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CFTC ENFORCEMENT ACTION AGAINST ENERGY COMPANY ACTING AS UNREGISTERED CTA—WORDS TO THE WISE FOR INVESTMENT ADVISERS RELYING ON CTA EXEMPTIONS

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A recent enforcement action by the Commodity Futures Trading Commission (CFTC) serves as a reminder of the importance the CFTC places on registration of commodity trading advisors (CTAs) in its regulatory scheme, and of the care with which the agency will review reliance on exemptions from CTA registration. While this case involved an energy management company, not an investment adviser registered with the Securities and Exchange Commission (SEC), several aspects of the CFTC's action and accompanying statements should be considered "words to the wise" meriting close attention by any firms, including SEC-registered investment advisers, that provide commodity trading advice in reliance on one or more CTA registration exemptions.

Three observations in the words-to-the-wise category are discussed below. As a preview, here is a summary of what readers might take away from the CFTC's action.

1. Take registration seriously, independently of other requirements. The CFTC does.

2. Review the firm's activities against each condition of the relevant exemptions. Read the words of the conditions carefully.

3. Watch your websites. Publicly describing services that sound like commodity trading advice can compromise compliance with critical conditions imposed by many relevant exemptions.

The Action—In the Matter of Summit Energy Services, Inc.

On Jan. 16, 2015, the CFTC issued a settlement order (Order) against Summit Energy Services, Inc. (Summit Energy) solely for its failure to register as a CTA

in violation of Section 4m(1) of the Commodity Exchange Act (CEA).[1] Section 4m(1) requires a person who is acting as a CTA and uses interstate commerce in connection with the person's business as a CTA to register with the CFTC unless the person (1) has not furnished commodity trading advice to more than 15 persons in the preceding 12 months and (2) does not hold itself out generally to the public as a CTA. Although Summit Energy registered with the CFTC as a CTA as of Sept. 26, 2014, and the Order did not find any misconduct other than failure to register, the CFTC imposed on Summit Energy a $140,000 civil monetary penalty and ordered Summit Energy (as well as its affiliates) to cease and desist from violating Section 4m(1) of the CEA.

The Order states that from Oct. 2012 to Sept. 25, 2014:

- Summit Energy acted as an unregistered CTA in violation of Section 4m(1) by, for compensation or profit, advising more than 15 clients as to the value of or the advisability of trading in over-the-counter (OTC) natural gas swaps and natural gas futures contracts.[2]
- Summit Energy held itself out publicly as a CTA by offering to others its risk management services, including commodity trading advice concerning natural gas swaps and futures, through its website and sales brochures.
- Summit Energy's commodity trading advice was part of, and not solely incidental to, its business.
- Summit Energy was not exempt from registration as a CTA under any provision of the CEA or CFTC rules.

Words to the Wise for SEC-Registered Investment Advisers

The Order appears to have been little observed outside the energy industry. And, for a number of reasons, it is hard to characterize the action as a "message" case. First and foremost, the case was settled, so the Order does not include a full statement of the facts or the CFTC's reasons for bringing the case. In addition, some of the statements in the Order are ambiguous, or even cryptic, and are made without explanation. If indeed this were a "message" case, one would be hard put to say, with any precision, what the message is.

Nonetheless, certain aspects of the Order stand out as possible signals that may serve as a useful trigger for firms relying on CTA exemptions to re-examine their compliance with the conditions imposed by those exemptions.

No. 1. The Importance of Registration on a Stand-Alone Basis

Unlike the vast majority of registration enforcement actions the CFTC has brought in the past, the Order does not find, or even refer to, a single instance of misconduct other than failure to register as a CTA.

It has never been in doubt that the CFTC considers registration of CTAs and other market professionals a key component in the overall regulatory scheme. Among other things, "registration assures a public source of information about those upon whom customers rely and protects the public from individuals unfit to act as advisors."[3] Historically, though, the CFTC has

focused its enforcement resources on cases that involve substantive misconduct, most often fraud or other behavior that harms or endangers investors.

