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Reframing Commodity Pools in the Wake of Dodd-Frank and the Volcker Rule

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NOTE

REFRAMING COMMODITY POOLS IN THE WAKE OF DODD-FRANK AND THE VOLCKER RULE

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INTRODUCTION

The massive financial disaster of 2008 and the international credit catastrophe that subsequently developed was a “historic economic crisis” that led to a near collapse of the U.S. and global economic systems.¹ In its aftermath, widespread demands for regulatory reform reverberated through the financial world. In the United States, authorities responded with the Dodd-Frank Wall Street Reform

† B.A., University of California, San Diego, 2010; J.D., Cornell Law School, 2013; Editor, *Cornell Law Review*, Volume 98. First and foremost, I am forever indebted to my family and friends for their everlasting love and encouragement. I am also grateful to Gary Barnett and Gregory Scopino for their invaluable insights and helpful suggestions, and to Allison Fumai for her inspiration. Special thanks to the members of the *Cornell Law Review* for their dedication and hard work, especially Joshua Wesneski, Zachary Glantz, Conor McCormick, Minsuk Han, Kelsey Baldwin, and Cristina Laramée, and to Jeffrey Dennyhard. Lastly, I would like to thank Milson Yu for his tireless patience and unwavering support.

¹ President Barack Obama, Remarks by the President on 21st Century Financial Regulatory Reform (June 17, 2009), *available at* <http://www.whitehouse.gov/the-press-office/remarks-president-regulatory-reform>.

and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank), which spanned an impressive 2,319 pages and provided sea changes unprecedented in scope since the Great Depression.² Within this sprawling legislation is the oft-cited Volcker Rule, which, in a nutshell, bans proprietary trading by banks whose deposits are federally insured by the Federal Deposit and Insurance Corporation and restricts their relationships with hedge funds and private equity funds.³ Yet among all of this discussion about market integrity and the need to protect the American investor, the public eye has overlooked a business entity operating in the derivatives markets that represents more than \$600 billion in net assets in the U.S. economy: commodity pools.⁴ Moreover, much of the scope of the Dodd-Frank Act and the Volcker Rule hinges on the definitions of “commodity pool” and “commodity pool operator” (CPO). Given this fact, it is perhaps surprising that commodity pools have garnered little public attention and remain in relative obscurity when compared to other financial instruments.

In their broadest sense, commodity pools are popular investment entities that collect funds from participants to then trade in commodities, other commodity pools, and commodity derivatives.⁵ A derivative is a financial contract whose value is determined by the underlying asset;⁶ therefore, a commodity derivative is a financial contract whose value is derived by the underlying commodity, such as wheat, oil, or other products.⁷ Commodity pools are attractive to investors because they enable investors to gain access to investment opportunities while simultaneously allowing these investors to diversify their portfolios to

² See Recent Legislation, *Corporate Law—Securities Regulation—Congress Expands Incentives for Whistleblowers to Report Suspected Violations to the SEC*, 124 HARV. L. REV. 1829, 1829 (2011) (explaining that Dodd-Frank “reaches almost ‘every corner’ of the financial industry, . . . governing everything from debit cards to hedge funds to mortgages” (footnotes omitted)).

³ See Colleen Murray, *In Case You Missed It: Paul Volcker Talks Dodd-Frank*, *Volcker Rule on Charlie Rose*, U.S. DEPARTMENT OF TREASURY (Oct. 26, 2011), <http://www.treasury.gov/connect/blog/Pages/In-Case-You-Missed-It-Paul-Volcker-Talks-Dodd-Frank-Volcker-Rule-on-Charlie-Rose.aspx>; John Carreyrou, *Goldman in Push on Volcker Limits*, WALL ST. J., Oct. 10, 2012, at C1.

⁴ See Sharon Brown-Hruska, Acting Chairwoman, Commodity Futures Trading Comm’n, Keynote Address at the Securities Industry Association Hedge Funds Conference (Nov. 30, 2004), available at <http://www.cftc.gov/opa/speeches04/opabrown-hruska-22.htm>. As of November 30, 2004, there were approximately 3,500 commodity pools run by some of the largest institutions in the financial industry. *Id.*

⁵ See Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call for Alternatives*, COLUM. BUS. L. REV. 1, 1–2 (1990) (explaining the progression of the regulation of futures contracts); *Commodity Pool Operator (CPO)*, NAT’L FUTURES ASS’N, <http://www.nfa.futures.org/nfa-registration/cpo/index.HTML> (last visited Sept. 19, 2013).

⁶ *Derivatives*, OFF. COMPTROLLER OF THE CURRENCY, <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/index-derivatives.html> (last visited Sept. 19, 2013).

⁷ See MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS § 14.01[A] (4th ed. 2012).

prevent risk.⁸ CPOs, on the other hand, are organizations or individuals that *manage* commodity pools. CPOs must register with the Commodity Futures Trading Commission (CFTC or the Commission), the administrative agency that generally oversees the derivatives and commodities markets.⁹ The Commodity Exchange Act (CEA) regulates, among other things, commodity futures trading.¹⁰

In amending the CEA, the Dodd-Frank Act became the first piece of legislation to add a definition of the term “commodity pool.”¹¹ This is a profound change given that commodity pools historically have been in the background in the formal rulemaking and legislation of financial instruments. Dodd-Frank reversed course and added a plethora of new mandates and oversight techniques for the CFTC. For example, Dodd-Frank expanded the definition of commodity pools to include investment vehicles that not only trade in futures but also in swaps—bilateral contracts in which parties agree to exchange cash flows at some predetermined schedule.¹² In addition, Dodd-Frank required the CFTC to narrow the circumstances that would exempt a CPO from registration.¹³

Dodd-Frank’s addition of a definition of commodity pools presents two major concerns for the financial industry. First, because “commodity pool” is now a defined term, the categorization of a business entity as a commodity pool becomes significant because it can subject the entity to certain clearing requirements.¹⁴ Clearing requirements mandate an institution or person to act as a central counterparty to the original participants in a contract to mitigate the

⁸ See MANAGED FUNDS ASS’N, COMMODITY TRADING ADVISOR & COMMODITY POOL OPERATOR 101, at 3 (2012), available at https://www.managedfunds.org/wp-content/uploads/2012/05/MFA_CTA_CPO101_05-2012.pdf.

⁹ See *Commodity Pool Operator (CPO)*, *supra* note 5.

¹⁰ *Commodity Exchange Act*, U.S. COMMODITY FUTURES TRADING COMMISSION, <http://www.cftc.gov/lawregulation/commodityexchangeact/index.htm> (last visited Sept. 19, 2013).

¹¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 721, 124 Stat. 1376, 1659 (2010) (codified at 7 U.S.C. § 1a(10) (2012)).

¹² ANDREW M. CHISHOLM, *DERIVATIVES DEMYSTIFIED: A STEP-BY-STEP GUIDE TO FORWARDS, FUTURES, SWAPS AND OPTIONS 2* (2d ed. 2010). A common type of swap is the credit default swap, in which one party pays premiums to another party to insure itself in the event a security defaults on payment. See Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 682–83 (2012).

¹³ For an explanation of the exemptions, see *Commodity Pool Operator & Commodity Trading Advisor Exemptions and Exclusions*, U.S. COMMODITY FUTURES TRADING COMMISSION, <http://www.cftc.gov/IndustryOversight/Intermediaries/CPOs/cpocpactexemptionsexclusions> (last visited Sept. 19, 2013).

