and the CEA.

The Commission addressed the required determinations separately with respect to each component of the amendments described above, and considerations supporting these determinations varied somewhat depending on the component. However, the following conclusions were common to most or all of the Exemption's components:

- The persons exempted are "appropriate persons" as used in Section 4(c); that term includes "a commodity pool formed or operated by a person subject to regulation under the Act," and the Commission has previously interpreted the clause "subject to regulation under the Act" as including persons who are exempt from registration or excluded from the definition of a registration category;[48]

- The Amendments will not have a material adverse effect on the ability of the Commission or any designated contract market to discharge its duties under the Act, because Non-U.S. CPOs relying on the revised 3.10 Exemption with respect to their offshore commodity pools would remain subject to the statutory and regulatory obligations imposed on all participants in the U.S. commodity interest markets;

- The Amendments will not affect the authority of the Commission to conduct investigations in order to determine compliance with the requirements or conditions of such exemption or to take enforcement action against a Non-U.S. CPO either for failure of a Non-U.S. CPO to satisfy the conditions of the

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[47] Opening Statement of Commissioner Rostin Behnam before the Meeting of the Commodity Futures Trading Commission (Oct. 15, 2020), https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement101520.

[48] S*ee* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant',' 77 Fed. Reg 30,596, 30,655 (May 23, 2012), https://www.federalregister.gov/d/2012-10562.

Exemption based on its activities within the U.S. commodity interest markets or for violations of CEA and rule provisions applicable to market participants generally;

- Where a Non-U.S. CPO operates both offshore and domestic commodity pools, the Amendments will not restrict or negatively affect the Commission's statutory and regulatory authority applicable to the commodity pool and intermediary activities of the Non-U.S. CPO involving persons located in the United States; and

- The Amendments reflect the Commission focusing its regulatory resources on U.S. pool participants and the firms soliciting them for trading commodity interests, which are squarely within its customer protection mandate.

C. Publication and Withdrawal of the 18-96 Exemption Proposal

The 2020 Proposal was an outgrowth of an earlier proposal to adopt a new registration exemption for operators of offshore pools under Part 4 of the Commission's regulations, the section of the Commission's rules that specifically govern regulation of CPOs and CTAs, which was part of the 2018 Proposal. That proposal was modeled on an existing staff advisory that provides limited regulatory relief to registered CPOs from some of the Part 4 CPO requirements with respect to their operation of offshore pools meeting a set of specified criteria (the "**18-96 Advisory**").[49] The proposed exemption, which was referred to as the "**18-96 Exemption**," was included in a broader set of proposals designed generally to codify outstanding staff no-action and other positions, and otherwise to simplify and streamline the Commission's CPO and CTA regulation under Part 4.[50] As explained in the 2018 Proposing Release, the 18-96 Exemption was intended to provide more comprehensive and flexible relief for operators of offshore pools than was currently available under either the 18-96 Advisory or the 3.10 Exemption in its then existing form.

The proposed 18-96 Exemption raised substantial concerns among commenters, which focused primarily on two areas: (1) the criteria for claiming the exemption and (2) statements in the 2018 Proposing Release about the 3.10 Exemption calling into question a Non-U.S. CPO's ability to rely on the Exemption on a pool-by-pool basis. Generally, these commenters viewed the criteria for claiming the proposed exemption (which had been developed in 1996) outdated and out of step with the realities of current global markets and global business practices, and thus unworkable as a practical matter, as well as unnecessarily narrow and burdensome relative to the Commission's stated regulatory goals. They also viewed the statements about the 3.10 Exemption to be inconsistent with widespread industry understanding and a departure from Commission precedent and regulatory policy.

In consideration of these comments, the Commission withdrew the 18-96 Exemption proposal, and subsequently undertook a broader inquiry as to whether the 3.10 Exemption should be amended to respond to the current CPO space and the issues articulated by commenters. The 3.10 Exemption amendments proposed in the 2020 Proposal were based on this experience and history, as well as the Commission's further consideration of the increasingly global nature of the commodity pool space.

IV. Food for Thought

There is a lot to digest in the Adopting Release, especially for an area that, while recognizing dramatic change in global developments, the Commission has not re-evaluated in depth for some time. The extensive policy discussions in the Adopting Release may also be useful in areas beyond the specific scope of the amendments. On the other hand, this rulemaking came towards the end of the current administration, and what is described as the Commission's "current" regulatory policy could evolve significantly with a new Chair and, ultimately, a Democratic majority. Thus, the "food for thought" embedded in these policy discussions should perhaps be taken with more than the usual grain of salt.