For the reasons discussed above, it is difficult to draw any firm conclusions about the factual background or the CFTC's motives in bringing the action. Clearly, however, the CFTC believed that a registration violation alone was worthy of an enforcement action.[4]

No. 2. Strict Adherence to Conditions of CTA Registration Exemptions—Interpretation of "Holding Out" and "Solely Incidental"

The Summit Energy action indicates that the CFTC will look carefully at compliance with all conditions of any exemption relied on by unregistered CTAs. In particular, statements in the Order address two key phrases—"holding out" and "solely incidental"—that appear in a number of CTA exemptions, including the exemptions on which SEC-registered investment advisers (RIAs) commonly rely. As discussed below, the specific statements in the Order about the exemptions at issue in the action are either not directly relevant to RIAs or insufficiently clear to provide substantive guidance. Nonetheless, the Summit Energy action can be read as a signal that the terms of an exemption, whatever they may be, should be strictly monitored and adhered to.

Holding Out

Section 4m(1) of the CEA provides an exemption from CTA registration for any person who both (1) has not furnished commodity trading advice to more than 15 persons in the preceding 12 months and (2) does not hold itself out generally to the public as a CTA.

The Order states that Summit Energy held itself out generally to the public as a CTA because Summit Energy offered its risk management services, which included natural gas swaps and futures advice, through its website and sales brochures. This conclusion is consistent with the CFTC staff's broad interpretation of "holding out" in Section 4m(1) under existing precedents: "[U]nless a CTA restricts his clients to family, friends, and existing business associates, a CTA will be viewed as holding himself out to the public as a CTA. . ."[5] Conduct that promotes or offers commodity trading advice through generally available media, such as directory listings, stationery, newspaper advertisements or websites, as well as direct or indirect solicitation of new commodity trading clients, will be viewed as holding oneself out to the public as a CTA.[6]

Implications for RIAs

For most RIAs, the Order's broad interpretation of "holding out" as used in Section 4m(1) should not have a substantive impact.

First, because of the specific requirements of the Section 4m(1) exemption—15 or fewer clients and the strict "holding out" prohibition—RIAs with a substantial client base typically do not rely on this exemption. Moreover, the CFTC's position in Summit Energy—that offering CTA services on a website constitutes holding the person out to the public as a CTA—is not new. Nonetheless, for RIAs that do rely on the Section 4m(1) exemption, it would be prudent to consider the Summit Energy action as a reassertion or emphasis of these interpretations, and to review their activities in that light.

Second, while the words "hold out" appear in other CTA registration exemptions on which RIAs commonly rely, they are used in a different context, which changes their meaning substantially. For example, in Section 4m(3) of the CEA, which provides an exemption specifically designed for RIAs, there is a restriction against the RIA holding itself out to the public as "engaged primarily" in the business of advising on commodity interests.[7] CFTC Rule 4.14(a)(8), which provides another exemption specifically designed for investment advisers (whether SEC-registered or exempt), restricts the adviser from "otherwise" holding itself out as a CTA, referring to activities expressly permitted by the exemption.

Therefore, the CFTC's broad interpretation of the phrase "hold himself out generally to the public as a [CTA]" in Section 4m(1) would not apply in the case of other CTA registration exemptions that have a more limited "holding out" restriction. Rather RIAs should interpret the "holding out" condition in any exemption on which they rely in accordance with the specific terms of the relevant exemption, and, to the extent available, in accordance with precedents interpreting those specific terms.

Solely Incidental

The Order states, as part of the recitation in the "Facts" section, that "Summit Energy's commodity trading advice was part of, and not solely incidental to, its business."

For a number of reasons, neither the factual meaning nor the legal significance of this statement in the context of the Order is clear. Many CTA exemptions or exclusions provided by the CEA and the CFTC rules include a condition using the phrase "solely incidental."[8] However, the Order does not identify any of these exemptions. Nor does the Order address the "solely incidental" finding in the Legal Discussion.[9] Further clouding the issue, the CFTC in its press release announcing the action used different wording, stating that Summit Energy's commodity trading advice "was not solely incidental to its business, but rather was an integral part of the services it provided to its clients."