¹⁴ Michael Bopp & Jeffrey L. Steiner, *Dodd-Frank Implementation: Impact of Title VII and Related CFTC and SEC Regulations on Derivatives End-Users*, GIBSON DUNN 1 (May 16, 2012), <http://www.gibsondunn.com/publications/Documents/DoddFrank-ImpactofTitleVII-RelatedCFTC-SECRegulations-DerivativesEndUsers.pdf>.

risk of nonperformance.¹⁵ Because the definition of commodity pools is subsumed under categories of entities that are subject to clearing requirements, it is important to interpret the definition of commodity pools in a sufficiently narrow fashion. This avoids the unintended consequence of encompassing business entities that fall under the technical definition of a commodity pool but functionally are not the types of collective-investment vehicles that the regulators envisioned. Secondly, the Dodd-Frank Act's expansion of the definition of a commodity pool and the CFTC's narrowing of the exemptions for CPOs have the effect of increasing regulatory burdens. Imposing these regulatory burdens may effectively prevent some investors from hedging or managing their risks, thereby undermining the CEA's dual purpose of market integrity and investor protection.¹⁶

These considerations bring to light the importance of the definitions of a commodity pool and a CPO. How these terms are defined ultimately direct the scope of some of the major provisions of the Volcker Rule and the Dodd-Frank Act. In functional terms, the definitions will also provide participants with sufficient information to allow them to effectively manage their investment risk, which ultimately promotes a more efficient market. This Note will demonstrate that the CFTC has traditionally declined to adopt a bright-line rule for determining whether a business entity is a commodity pool and whether an institution or a person is a CPO. This Note will argue that the current ad hoc approach should be further refined and that the CFTC should provide more concrete definitions by using the Investment Company Act of 1940 (1940 Act) and its treatment of investment companies as a model.

Part I provides the factual background regarding relevant aspects of a commodity pool and a CPO and the responsibilities that attach to these designations. Part II of this Note will detail the current regulatory regime surrounding commodity pool operators. It will discuss prominent interpretative letters that the CFTC has issued and highlight discrepancies in the current approach. Part II will also examine why, in light of the new legislation, a more concrete standard is necessary. Part III outlines the relevant legislative history. In addition, Part III argues that the Investment Company Act of 1940's treatment of investment companies should serve as a standard for determining who is a commodity pool operator under the Commodity Exchange Act.

¹⁵ Ed Nosal & Robert Steigerwald, *What Is Clearing and Why Is It Important?*, FED. RESERVE BANK CHI. (Sept. 2010), http://www.chicagofed.org/webpages/publications/chicago_fed_letter/2010/september_278.cfm.

¹⁶ The underlying rationale for regulation includes managing externalities such as liquidity risks, facilitating the transfer of information in an efficient marketplace, and fostering healthy competition. See Yesha Yadav, *Looking for the Silver Lining: Regulatory Reform After the "Credit Crunch,"* 15 STAN. J.L. BUS. & FIN. 314, 319 (2010).

I

LOGISTICS: THE FUNCTIONS AND REQUIREMENTS OF COMMODITY POOLS
AND COMMODITY POOL OPERATORS

Before engaging in a discussion of the standard by which to evaluate whether a person's activities subject him or her to the CFTC's rules governing commodity pool operators, an understanding of the functions of commodity pools and CPOs is necessary.

A. Commodity Pools

Commodity pools are funds that are operated and managed by CPOs and traded by commodity trading advisors (CTAs).¹⁷ The CFTC defines a commodity pool as “[a]n investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity futures or option contracts.”¹⁸ In practical terms, a commodity pool is an investment vehicle in which assets of multiple individuals are collected, or “pooled” together, to engage in the business of investing in commodity contracts.¹⁹ The commodity pool raises capital by selling interests in the commodity pool and using the capital to make its investments.²⁰ The individuals share on a pro rata basis the profits and losses of the commodity pool.²¹ Commodity pools can be structured as joint trading accounts or general partnerships.²² However, limited partnerships, limited liability companies or corporations, and trusts are the more conventional structures of commodity pools, as these forms allow the participants to limit their liability.²³ Regardless of the structure, commodity pools often contain a substantial amount of re-

¹⁷ See 7 U.S.C. § 1a(11) (2012) (defining CPOs); *id.* § 1a(12) (defining commodity trading advisors). A commodity trading advisor is an organization or a person who advises others in buying or selling financial instruments such as futures contracts or swaps in exchange for compensation. See *Commodity Pool Operator (CPO)*, *supra* note 5. For more information about CTAs and their registration requirements and exemptions, see 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION 238–50 (2004).

¹⁸ *CFTC Glossary*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_co (last visited Sept. 19, 2013); see also 7 U.S.C. § 1a(10) (defining “commodity pool”); 17 C.F.R. § 4.10(d)(1) (2012) (defining “pool”). This also includes any commodity for future delivery, swap, or commodity option. See 7 U.S.C. § 1a(10).

¹⁹ See *CFTC Glossary*, *supra* note 18.

²⁰ 13 JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION & OTHER CLAIMS § 17A:1, at 17A-1 (2009) [hereinafter *COMMODITIES TREATISE*].

²¹ See *CFTC Glossary*, *supra* note 18.

²² 2 EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 18.13[1], at 18-95 (10th ed. 2012).

²³ See *id.* The personal liability of a participant is limited to the amount of their investment in the pool. See *id.* However, although the investors enjoy limited liability, the commodity pool must have a general partner if they are structured as a limited partnership. See James G. Smith, *A Securities Law Primer for Commodity Pool Operators*, 1996 COLUM. BUS. L. REV. 281, 287. A CPO is typically the general partner of the commodity pool and is personally liable for its debts. *Id.* For this reason, a CPO is often a business entity structured as a

sources and thus can assume diversified risk in investments.²⁴ This allows the investor a wider range of opportunities than if the investor had participated in the transactions as an individual.²⁵ It effectively increases the investing power of each participant. Moreover, investors participating in commodity pools do not shoulder the burden of delivery on futures contracts and are not required to meet margin calls.²⁶

The CFTC has broadly interpreted the definition of a commodity pool, and the courts have attempted to clarify the definition.²⁷ In determining whether an investment vehicle is a commodity pool, the CFTC has considered factors such as (i) the rate at which it trades commodity interests; (ii) the percentage of its assets dedicated to commodity interest trading; (iii) the purpose for the trades, whether it be for speculation or hedging; (iv) the types of investors; and (v) the way in which it is marketed to investors.²⁸ The CFTC has indicated that the inquiry necessarily requires a case-by-case evaluation.²⁹ Moreover, the CFTC has explicitly stated that trading commodity interests does not need to be the sole or even dominant purpose of a fund for it to be a commodity pool.³⁰ In some instances, simply having the trading of commodity interests as “a purpose” is sufficient for the entity to constitute a commodity pool.³¹ Courts have elaborated on the CFTC’s guidelines.³² Courts consider the presence of certain factors, including (i) the presence of combined funds from multiple investors, the solicitation of which is for the purpose of trading in commodity futures contracts; (ii) participation in losses and profits on a pro rata basis; (iii) the designation of a CPO to engage in transactions rather than the participants of the entity; and (iv) the engagement of business on behalf of the entire account.³³

corporation, since the corporate form shields the general partner from unlimited liability. *See id.*

²⁴ See COMMODITIES TREATISE, *supra* note 20, at 17A-2.

²⁵ Daniel F. Zimmerman, Note, *CFTC Reauthorization in the Wake of Long-Term Capital Management*, 2000 COLUM. BUS. L. REV. 121, 133–34.

²⁶ See COMMODITIES TREATISE, *supra* note 20, at 17A-2.

²⁷ See 2 GREENE ET AL., *supra* note 22, at 18-94; *infra* notes 32–33 and accompanying text.

²⁸ 2 GREENE ET AL., *supra* note 22, at 18-95.

²⁹ *Id.*

³⁰ *Id.*

³¹ *See id.* (internal quotations marks omitted).