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[49] *See* CFTC Advisory 18-96 (Apr. 11, 1996), https://www.cftc.gov/sites/default/files/tm/advisory18-96.htm.

[50] *See* 2018 Proposing Release.

Nonetheless, taking this rulemaking as the state of play for the time being, there are three main areas that merit further consideration.

A. Potential Open Issues

There were several issues raised by the 2020 Proposal, either implicitly or expressly by commenters, that the Adopting Release does not resolve, and which remain areas where market participants will have to make reasonable judgments based on limited, and in many cases, indirect authorities and precedents.

1. Definition of U.S. Person

The 3.10 Exemption has never, since originally adopted or as amended from time to time, used the term "U.S. person" or provided a definition. Rather the Exemption uses the term "foreign located person," defined only as "a person located outside the United States, its territories, or possessions." The Adopting Release does not discuss what it means to be "located" outside the United States. This is an important question for complying with the Foreign Participant Condition, which requires all participants (other than IFIs and subject to the safe harbor) to be foreign located persons. However, consistent with the plain meaning of the word located, which implies a physical place, a colloquy during the open meeting at which the amendments were proposed indicates that the term "located" refers to domicile, both with respect to natural persons and entities (for entities the location would refer to the legal domicile).[51]

2. U.S. Administration of Offshore Pools

The first requirement of the safe harbor is that the pool be "organized and operated" outside of the United States. However, the Exemption does not define "operated," nor does the Adopting Release indicate that the term necessarily includes administrative activities or the provision of administrative services to the pool. It is worthy of note that this is a significant departure from the withdrawn 18-96 Exemption proposal, which included, as one of the eligibility criteria, a requirement that the pool not hold meetings or conduct administrative activities within the United States. Commenters on that aspect of the 18-96 Exemption proposal opposed this criterion as both unworkable in the integrated global asset management world, which the Commission recognized had developed since 1996, and unnecessary for protection of U.S. investors.

3. Stacking of CTA Exemptions

Commenters recommended that the Commission incorporate into the 3.10 Exemption for non U.S. CTAs express stacking provisions similar to those proposed for Non-U.S. CPOs, specifically provisions that would expressly permit non-U.S. CTAs to rely on the 3.10 Exemption on an account-by-account basis while simultaneously relying on registration or other exemptions or exclusions for CTA activities on behalf of U.S. investors. The Adopting Release notes that in support of this request, commenters "cited multiple instances of the Commission and its staff historically permitting the 'stacking' of statutory and regulatory exemptions with registration for CTAs, and stated that 'the Commission's focus on [commodity trading] advice to U.S. investors [is] well established in the Commission's regulatory framework.'"[52]

The Adopting Release states that the Commission does not disagree with the commenters' characterization of the Commission's or its staff's past positions with respect to the stacking of statutory and/or regulatory exemptions from CTA registration, or their combination with registration as such, being permissible. However, despite these comments, the Commission declined to adopt the

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[51] *See* Remarks of Commissioner Dan M. Berkovitz at the Proposing Release Open Commission Meeting (May 28, 2020), https://www.youtube.com/watch?v=g5DYthXSLrQ&feature=youtu.be.

[52] Adopting Release at 78,732 (quoting Joint Industry Letter) (brackets in Adopting Release).

suggested amendments absent a prior published rulemaking proposal raising, addressing, and soliciting public comment on that specific policy question.[53]

4. Treatment of Segregated Portfolios in an "Umbrella Structure"

Commenters noted that many offshore funds are organized in an "umbrella" structure, where one entity houses a number of entirely separate portfolios, the assets and liabilities for each of which are, by statute, insulated or ring-fenced from the operations of the others, and suggested that the Commission clarify that certain aspects of the Exemption, including the pool-by-pool application of the Exemption and the Affiliate Contribution Exception, would apply to these portfolios, rather than to the umbrella entity. These commenters pointed out that treatment of such segregated portfolios as separate pools is essential to the workability of the 3.10 Exemption as contemplated by the Proposal. The Commission declined to take action on this request, stating that (1) the 2020 Proposal did not address the treatment of segregated portfolios; (2) the Commission has not, to date, revised the definition of the term "pool" in Rule 4.10(d) in this respect; and (3) given that the term "pool" is used throughout the Commission's rules, it would be more appropriate to address the issue more globally, which could not be accomplished in the current rulemaking, rather than adopting a definition specifically for purposes of the 3.10 Exemption.[54]