Implications for RIAs

Two of the CTA exemptions or exclusions on which RIAs commonly rely include the words "solely incidental." CFTC Rule 4.14(a)(8), one of the most important exemptive rules for RIAs, provides an exemption from CTA registration for an RIA (or investment adviser that is exempt from SEC registration) that, among other requirements, "[p]rovides commodity interest trading advice solely incidental to its business of providing securities or other investment advice" to certain specified types of clients. CFTC Rule 4.6 excludes from the definition of CTA a person that is excluded from the term "commodity pool operator" by CFTC Rule 4.5, if the person's "commodity interest advisory activities are solely incidental" to its operation of the vehicles for which Rule 4.5 provides the exclusion.[10]

Because the exemptions provided by CFTC Rule 4.14(a)(8) and Rule 4.6 are critical for RIAs, the CFTC's provision of meaningful new guidance on the term "solely incidental," through an enforcement case or otherwise, could represent a significant development. Given the ambiguity in the wording of the "solely incidental" statement in the Order, however, along with the absence of any legal analysis, reference to a specific exemp-

tion, or recitation of relevant facts, it is difficult to glean any clear guidance on this issue.

That said, the CFTC took pains to make a "solely incidental" finding in the Order. This may suggest that interpretation of this condition, which is relevant for so many CTA exemptions, is a subject of regulatory attention. For that reason alone, RIAs and other CTAs relying on one or more of these exemptions may wish to review the considerable body of precedents interpreting the term in relevant contexts, as they apply to the firm's activities.

3. Watch Your Websites

The Order states that Summit Energy's website offered the firm's swaps and futures advisory services. This fact appears to have been central to the conclusion that Summit Energy held itself out to the public as a CTA. While we cannot tell from the Order, it may be that the nature of the description also gave rise to the CFTC's statement that swaps and futures advice was "part of, and not incidental to," Summit Energy's business.

Implications for RIAs

RIAs often maintain multiple websites, on which they provide extensive information including descriptions of their activities. Under the logic of the Order, an RIA's public website that describes its services as including commodity trading advice would result in the RIA holding itself out to the public as a CTA, and thus render the RIA ineligible to rely on the Section 4m(1) exemption. By analogy, RIAs that rely on other exemptions with "holding out" restrictions should tailor their website descriptions of their services to conform to those restrictions.

We do not know how the Summit Energy matter originated. One possibility is that the matter came to the CFTC's attention through some type of website surveillance, either by the CFTC staff on its own or by the National Futures Association (NFA) (in the CFTC's press release announcing the Order, the CFTC states its appreciation for the assistance of the NFA).[11] In any case, the Order is a reminder that as part of their overall programs for monitoring website content, RIAs relying on CTA exemptions should include a component for review of any description of CTA services against the requirements of those exemptions.

Conclusion

As this discussion illustrates, interpreting a CFTC enforcement action, especially one that is settled and thus reflects a negotiation with the respondent, often resembles the reading of tea leaves. This action, in particular, seems rife with unclear signals.

Accordingly, while the Order does not provide new law or guidance that dictates a substantive change in behavior, RIAs relying on CTA exemptions might be wise to view it as a reminder to keep close track of those exemptions and their compliance with the relevant conditions.

ENDNOTES:

[1]Summit Energy Services, Inc., CFTC Docket No. 15-12, Order Instituting Proceedings, Making Findings, and Imposing Remedial Sanctions (Jan. 16, 2015). Summit Energy consented to the entry of the Order without admitting or denying the findings or conclusions in the Order.

[2]The Order states that most of Summit Energy's clients were commercial entities that purchased physical natural gas and electricity as part

of their energy needs, that Summit Energy provided these and other clients with advice about physical natural gas and electricity transactions, and that during the two-year period more than 15 clients received advice from Summit Energy as to the value of or the advisability of trading in natural gas OTC swaps and futures for hedging purposes.