³² *See Lopez v. Dean Witter Reynolds, Inc.*, 805 F.2d 880, 883–84 (9th Cir. 1986).

³³ *Id.* at 884. *But see* American Securitization Forum, CFTC Interpretative Letter No. 12-14, 2012 WL 4863670, at *3 (Oct. 11, 2012) (stating that “although the *Lopez* factors are useful, they are not dispositive and the failure of a fund to satisfy one or more of the factors does not mean that the fund is not a pool”).

B. Commodity Pool Operators

The CFTC views the CPO and the commodity pools that the CPO operates as separate legal entities.³⁴ The CFTC does not regulate the actual commodity pool itself; rather, it regulates the CPO.³⁵ Section 1a(11)(A) of the Commodity Exchange Act defines a CPO as:

any person (i) engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests, including any—(I) commodity for future delivery, security futures product, or swap; . . . [or] (ii) who is registered with the Commission as a commodity pool operator.³⁶

In other words, a CPO is someone who controls the daily operations of the commodity pool and solicits funds on its behalf.³⁷

The CEA permits the CFTC to exercise discretion in determining who to include, or exclude, from the definition of CPO outlined in the CEA at section 1a(11)(B).³⁸ The determination of whether a person is a CPO has significant regulatory consequences because the CEA and accompanying regulations subject a CPO to registration and reporting requirements.³⁹ Absent an exemption,⁴⁰ the statute requires that all CPOs register with the National Futures Association (NFA) to engage in futures business.⁴¹ Registration with the NFA entails filing documents such as a Form 7-R and ensuring that pool participants receive the financial statements that are to be included in the annual reports.⁴² Registrants must file electronically with the NFA as well as

³⁴ Jeffrey S. Rosen, *Regulation of Commodity Pool Operators Under the Commodity Exchange Act*, 40 WASH. & LEE L. REV. 937, 950 (1983).

³⁵ COMMODITIES TREATISE, *supra* note 20, at 17A-3. The CEA's regulation of the operator of the investment entity instead of the entity itself differs from regulation under the Investment Company Act. *Id.* at 17A-18.

³⁶ CEA § 1a(11)(A), 7 U.S.C. § 1a(11)(A) (2012).

³⁷ Jonathan H. Gatsik, Note, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 608 (2001). A CPO is a kind of financial intermediary and plays a role in matching supply with demand. See Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 7-16 (2010) (describing "the role of financial intermediaries in allocating and transferring capital"). Intermediaries exist to facilitate market efficiency and to lower transaction costs, as well as assist investors in managing risk. *Id.* at 8-9. They are responsible for not only transmitting information to investors but also providing access to investment opportunities through their relationships and knowledge. *Id.*

³⁸ 7 U.S.C. § 1a(11)(B).

³⁹ See *Commodity Pool Operator (CPO)*, *supra* note 5.

⁴⁰ See *id.*; see also *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 17,328, 17,328-29 (Mar. 26, 2012) (describing amendments to 17 C.F.R. pt. 4 relating to exemption).

⁴¹ See *Commodity Pool Operator (CPO)*, *supra* note 5.

⁴² 2 GREENE ET AL., *supra* note 22, § 18.17[1][a], at 18-132.

pay both a \$200 registration fee and a \$750 annual fee to the NFA.⁴³ Moreover, with certain exceptions, a CPO has the additional responsibility of ensuring that each associated person⁴⁴ of the CPO also registers with the NFA.⁴⁵ In addition, CPOs and associated persons are required to meet certain proficiency standards.⁴⁶ Principals also need to file certain documents with the NFA.⁴⁷ Furthermore, both the principals and the associated persons must file a Form 8-R, which requires them to detail relevant biographical information such as employment history.⁴⁸

C. Disclosure, Reporting, and Recordkeeping Requirements

Aside from compliance with stringent registration requirements, a CPO also must furnish a two-part disclosure document to each prospective investor of a commodity pool.⁴⁹ This entails enclosing (1) a Disclosure Statement and (2) a Statement of Additional Information.⁵⁰ The information contained in the Disclosure Statement is limited to “information required by the CFTC’s Part 4 Regulations and any other information that the SEC or state securities administrators require to be included.”⁵¹ This information includes identification of the CPO, the major CTAs,⁵² and principals, along with the business

⁴³ *Id.* at 18-133. For a template of Form 7-R, see NAT’L FUTURES ASS’N, 7-R TEMPLATE (2013), available at <http://www.nfa.futures.org/NFA-registration/templates-and-forms/Form7-R-entire.pdf>.

⁴⁴ An associated person is a natural person (as opposed to a corporation) who solicits investors and funds for a commodity pool or supervises anyone who acts in that capacity. *Id.* They are often described as the “salespersons.” *Associated Person (AP)*, NAT’L FUTURES ASS’N, <http://www.nfa.futures.org/NFA-registration/ap/index.HTML> (last visited Sept. 19, 2013). For a more detailed explanation of exemptions and registration requirements, see 17 C.F.R. § 1.3(aa)(3) (2012); *Associated Person (AP)*, *supra*.

⁴⁵ 2 GREENE ET AL., *supra* note 22, § 18.17[1][b], at 18-134.

⁴⁶ *Proficiency Requirements*, NAT’L FUTURES ASS’N, <http://www.nfa.futures.org/NFA-registration/proficiency-requirements.HTML> (last visited Sept. 19, 2013) (listing the proficiency standards, which are demonstrated either by taking an exam or meeting one of the alternatives listed on the website).

⁴⁷ For more information on what documents principals need to file, see *Principal*, NAT’L FUTURES ASS’N, <http://www.nfa.futures.org/NFA-registration/principal/index.HTML> (last visited Sept. 19, 2013).

⁴⁸ 2 GREENE ET AL., *supra* note 22, at 18-135; *Commodity Pool Operator (CPO)*, *supra* note 5.

⁴⁹ 2 GREENE ET AL., *supra* note 22, § 18.17[2], at 18-136.

⁵⁰ NAT’L FUTURES ASS’N, DISCLOSURE DOCUMENTS: A GUIDE FOR CPOs AND CTAs 21 (2010) [hereinafter DISCLOSURE DOCUMENTS GUIDE], available at <http://www.nfa.futures.org/NFA-compliance/publication-library/disclosure-document-guide.pdf>. For more information regarding CPO disclosure documents, see *Disclosure Documents*, NATIONAL FUTURES ASSOCIATION, <http://www.nfa.futures.org/NFA-compliance/NFA-commodity-pool-operators/cpo-disclosure-documents.HTML> (last visited Sept. 19, 2013).

⁵¹ DISCLOSURE DOCUMENTS GUIDE, *supra* note 50, at 21.

⁵² The NFA defines a major commodity trading advisor as “any CTA that is currently or will be allocated 10 percent or more of the pool’s assets.” DISCLOSURE DOCUMENTS

background of each individual.⁵³ Moreover, the CPO must detail the “types of commodity interests and other interests that the pool will trade, including the approximate percentage of the pool’s assets that will be used to trade commodity interests,” and other applicable information.⁵⁴ Furthermore, a discussion of principal risk factors must be included, analyzing issues such as leverage, volatility, and concentration risk.⁵⁵ Other disclosures related to performance, proprietary trading results, conflicts of interest, and liability must also be included.⁵⁶ To ensure delivery, the CPO must obtain written confirmation from the pool participants and prospective investors that they received the Disclosure Statement.⁵⁷ The CPO may also submit supplemental information in the Statement of Additional Information, provided that the information is not misleading and does not violate applicable regulations or law.⁵⁸

The CPO must also maintain timely records and adhere to reporting requirements pertaining to each individual commodity pool.⁵⁹ For example, the CPO must furnish audited financial statements.⁶⁰ CPOs are also required to “keep certain books and records in an accurate, current and orderly manner at its main business office” for five years.⁶¹ Specifically, CPOs must maintain records of their

GUIDE, *supra* note 50, at 27; *see also* 7 U.S.C. § 1a(12) (2012) (defining “commodity trading advisor”).