B. Source of Commission Authority

As noted above, in adopting the amendments to the 3.10 Exemption, the Commission relied on the authority provided by Section 4(c) of the CEA, which requires a number of specific findings. To our knowledge, the Commission's reliance on its Section 4(c) authority in this area reflects a difference from past approaches, which merits attention in two respects.[55]

First, the number of findings required for exercise of the Section 4(c) authority both requires and provides an opportunity for the Commission to discuss at length and in detail the policy rationale for its determinations. As a consequence, a substantial portion of the Adopting Release is devoted to explaining the basis for the different findings and citing both the benefits of the amendments and the absence of adverse consequences likely to flow from them. This discussion provides considerable insight into the Commission's policy goals that may be helpful in other circumstances, such as interpreting issues on which statutes or rules do not provide complete clarity or as a source of support in further advocacy efforts.

Second, this instance of reliance on Section 4(c) as a source of authority for Commission rulemaking affecting CPOs and CTAs may prove to be a factor in having an influence in further rulemaking efforts, which could operate in a number of ways either to facilitate rulemaking or to impose obstacles. Petitioners for rulemaking in these areas could point to Section 4(c) as a basis for the requesting rulemaking. The Commission itself could again rely on this authority. On the other hand, the numerous findings required by Section 4(c) could, when that is the authority relied on, if that is the authority relied on, make Commission action more difficult.

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[53] *See supra*, note 12. As explained in the Adopting Release, the 2020 Proposal dealt primarily with the activities of CPOs and did not contemplate or discuss comparable modifications with respect to CTAs, nor did the Proposing Release ask for comment on the subject or consider related regulatory impact. Accordingly, the Commission did not believe that the public would have had sufficient notice regarding the issue of adopting parallel provisions for non-U.S. CTAs, such that the public could provide meaningful comment as required by the Administrative Procedure Act, and thus declined to amend the revised 3.10 Exemption in a manner that would substantively alter or change the relief currently provided by the Exemption to qualifying non-U.S. CTAs. *See* Adopting Release at 78,732-33, n. 201.

[54] *Id.* at 78,730-31.

[55] Neither the releases accompanying the proposal and adoption of the 2019 Part 4 amendments nor those relating to the original or prior amended versions of the 3.10 Exemption refer to reliance on authority provided by Section 4(c).

In any case, while the impact of reliance on Section 4(c) for this rulemaking on future Commission actions remains uncertain, it will be worth following the new Commission's rulemaking to see if whether this approach to the 3.10 Exemption amendments will turn out to be specific to this rulemaking or rather portends a trend to be used more broadly.

C. Next Steps and Practical Implications

In light of the additional certainty and flexibility offered by the amendments, asset management organizations with global operations may wish to review the operations and exemption status of their Non-U.S. CPOs to determine whether various aspects of the amendments may provide opportunities for efficiencies, regulatory rationalization, or other benefits. Specific areas that may merit attention are:

- Review of Non-U.S. CPO activities to determine whether reliance on the stacking provisions for offshore pools meeting the Foreign Participant Condition could offer opportunities for operational simplification, such as reducing the need for CFTC filings, monitoring for compliance, or other regulatory burdens;

- For pools for which the Non-U.S. CPO currently relies, or wishes to rely, on the Exemption, review of disclosure and distribution channels in light of safe harbor requirements and make appropriate adjustments;

- Consideration of whether it would be appropriate to make adjustments to current practices in making requests under NFA Bylaw 1101 or in responding to such requests;

- Review of the organization's historical approach to seeding offshore pools, and consider changes that may be necessary or appropriate in order to take advantage of the Affiliate Contribution Exception; and

- Consideration of future engagement with the CFTC and/or its staff on areas of significant remaining friction, such as the possibility of (1) relief expanding the Affiliate Contribution Exception beyond initial capital or (2) grandfathering relief for existing pools that have received capital contributions outside the scope of the Affiliate Contribution Exception, and for which the CPO currently relies on Rule 4.13(a)(3) but would like to convert to the 3.10 Exemption.

As the Commission recognized, global operations of asset managers have evolved significantly since the 3.10 Exemption was originally adopted, and operational structures will vary among organizations depending on a range of factors, including scope and nature of operations and the jurisdictions involved. For these reasons, the above list should be viewed as a starting point, and as organizations become familiar with the revised Exemption there are likely to be additional opportunities for taking advantage the improvements reflected in the amendments, as well as areas in which additional questions or opportunities for engagement with the Commission or its staff emerge.

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