[3]CFTC v. Savage, 611 F.2d 270, 280 (9th Cir. 1979). The CFTC has stated that a failure to register is "only slightly less serious" than a fraud violation, because it "thwart[s] the 'system of effective self-regulation of . . . market participants and market professionals under the oversight of the Commission,' which is the first listed purpose of the [CEA] in Section 3(b)." U.S. Securities & Futures Corp., CFTC Docket No. 01-01(Oct. 7, 2009). In the same vein, "[r]egistration is the kingpin in this statutory machinery, giving the Commission the information about participants in commodity trading which it so vitally requires to carry out its other statutory functions of monitoring and enforcing the Act." *Id.* (quoting CFTC v. British American Commodity Options Corp., 560 F.2d 135, 139-40 (2d Cir. 1977), cert. denied, 438 U.S. 905 (1978)("British American").

[4]Shortly before this article went to press, the CFTC brought another case that underscores the regulatory concern with registration, this time against a commodity pool operator. *See* Hope Advisors LLC, CFTC Docket No. 15-19 (Apr. 15, 2015)(settled). The Order points out that registration is a strict liability requirement (no "state of mind" limitation) and, although the case involved sufficient findings of reporting violations as well, cites British American for the proposition that "[w]hile fraud and misconduct may also be violations of the [CEA] ... violations of [the registration requirement] alone are sufficient' to warrant the granting of an injuction." *Id*. (quoting British American, 560 F.2d at 142)

[5]*See, e.g.*, CFTC Interpretative Letter No. 97-26 (Mar. 26, 1997). This letter emphasizes that the "holding out" restriction applies whether or not the CTA is advising 15 or fewer persons, since in order to qualify for the Section 4m(1) exemption, the CTA must satisfy both conditions. *See also* CFTC Interpretative Letter No. 91-9 (Dec. 30, 1991).

[6]*See, e.g.*, Lavender, CFTC Docket No. 00-23 (June 30, 2003) (settled) (CTA was holding himself out as such because he solicited prospective clients from the general public in the course of his work as an electrician; he was also aware that his friends were soliciting client accounts for him to manage).

[7]Section 4m(3) is available to an RIA whose business does not consist primarily of acting as a CTA and that does not act as a CTA to any commodity pool that is engaged primarily in trading commodity interests. An RIA or commodity pool is considered to be "engaged primarily" in the business of being a CTA or commodity pool for purposes of Section 4m(3) "if it is or holds itself out to the public as being engaged primarily, or proposes to engage primarily, in the business of advising on commodity interests or investing, reinvesting, owning, holding, or trading in commodity interests, respectively."

[8]For example, the definition of CTA in Section 1a(12) of the CEA excludes certain entities conducting another business or profession (for example, banks, news reporters, lawyers, accountants, teachers, floor brokers and futures commission merchants), as long as the furnishing of any CTA services is "solely incidental to the conduct of their business or profession." Similarly, CFTC Rule 4.14(a)(1) provides an exemption for a CTA that is "a dealer, processor, broker, or seller in cash market transactions of any commodity (or product thereof) and the person's commodity trading advice is solely incidental to the conduct of its cash market business."

[9]The Order does state that Summit Energy was not exempt from registration as a CTA under any provision of the CEA or CFTC rules. The CFTC's inclusion of the statement, as part of the facts, that Summit Energy's commodity trading advice was not solely incidental to its business suggests that Summit Energy may have sought to rely on one or more of the exemptions that impose such a condition.

[10]CFTC Rule 4.5 provides an exclusion from the definition of commodity pool operator for

operators of SEC-registered investment companies that meet certain conditions and other specified categories of "otherwise regulated" entities.

[11]We understand that website review is a component in the NFA's program for monitoring compliance with NFA advertising rules, among other regulatory requirements.