⁵³ DISCLOSURE DOCUMENTS GUIDE, *supra* note 50, at 25, 27.

⁵⁴ *Id.* at 26. Applicable information includes categorizing the commodity interests by: type of commodity or market sector, type of security (debt, equity, preferred equity), whether traded or listed on a regulated exchange market, maturity ranges and investment ratings, . . . [and] the extent to which such interests are subject to state or federal regulation, regulation by non-United States jurisdiction or rules of a self-regulatory organization.

Id.

⁵⁵ *Id.* at 28.

⁵⁶ *Id.* at 10, 17, 32, 35.

⁵⁷ *Id.* at 1; *see also* CFTC Rule 4.23, 17 C.F.R. § 4.23 (2012) (provision for recordkeeping); CFTC Rule 4.22, 17 C.F.R. § 4.22 (2012) (provision for reporting to pool participants). An exception to the reporting requirement applies if the CPO is soliciting interest from only Qualified Eligible Persons or if the commodity trading advisor is directing the account of one. DISCLOSURE DOCUMENTS GUIDE, *supra* note 50, at 1.

⁵⁸ 2 GREENE ET AL., *supra* note 22, at 18-140.

⁵⁹ *Commodity Pool Operators (CPOs) & Commodity Trading Advisors (CTAs)*, U.S. COMMODITY FUTURES TRADING COMMISSION, <http://www.cftc.gov/IndustryOversight/Intermediaries/CPOs/index.htm> (last visited Sept. 19, 2013) [hereinafter *CPOs & CTAs Oversight*]. For details on how the structure of funds can affect filing requirements, *see generally* THOMAS J. SMITH, U.S. COMMODITY FUTURES TRADING COMM’N, ANNUAL GUIDANCE LETTER FOR COMMUNITY POOL OPERATORS 2011 (2012), *available at* <http://www.cftc.gov/industryoversight/intermediaries/guidancecporeports>.

⁶⁰ SMITH, *supra* note 59, at 4; *CPOs & CTAs Oversight*, *supra* note 59. For information regarding timeliness of filing and possible circumstances that warrant an extension, *see* 17 C.F.R. § 4.22.

⁶¹ 2 GREENE ET AL., *supra* note 22, § 18.17[5], at 18-146 to -147.

marketing activity, their pools' transactions, and the financial condition of their pools.⁶²

II

THE CURRENT REGULATORY SCHEME FOR CPO DETERMINATION

An understanding of how commodity pools and CPOs fit within the current financial regulatory structure is crucial. This is due in large part to the administrative finding that the activities of CPOs, along with the associated persons and CTAs of commodity pools, "are affected with a national public interest."⁶³ Specifically, the CFTC has stated that the CPOs affect national public interest by "providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."⁶⁴ Therefore, the responsibilities that the CEA and regulations promulgated thereunder placed on the CPO are meant to "serve the public interests . . . through a system of effective self-regulation of . . . market participants and market professionals under the oversight of the Commission."⁶⁵ The purpose of regulatory requirements is to "deter and prevent price manipulation or any other disruptions to market integrity[,] . . . the avoidance of systemic risk[,] . . . [and] to protect all market participants from fraudulent or other abusive sales practices."⁶⁶

Although the requirements that the CFTC imposes on CPOs are clear and well settled, the determination of who qualifies as a CPO is more ambiguous. Since the inception of the CPO as a regulated entity in 1975, the CFTC has pursued an informal system to make the determination of who qualifies as a CPO.⁶⁷ Rather than make affirmative, categorical distinctions based on factors that would make a person a CPO, the CFTC has instead adopted a broad definition and granted exceptions when necessary.⁶⁸ The Commission utilizes an ad hoc approach, granting exemptions from CPO status on a case-by-case basis.⁶⁹ This method is reflected through the interpretative letters

⁶² *Id.*; see also 17 C.F.R. § 4.23 (recordkeeping requirements).

⁶³ See 7 U.S.C. § 5 (2012).

⁶⁴ *Id.*; see also *id.* § 2(b) (stating that "a transaction in respect to any article shall be considered to be in interstate commerce if such article is part of that current of commerce usual in the commodity trade").

⁶⁵ See *id.* § 5.

⁶⁶ See *id.*; see also *id.* § 2(b) (stating that transactions involving commodities are considered to be transactions in interstate commerce).

⁶⁷ See Rosen, *supra* note 34, at 961.

⁶⁸ See *infra* Part I.B.

⁶⁹ See Rosen, *supra* note 34, at 961 ("The Commission has never used its power to exclude persons or entities from the [pool operator] definition [by rule], but it has excluded specific entities from pool operator regulation on an *ad hoc* basis."); cf. CFTC Inter-

that the CFTC issues upon request, and it can produce results that at first glance are not intuitive.

A. Regulation by Ad Hoc Interpretation

There are a few prominent interpretative letters that are widely cited. One of these letters concerns family investment entities.⁷⁰ The interpretative letter No. 10-25 involved an investment entity “A,” which was a limited liability company with two members and was managed by “C”; “C” was an investment professional who also established a family trust.⁷¹ “A” was the only member of “B,” another limited liability company.⁷² “B” would trade commodity futures contracts exclusively for its own account.⁷³ “C” would manage only “A” and “B” but would not receive compensation for those services.⁷⁴ The CFTC held that because of the close family relationships of the persons involved and the realm of their financial transactions, “A” and “B” were not pools “within the meaning and intent of [the CPO regulations] and, consequently, that “C” [was] not a CPO thereof.”⁷⁵

This result is seemingly inconsistent with the decision that the CFTC reached in another interpretative letter, No. 75-17, regarding investment entities that were registered with the SEC as investment companies.⁷⁶ The CFTC noted that although the investment entities did not engage in trading commodity futures, they had solicited funds from others in the past.⁷⁷ The CFTC held that mere intent to trade commodity futures in the future was sufficient to render the investment entities commodity pools.⁷⁸ Moreover, the CFTC stated that the regulations did not contain an exemption for CPOs that operated

pretative Letter No. 00-89, 2000 WL 34514266, at *2 (Sept. 11, 2000) (stating “[w]hether a particular entity is operated ‘for the purpose’ of trading commodity interests, and thus is a pool within the scope of Rule 4.10(d), depends on an evaluation of *all the facts relevant to the entity’s operation*” (alteration in original) (emphasis added) (quoting Revisions of Commodity Pool Operator and Commodity Trading Advisor Regulations, 46 Fed. Reg. 26,004, 26,006 (May 8, 1981) (to be codified at 17 C.F.R. pts. 4, 140) (internal quotation marks omitted)). This illustrates that the ambiguity is due in part to the broad definition the Commission gives to a commodity pool. See CFTC Interpretative Letter No. 00-89, *supra*, at *2. In any case, the determination of whether something is a commodity pool or whether someone is a CPO is often a fact-specific inquiry.

⁷⁰ See CFTC Interpretative Letter No. 10-25, 2010 WL 3923132, at *1 (June 25, 2010).

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ CFTC Interpretative Letter No. 75-17, [1975–1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,112 (Nov. 4, 1975).

⁷⁷ *Id.*

⁷⁸ *Id.*

commodity pools that presently were not soliciting or trading.⁷⁹ Thus, the CFTC asserted that the persons who operated the investment companies were CPOs and therefore subject to the CFTC's registration requirements.⁸⁰ The CFTC determined that "the legislative history of the [Commodity Exchange] Act [made] clear that Congress intended the pool operator definition to cover any firm or individual that *handles or exercises control over* the funds of persons who invest[ed] in commodity pools, regardless of whether the firm or individual is also currently engaged in soliciting, accepting or receiving funds."⁸¹

The CFTC added yet a further wrinkle in a more recent interpretative letter, No. 00-89.⁸² The CFTC asserted that a limited partnership that engaged in commodity futures transactions in the hog industry was not a commodity pool for the purposes of the regulations.⁸³ The CFTC reasoned that because the "commodity interest trading [was] solely for the purpose of hedging its hog production and related feed costs" and therefore not a commodity pool, the general partner did not need to register as a CPO.⁸⁴ In another interpretative letter, No. 09-44, the CFTC decided that a person who was a general partner of a commodity pool organized as a limited partnership was not required to register as a CPO when the general partner delegated its management authority to another registered CPO.⁸⁵

When one takes into account the interpretative letters just discussed, one can come to a series of dubious conclusions. The interpretative letters seem to suggest that an entity that operated an inactive commodity pool would be required to register⁸⁶ but could effectively shirk the registration responsibilities by delegating its tasks to another person or entity.⁸⁷ Furthermore, it would seem that entities could lessen their obligations if they entrusted someone with whom they had a personal relationship with their investments.⁸⁸

⁷⁹ *Id.* In explaining that there was an "absence of a 'present solicitation' requirement," the CFTC noted that the requirement would lead to a perverse result. *Id.* For example, a registered pool operator could potentially refuse to renew his registration until the pool actively solicited or engaged in trading. *Id.* However, throughout the time the pool remained dormant, the pool would be without the protection afforded by the registration requirements imposed on the CPO. *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² See CFTC Interpretative Letter No. 00-89, *supra* note 69, at *3.

⁸³ *Id.* The limited partnership had forty-two participants, the majority of which were farmers from Iowa. *Id.* at *1. The transactions at issue in the interpretative letter occurred in the hog, corn, and soymeal markets. *Id.* In this particular instance, ninety-five percent of the revenue of the limited partnership was derived from the sale of hogs. *Id.*

⁸⁴ *Id.* at *2.

⁸⁵ CFTC No-Action Letter No. 09-44, 2009 WL 2923476, at *1 (Aug. 21, 2009).

⁸⁶ See CFTC Interpretative Letter No. 75-17, *supra* note 76.

⁸⁷ CFTC No-Action Letter No. 09-44, *supra* note 85, at *1.

⁸⁸ See CFTC Interpretative Letter No. 10-25, *supra* note 70, at *1.

The interpretative letters discussed above highlight the ad hoc approach the CFTC has adopted in determining who is a CPO and subject to registration.⁸⁹ The interpretative letters also demonstrate that whether or not someone is a CPO is often a fact-intensive inquiry that is highly contingent on the individual circumstances of each business.⁹⁰ An ad hoc approach has the advantage of providing the flexibility that a “totality of the circumstances” test requires.⁹¹ An amorphous standard can also benefit investors because it encourages those that could be potentially liable to err on the side of disclosure. In this instance, it will encourage potential CPOs to try to determine whether or not they should register as such. A somewhat ambiguous standard also allows investors to bring suit more easily and argue that someone should have registered as a CPO, and it gives the courts more flexibility to apply the definition of a commodity pool. However, such a standard creates difficulties for people in predicting whether they have CPO status and obscures the purpose the CPO registration requirements were intended to effectuate: to provide a “foundation for eliminating certain undesirable practices by unscrupulous operators and advisors who . . . ‘enticed unsuspecting traders into the markets with, far too often, substantial loss of funds.’”⁹²

B. Inefficiencies of the Status Quo

This ad hoc approach creates an ambiguity that is especially problematic in light of the Dodd-Frank Act and the Volcker Rule. Dodd-Frank’s treatment of end-users provides an example of how an ad hoc approach can actually undermine market efficiency; it can also provide investors with less protection if the standard is not sufficiently concrete. “End-users are a category of market participants that utilize the . . . market to hedge exposed market risk and minimize volatility of their overall earnings” and can be either financial or nonfinancial entities.⁹³ Under Dodd-Frank, end-users are subject to obligations such as clearing requirements, which require the end-users’ transacted financial instruments to be traded through a central counterparty.⁹⁴ However, the CFTC provides an “end-user exception” to nonfinancial entities that trade derivatives only for hedging pur-

⁸⁹ See *supra* notes 70–85 and accompanying text.

⁹⁰ See *supra* notes 67–69 and accompanying text.

⁹¹ See *supra* notes 70–85 and accompanying text (demonstrating the CFTC’s ad hoc approach to CPO and commodity pool determination, which allows the agency to address circumstances as they arise).

⁹² CFTC Interpretative Letter No. 00-89, *supra* note 69, at *2 (quoting H.R. REP. NO. 93-975, at 86 (1979)).

⁹³ Carney Simpson, Note, *Do End-Users Get the Best of Both Worlds?—Title VII of Dodd-Frank and the End-User Exception*, 69 WASH. & LEE L. REV. 1759, 1773–74 (2012).

⁹⁴ See *id.* at 1782–83.

poses and exempts them from the clearing requirement.⁹⁵ In light of this exception, the definition of a commodity pool and who operates a commodity pool is significant. A commodity pool, as currently defined, falls under the definition of “financial entity” and thus is not entitled to the end-user exception.⁹⁶ Therefore, CPOs and the participants of the commodity pool would have to concern themselves with the clearing requirements.⁹⁷ Moreover, persons or entities that apply for the exemption from registration would, in effect, be claiming that they are currently commodity pools. Consequently, these “commodity pools” would be “financial entities” subject to the requirements Dodd-Frank imposes on these institutions.

The addition of swaps into the definition of commodity pools further muddles the picture. Due to the recent amendments, securitization vehicles that use swaps are now required to consider whether their entities constitute commodity pools.⁹⁸ Uncertainty continues to linger, as the CFTC has not promulgated a *de minimis* exception or delineated any rule for determining the threshold involvement of swaps that would cause a securitization vehicle to become a commodity pool.⁹⁹ Absent an exemption, characterizing a securitization vehicle as a commodity pool would subject its sponsor to CPO registration requirements.¹⁰⁰ Moreover, labeling a securitization vehicle as a commodity pool has implications that are independent of CPO registration.¹⁰¹ The Volcker Rule restricts banks from certain activities such as sponsoring a covered fund,¹⁰² which *may* include a commodity pool.¹⁰³ Potentially, subsuming commodity pools under the definition of a covered fund could significantly expand the reach of a “cov-

⁹⁵ *Id.* at 1784–85.

⁹⁶ Bopp & Steiner, *supra* note 14, at 2.

⁹⁷ *See id.*

⁹⁸ *Is Your Securitization Vehicle a Commodity Pool Because of Its Use of Swaps, and Do You Have to Register as a Commodity Pool Operator?*, SIDLEY AUSTIN LLP 1 (Oct. 19, 2012), <http://www.sidley.com/files/News/24f1f05b-59e6-4301-8c37-e418a81fcd7/Presentation/NewsAttachment/acab6caa-9565-45b7-ad05-0fc0cc67796a/FinRegReform.10.19.12.pdf> [hereinafter SIDLEY AUSTIN].

⁹⁹ *Id.* at 2.

¹⁰⁰ *See id.* at 1–2.

¹⁰¹ *See id.* at 1.

¹⁰² *The Volcker Rule Proposal: Regulators Propose Restrictions on “Covered Funds,”* PRICEWATERHOUSECOOPERS 1 (Dec. 2011), http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/closer-look-volcker-covered-funds.pdf [hereinafter *Volcker Rule Proposal*]. A banking entity “sponsors” a fund if it “serves as general partner, managing member, trustee or commodity pool advisor or in any manner selects or controls directly or indirectly a majority of the directors, trustees, or management of a covered fund.” *Id.* at 4. These provisions regarding covered funds are meant to prevent the banking entity from sidestepping the prohibition of trading as a principal in various financial instruments. *Id.* at 2. The covered fund provisions are meant to further the ban on banking entities in engaging in proprietary trading. *Id.* at 2.

¹⁰³ SIDLEY AUSTIN, *supra* note 98, at 11.

ered fund” and implicate funds that are only minimally involved in commodities such as swaps.¹⁰⁴ This would effectively prevent the banking entity from entering into transactions with the securitization vehicle.¹⁰⁵ Those affected are also reluctant to seek guidance or relief from the CFTC as “an approach to the CFTC [might] not result in relief being granted or [might] result in unacceptable conditions to relief.”¹⁰⁶ Moreover, the CFTC, “in the course of granting or denying relief, [might] articulate additional criteria . . . that may be problematic for certain transaction structures.”¹⁰⁷ Furthermore, simply requesting relief is an implicit acknowledgment that the securitization vehicle *is* a commodity pool.¹⁰⁸

These instances are representative of undesirable results that would occur if the definitions of the terms “commodity pool” and “CPO” are not sufficiently clear. This is an undesirable result since the types of investors that will be negatively impacted by these ambiguities are more likely to be the types of investors that Congress did not intend to regulate. The institutions and persons that would be more likely to apply for an exemption from CPO registration are probably those who operate business entities that technically could fall under the definition of CPO but who do not function as conventional commodity pools due to their more esoteric structures. These ambiguities would impose high transactional risks that could impede a market participant’s ability to manage its own business risk. It would make it more difficult for the average market participant in the commodities and derivatives space to understand the impact of these regulations on its day-to-day transactions and make compliance with the regulations more difficult. Oftentimes, these market participants participate in commodity pools to hedge risk, not to turn a profit on the investment. But these ambiguities could potentially negate the risk-mitigating benefits derived from the investment, which could lead these market participants to pull out of the market. Fewer market participants would lead to a net reduction in the industry, which in turn would mean less liquidity in the market due to fewer transacting parties.

104 See *Volcker Rule Proposal*, *supra* note 102, at 4.

105 SIDLEY AUSTIN, *supra* note 98, at 11.

106 *Id.* at 8.

107 *Id.*

108 *Id.* at 11.

III.

A COMPARATIVE ANALYSIS OF TWO REGIMES

Given the inefficiencies described above, a more specific standard would lower transaction costs in the market.¹⁰⁹ The obvious question is how much more stringent the modified standard should be as compared to the current one. The CFTC has traditionally defined “commodity pool” broadly.¹¹⁰ A large part of the confusion in whether or not someone is a CPO rests upon the difficulty in determining what a commodity pool actually is.¹¹¹ Thus, clarifying the scope of what constitutes a commodity pool would reduce the confusion concerning who must register as a CPO. To do so, rather than examine commodity pool regulation from only within the derivatives area, the CFTC should look into the parallel regime of securities law, which provides noteworthy insights.

A. History of the Commodity Futures Trading Commission Act of 1974

Before addressing potential substantive changes, an understanding of the history of the statutory provisions governing commodity pools and CPOs is necessary. Analyzing the progression of the Commodity Futures Trading Commission Act of 1974, which first regulated CPOs,¹¹² sheds light on the purpose of the regulations. Congress enacted the Commodity Exchange Act in 1936 to regulate futures trading.¹¹³ Originally, the CEA relied upon exchanges to preserve market integrity.¹¹⁴ However, abusive trading was rampant, and there was excessive speculation and manipulation of the markets to the detriment of unsophisticated investors.¹¹⁵ Consequently, Congress established the present regulatory structure by amending the CEA and creating the CFTC as an independent regulatory agency through the Commodity Futures Trading Commission Act of 1974.¹¹⁶

¹⁰⁹ See *supra* Part II.B. For a general discussion on the impact of transaction costs on investor decisions using the Sarbanes-Oxley Act of 2002 as context, see Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333 (2006).

¹¹⁰ See *supra* notes 27–31 and accompanying text.

¹¹¹ See *supra* notes 67–91 and accompanying text.

¹¹² Rosen, *supra* note 34, at 939–40.

¹¹³ JERRY W. MARKHAM, *THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION* 28 (1987). For a condensed timeline of the development of futures trading prior to the CFTC, see *History of the CFTC*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/About/HistoryoftheCFTC/history_precftc (last visited Sept. 19, 2013).

¹¹⁴ See MARKHAM, *supra* note 113, at 62.

¹¹⁵ *Id.* at 62–63. Some abusive trading practices included “bucketing of customers’ orders, excessive trading between brokers, . . . and improper matching of customer orders.” *Id.* at 62.

¹¹⁶ Ed Jones & John F. Cook II, *The Commodity Futures Trading Commission Act of 1974*, 5 MEM. ST. U. L. REV. 457, 457 (1975); Rosen, *supra* note 34, at 939–40. The CFTC is headed

Specifically, Congress granted the CFTC exclusive and pervasive authority over the professionals who engaged in commodity trading and interacted with the customers.¹¹⁷ Congress also brought into the purview of the CFTC the regulation of CPOs, commodity trading advisors, associated persons, and futures commission merchants.¹¹⁸ Prior to the Congressional amendments to the CEA, these professionals had remained largely unregulated with the exception that pools had to post higher margins and CPOs had to keep records of the transactions.¹¹⁹ Aside from general antifraud provisions in section 4 of the CEA, the statute offered few private causes of action that an investor could bring against the trading professionals.¹²⁰ The CFTC imposed registration requirements on these professionals, notably the CPOs in 1975.¹²¹ However, CFTC often granted exemptions on an informal basis.¹²² The CFTC promulgated the first substantive regulations governing CPOs in 1979.¹²³

The CFTC promulgated even more comprehensive regulations in 1981, and an examination of that process and the result is instructive.¹²⁴ On August 4, 1980, the CFTC proposed substantial revisions to the regulations passed in 1979.¹²⁵ The revisions were proposed in

by four commissioners and a chairman. See MARKHAM, *supra* note 113, at 65. To maintain independence, the commissioners were appointed by the president and had the authority to hire investigators, experts, and clerks. *Id.* at 66. For further discussion of the regulatory scheme created by the Commodity Futures Trading Commission Act, see generally Jones & Cook, *supra*.

¹¹⁷ Rosen, *supra* note 34, at 939–40.

¹¹⁸ *Id.* at 940, 953. A futures commission merchant engages in the actual transaction of accepting orders from investors to sell or buy commodity futures; it is analogous to a brokerage house. Jason E. Friedman, CFTC v. Gibraltar Monetary Corp. and Vicarious Liability Under the Commodity Exchange Act, 79 FORDHAM L. REV. 737, 746 (2010).

¹¹⁹ Rosen, *supra* note 34, at 941.

¹²⁰ See *id.* at 941, 997–98 & n.437. For more on the litigation permitted by the CEA and its attendant difficulties, see generally William D. Harrington, *Culpability and Its Content Under the Commodity Exchange Act*, 17 CONN. L. REV. 1 (1984).

¹²¹ See Rosen, *supra* note 34, at 960–61; see also Carl E. Stetz, Note, *The New Regulation of Foreign Based Futures Contracts and Commodity Options: Is International Regulatory Uniformity Far in the Future?*, 14 BROOK. J. INT'L L. 73, 84 (1988) (describing the registration process and stating that the “federal courts have termed the registration requirements under the CEA as the ‘kingpin’ of the regulatory framework” (quoting CFTC v. British Am. Commodity Options Corp., 560 F.2d 135, 139–40 (2d Cir. 1977))).

¹²² Rosen, *supra* note 34, at 961; see also *supra* Part II.A (discussing the CFTC’s ad hoc approach to granting exemptions).

¹²³ See Frank A. Camp, Note, *The 1981 Revisions in the CFTC’s Commodity Pool Operator Regulations*, 7 J. CORP. L. 627, 634 & n.56, 635 (1982). An in-depth discussion of the 1979 regulations is beyond the scope of this Note. See *id.* at 635–50 for such a discussion and specifically a comparison of the 1979 regulations with the 1981 revisions.

¹²⁴ *Id.* at 636.

¹²⁵ See Revisions of Commodity Pool Operator and Commodity Trading Advisor Regulations, 46 Fed. Reg. 26,004, 26,004 (May 8, 1981) (to be codified at 17 C.F.R. pts. 4, 140). The Commission ultimately received ninety-four comment letters during the commentary period from CPOs, commodity trading advisors, futures commission merchants, investors, the SEC, and numerous regulatory agencies, among others. *Id.*

response to the rapid growth and popularity that commodity futures trading experienced.¹²⁶ Significantly, the Commission modified the regulations to require that a CPO and the commodity pools it operates be separate legal entities.¹²⁷ Ultimately, the Commission also sought to narrow the definition of “pool” by clarifying in Regulation 4.10(d) that it includes only business entities “‘operated for the purpose’ of trading commodity interests.”¹²⁸ However, the Commission explicitly rejected proposals to narrow the definition of the term “pool” further.¹²⁹ For example, the Commission declined a *de minimis* exemption for business entities that traded commodities futures under a certain percentage of their overall assets.¹³⁰ The Commission stated that they found this approach “deficient because it fails to take into account the fact that such an entity might, nonetheless, *be marketed and sold* as a commodity pool, so that the participants therein should not be denied the protections” of the statute.¹³¹ The Commission also rejected narrowing the language to the “*principal* purpose of acquiring or trading commodity interests.”¹³² The Commission stated that this suggestion was unsatisfactory, as “it [did] not recognize that an entity may commence operations in one line of business and subsequently may engage in another line of business—*i.e.*, a commodity pool.”¹³³

The Commission, after considering the comments, decided to adopt the revisions to Rule 4.10(d) as originally proposed.¹³⁴ Moreover, it stated that the purpose of the revisions was to “make the information CPOs and CTAs furnish customers more meaningful and to effectuate the Commission’s intent that such information be presented in a uniform format.”¹³⁵ Furthermore, the Commission asserted that

¹²⁶ Rosen, *supra* note 34, at 976.

¹²⁷ Revisions of Commodity Pool Operator and Commodity Trading Advisor Regulations, 46 Fed. Reg. at 26,012. In a practical sense, this meant that the funds had to be received in the pool’s name, and the CPO was required to keep the funds of the property separate with other personal assets. *Id.* Moreover, Regulation 4.20(b) required that all funds received by the pool must be made payable to the pool; the CPO may not receive the funds on the pool’s behalf and reimburse the pool at a later date. *Id.* at 26,013.

¹²⁸ *Id.* at 26,005.

¹²⁹ *Id.* at 26,005–06.

¹³⁰ *Id.* at 26,005. The specific percentage suggested was ten percent. *Id.*

¹³¹ *Id.* (emphasis added).

¹³² *Id.* at 26,005–06 (emphasis added).

¹³³ *Id.* at 26,006.

¹³⁴ *Id.* at 26,005–06.

¹³⁵ *Id.* at 26,004. The Commission also adopted new regulations regarding the manner in which CPOs had to prepare their disclosures, specifying the paper, size, and type of acceptable reports. *Id.* at 26,005. For more information on the revisions to administrative provisions such as the pagination of documents, see *id.*

[t]hese revisions also are intended to ensure that CPOs and CTAs are dealing fairly with their customers and maintaining adequate records of those dealings; to facilitate the Commission's inspections of the operations and activities of CPOs and CTAs; and to relieve certain regulatory burdens and streamline and simplify reporting and record-keeping requirements for CPOs and CTAs.¹³⁶

However, the Commission did agree to expand the availability of exemptions under section 4.13 for CPOs.¹³⁷ Notably, the Commission in section 4.13(a)(1) continued to exempt persons from registration under certain circumstances if the person operated only one pool.¹³⁸ The Commission also granted exemptions to persons operating a pool in which the total gross capital contributions for all pools the CPO operated were lower than \$200,000 combined and each pool had fewer than or equal to fifteen investors.¹³⁹

B. Juxtaposing the Two Regimes

The history of commodity pool regulation is very telling of the CFTC's and Congress's intent in placing commodity pools under government supervision. This intent mirrors the SEC's purpose in regulating the commodity pool's sister entity: the investment company. Though of course the two types of funds operate in widely divergent environments, their fundamental structures are very similar. For example, both solicit capital from outside investors, which a "manager" or "sponsor" exchanges for financial instruments that further the entity's purpose. On a deeper note, both share similar risks in misleading and harming investors. That is, the operator of either the investment company or the commodity pool can operate the fund in such a way as to extract a benefit at the expense of investors, who realize the scheme *ex post*. So the question this all leads to is whether the SEC's well-developed regulatory regime for determining investment company status can be adopted and molded by the CFTC.

Investment companies are business entities that issue securities, which are defined under section 2(a)(1) of the Securities Act of 1933 as "any note, stock, treasury stock, security future, security-based swap, bond, debenture, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a 'security.'"¹⁴⁰ Section 3(a)(1) of the 1940 Act governs the definition of an "investment com-

¹³⁶ *Id.* at 26,004.

¹³⁷ *Id.* at 26,006.

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ 15 U.S.C. § 77b(a)(1) (2012); *see also Investment Companies*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/mfinvco.htm> (last updated July 9, 2013) ("Generally, an 'investment company' is a company . . . that issues securities and is primarily engaged in the business of investing in securities.").

pany.”¹⁴¹ A company can become subject to the 1940 Act by becoming an investment company in one of three ways.¹⁴² An investment company is any issuer that

(A) . . . holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type . . . ; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40[%] of the value of such issuer’s total assets¹⁴³

Business entities that fall within the realm of section 3(a)(1)(A) are “engaged primarily” in the trading of securities.¹⁴⁴ By contrast, companies that become investment companies via section 3(a)(1)(C) do not need to be “primarily” engaged but simply “engaged” in the trading of securities.¹⁴⁵ However, section 3(b) of the Investment Company Act provides an exemption to the expansive 3(a)(1)(C) provision.¹⁴⁶ Section 3(b) states that “[n]otwithstanding paragraph (1)(C) of subsection (a) [,] . . . [a]ny issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities” is not an investment company.¹⁴⁷ Therefore, the SEC defines a company meeting the threshold level of activity “engagement” needed to fall within the purview of the 1940 Act as “any entity that (i) engages in the trading of securities, (ii) has a significant investment in securities and (iii) is *not primarily engaged* in a business other than that of trading in securities.”¹⁴⁸ Section 3(b)(1) effectively allows companies that are primarily engaged in a business that does not involve trading securities to escape regulation as an investment company, thereby implying that the threshold level of activity needed to deem a company as “engaging” in securities trading is not met in those instances.¹⁴⁹ Hence, the definition of “primarily engaged” may be instructive when making a determination of whether a business entity’s level of securities trading is sufficient to constitute being “engaged” and, consequently, whether the business entity is subject to section 3(a)(1)(C).

¹⁴¹ 15 U.S.C. § 80a-3(a)(1).

¹⁴² *See id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.* § 80a-3(a)(1)(A).

¹⁴⁵ *Id.* § 80a-3(a)(1)(C).

¹⁴⁶ *See id.* § 80a-3(b).

¹⁴⁷ *Id.* § 80a-3(b)(1).

¹⁴⁸ Brian Vito, *Revisiting the Inadvertent Investment Company*, 16 FORDHAM J. CORP. & FIN. L. 125, 132 (2011) (emphasis added).

¹⁴⁹ *See* 15 U.S.C. § 80a-3(b)(1).

The SEC issued its first opinion interpreting the words “primarily engaged” as stated in the 1940 Act in the matter of *Tonopah Mining*.¹⁵⁰ In making its decision, the SEC stated that the “principal relevant considerations [were] 1) the company’s historical development; 2) its public representations of policy; 3) the activities of its officers and directors; and, most important[ly], 4) the nature of its present assets; and 5) the sources of its present income.”¹⁵¹ After *Tonopah*, the SEC as well as the courts have continued to refer to these five factors to provide guidance as to whether a company’s activities rise to the level of one “primarily engaged” in trading securities.¹⁵² The SEC has further refined the *Tonopah* analysis in interpretative letters, explaining that the SEC “consider[ed] of first importance the area of business in which the entity anticipates realization of the greatest gains and exposure to the largest risks of loss.”¹⁵³ Significantly, the SEC cautioned that the gains and losses in futures trading would also be compared to the company’s gains and losses in its other activities.¹⁵⁴

The standard discussed above is applicable to reshaping the standard for determining whether a business entity is “operated for the purpose of trading in commodity interests.”¹⁵⁵ Recall that the primary issue with the current standard is that market participants will find it too ambiguous and a costly obstacle, and that the standard may sweep too broadly in determining commodity pool status. In analyzing whether the entity’s activities in commodities trading are sufficient to rise to the level of “purpose,” the CFTC has expressly declined to adopt a *de minimis* approach and rejected the modification of the provision to include “principal purpose.”¹⁵⁶ This means that the CFTC intended for the definition of commodity pools to encompass more entities than those that primarily trade in commodities; however, a strict and literal reading of the provision would include entities that the CFTC did not intend to cover. The CFTC could clarify the standard for the financial industry by adopting the SEC’s approach: permit entities that could prove their primary purpose is to engage in a business *other than* trading in commodity futures to circumvent the definition of a commodity pool. This general approach would allow a company using commodities trading mainly to, for example, “hedge its hog production and related feed costs”¹⁵⁷ to escape the definition

¹⁵⁰ *Tonopah Mining Co.*, 26 S.E.C. 426, 426–27 (1947).

¹⁵¹ *Id.* at 427.

¹⁵² See Vito, *supra* note 148, at 146.

¹⁵³ Peavey Commodity Futures Funds, [1983–1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,511, at 78,652 (1983).

¹⁵⁴ *Id.*

¹⁵⁵ 7 U.S.C. § 1a(10) (2012).

¹⁵⁶ See *supra* notes 130–33 and accompanying text.

¹⁵⁷ See CFTC Interpretative Letter No. 00-89, *supra* note 69, at *1; see also *supra* Part II.A and accompanying text (discussing CFTC Interpretative Letter No. 00-89).

of a commodity pool. In defining primary purpose, the CFTC could look to the ways in which the SEC has defined “primary,”¹⁵⁸ which directly address the CFTC’s concerns regarding commodity pools. For example, one of the factors that the SEC considers is how the company markets itself, which was one of the concerns the CFTC expressed in declining the *de minimis* approach.¹⁵⁹ The CFTC could effectively decide that failure to meet this prong means failure to prove that a company is primarily engaged in a business other than commodities trading.¹⁶⁰

If the CFTC decides to mirror the SEC’s analysis and provide an exemption for businesses that can provide a showing of a “primary purpose” in something other than commodities trading, the CFTC could also further refine the meaning of “purpose” by adopting nonexclusive safe harbors. Again, the CFTC could look to the SEC as an instructive example; the relationship between the statutory exemption of section 4(2) of the Securities Act of 1933 and Regulation D is relevant.¹⁶¹ Much like how Regulation D contains rules that clarify the circumstances under which issuers qualify for a private placement exemption under section 4(2),¹⁶² the CFTC could adopt nonexclusive safe harbors that contain more concrete requirements that would exempt funds from falling within the definition of commodity pools. Like other safe harbors, Regulation D provides issuers with quantitative thresholds and ceilings for *de jure* satisfaction of section 4(2).¹⁶³ These thresholds and ceilings are meant to proxy the SEC’s goal of permitting only sophisticated investors to have access to the private offerings section 4(2) contemplates while relieving potential private issuers of the *ex ante* headache of assessing nebulous and ambiguous section 4(2) noncompliance risk. In other words, the purpose of Regulation D was to lower transaction costs of private placement by eliminating some of the ambiguities surrounding section 4(2). The

¹⁵⁸ See *supra* notes 150–54 and accompanying text.

¹⁵⁹ See *supra* notes 130–31 and accompanying text.

¹⁶⁰ See *supra* note 79. This issue speaks directly to the CFTC’s holding in the interpretative letter concerning commodity pools that had solicited funds from others in the past (presumably marketing themselves as investment vehicles trading in commodities) but were not presently engaged in the business of actively trading commodities. See *supra* notes 76–81 and accompanying text.

¹⁶¹ See Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (2012) (exempting from regulation “transactions by an issuer not involving any public offering”); Definitions and Terms Used in Regulation D, 17 C.F.R. § 230.501 (2012); *cf. Vito, supra* note 148, at 167–70 (arguing that the SEC should utilize Regulation D to create an SEC exemption for commodity pools so that the commodity pools do not fall within the purview of the Investment Company Act). Taking Vito’s argument a step further, the CFTC could follow suit and use Regulation D to help define what a commodity pool is.

¹⁶² Jerry W. Markham, *Fiduciary Duties Under the Commodity Exchange Act*, 68 NOTRE DAME L. REV. 199, 261 (1992).

¹⁶³ See 17 C.F.R. § 230.501.

CFTC's goal in its commodity pool regulations (and, similarly, Congress's) mirrors the SEC's purpose in creating Regulation D: to protect unsophisticated investors from unregulated investment structures, such as commodity pools. Thus, to provide specificity for the proposed standard of "not primarily engaged," the CFTC might delineate notional value thresholds or aggregate profit and loss ceilings. Should the commodity pools in question be subsidiary operations of, for example, an agricultural company, the subsidiary's profit and loss on derivatives and commodities trading can be used to proxy whether the pool is acting speculatively and whether it is operating as a primary profit center for the parent company. If it is, then the pool can be seen as a threat to investors that should be regulated.

CONCLUSION

The CFTC's current regulatory structure for determining whether someone is a CPO is to implement an ad hoc approach that is contingent on the circumstances of each case and to grant exemptions from registration requirements by issuing interpretation letters. However, this method increases the likelihood that market intermediaries will be incapable of predicting whether the CFTC will regard them as CPOs. The uncertainty stems from the ambiguity of the meaning "commodity pools"; the CFTC can decrease the level of uncertainty that faces market intermediaries by adopting a more concrete standard for the definition, specifically for the phrase "for the purpose of trading in commodity interests." The CFTC should exempt the funds that can demonstrate a "primary purpose" in another business activity from the definition of commodity pools, thereby creating an exemption for the potential CPOs. To further clarify the exemption and the meaning of "primary purpose," the CFTC should also adopt nonexclusive safe harbors. The safe harbors would provide more specific requirements that would exempt potential CPOs from registration because the requirements would take the fund out of the definition of a commodity pool. Aside from providing market intermediaries with more certainty regarding their potential CPO status, the CFTC would provide more clarity to the definition of a commodity pool, an issue that has an independent significance in light of Dodd-Frank and the Volcker Rule. A more solidified standard would provide a more comprehensive regime in which the scope of the new regulations can be more easily ascertained, thereby promoting market integrity and investor protection.

