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Recent Regulatory Developments

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This paper surveys some of the recent regulatory developments that have impacted many commodity market participants. Discussed below are: (i) National Futures Association ("NFA") rule amendments and rules related to digital asset disclosures and supervision requirements, distress events and compliance reporting, a reminder that branch office inspections are once again required, and a review of NFA's most recent survey of common deficiencies; (ii) a Commodity Futures Trading Commission ("CFTC") staff advisory and CFTC enforcement cases outlining activities that could render an entity a swap execution facility ("SEF"), and a review of a recent Fifth Circuit appeals court case that considered the question of what constitutes final agency action in the context of CFTC no-action relief review; (iii) key issues as discussions continue in Congress on how to regulate the digital asset market, updates on regulatory responses by the SEC and CFTC to the FTX scandal, and a review of two recent cases in the Southern District of New York applying the *Howey* test to crypto assets; and (iv) a Securities and Exchange Commission ("SEC") rule proposal regarding supervisory requirements for third-party service providers.

I. NFA Adopts New Rule on Digital Assets

The NFA recently adopted Compliance Rule 2-51 to mandate new digital asset disclosure and supervision requirements.[1] NFA Rule 2-51 expands on NFA Interpretative Notice 9073,[2] which previously outlined disclosure requirements for members that are engaged in activities that

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[1]*See* https://www.willkie.com/-/media/files/publications/2023/nfa_mandates_digital_asset_disclosure_and_supervision.pdf.
[2] S*ee* NFA Interpretive Notice to Members 9073 (May 17, 2018), https://www.nfa.futures.org/rulebooksql/rules.aspx?Section=9&RuleID=9073.

are related to virtual currencies and their derivatives. Rule 2-51, which became effective on May 31, 2023, extends NFA's traditional supervision and anti-fraud rules to "digital asset commodities," which the rule defines as Bitcoin and Ether. Generally, the rule imposes anti-fraud, just and equitable principles of trade, disclosure and supervision requirements on Members that engage in digital asset activities, including in the spot and cash market, as follows:

- *Fraud and Related Matters*—No Member or associate engaged in activities involving any digital asset commodity shall:
  - Cheat, defraud, or deceive, or attempt to cheat, defraud or deceive, any other person involved in those activities;
  - Make a communication related to a digital asset commodity that operates as a fraud or deceit; employs or is part of a high-pressure approach; or make any statement that trading in digital asset commodities is appropriate for all persons;
  - Willfully make or cause to be made a false report, or willfully enter or cause to be entered a false record in, or in connection with, any transaction involving a digital asset commodity;
  - Disseminate, or cause to be disseminated, false or misleading information, or a knowingly inaccurate report, that affects or tends to affect the price of any digital asset commodity;
  - Engage in manipulative acts or practices regarding the price of any digital asset commodity; or
  - Embezzle, steal, or purloin or knowingly convert to its own use or the use of another, any money, securities, digital assets or other property received from or accruing to any person in connection with a transaction involving a digital asset commodity.
- *Just and Equitable Principles of Trade*—Members and their associates are required to observe high standards of commercial honor and just and equitable principles of trade related to the conduct of their business involving any digital asset commodity.
- *Disclosure and Related Matters*—Members engaged in activities involving digital asset commodities are required to comply with the applicable requirements set forth in NFA's Interpretive Notice 9073.
- *Supervision*—Each Member engaged in digital asset commodity activities must diligently supervise its employees and agents in the conduct of their digital asset commodity activities for or on behalf of the Member. Moreover, each associate that has supervisory duties over a Member's digital asset commodity activities must diligently exercise such

duties in the conduct of that associate's digital asset commodity activities for or on behalf of the Member.

The content of Rule 2-51 was discussed at a summit between FINRA and NFA on May 10, 2023. During this summit, the self-regulatory organizations agreed to expand their memorandum of understanding to address crypto-related activities and to leverage their respective areas of expertise. This meeting indicates that cooperation among regulators will continue as Congress evaluates how the various aspects of digital asset markets will be regulated.[3]

II. Reminder to Notify NFA of Certain CPO or Pool Distress Events

NFA adopted a rule in 2021 to require commodity pool operators ("CPOs") to notify NFA upon the occurrence of certain events indicating that a pool may be in distress.[4] Citing then-recent market volatility across asset classes, NFA issued a notice in March 2022, reminding NFA Members ("Members") of their obligation to file any required notices in accordance with NFA Compliance Rule 2-50.[5] Pursuant to NFA Compliance Rule 2-50, a CPO experiencing any of several "reportable events" must notify NFA by 5:00 p.m. (U.S.) Central Time on the following business day. Importantly, notice to investors is not sufficient.

The notice requirement is designed to assist NFA in identifying CPOs and commodity pools that may be faced with adverse financial situations, and thus potentially unable to meet their obligations. It is also worth noting that the SEC recently adopted amendments to Form PF that will require large hedge fund advisers to report information on Form PF related to certain key events, including certain "distress" events, within 72 hours, and require advisers to private equity funds to report certain other information quarterly.[6]

Summary of NFA Compliance Rule 2-50

Under Compliance Rule 2-50, any of the following events would be reportable by the CPO of the relevant commodity pool:

- The pool is unable to meet a margin call;

[3] *See* NFA News Release: FINRA and NFA Discuss Crypto Assets at Special Summit (May 10, 2023), https://www.nfa.futures.org/news/newsRel.asp?ArticleID=5554.

[4] NFA Compliance Rule 2-50; *see* NFA Notice to Members I-21-15 (Apr. 13, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5346; NFA Notice to Members I-21-20 (June 29, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5377; Proposed NFA Compliance Rule 2-50 and related Interpretive Notice entitled NFA Compliance Rule 2-50: CPO Notice Filing Requirements (Mar. 5, 2021), https://www.nfa.futures.org/news/PDF/CFTC/Proposed-CR-2-50-and-Interp-Notc-CPO-Notice-Filing-Requirements.pdf.

[5] *See* NFA Notice I-22-10 (March 11, 2022), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5455.

[6] *See* https://www.willkie.com/-/media/files/publications/2023/sec_adopts_amendments_to_form_pf_to_enhance_private_fund_reporting.pdf.

- The pool is unable to satisfy redemption requests in accordance with the pool's governing documents;
- The CPO suspends investor withdrawals or redemptions; or
- A swap counterparty of the pool asserts that the pool is in default.

Compliance Rule 2-50 is accompanied by an interpretive notice that clarifies that the new rule applies with respect to commodity pools for which the CPO has a reporting requirement to NFA (*e.g.*, Rule 4.7 pools).[7]

III. On-site Inspections of Branch Offices Once Again Required

NFA Interpretive Notice 9019, among other things, generally requires an NFA Member to conduct on-site inspection of its branch offices on an annual basis.[8] In response to the onset of the COVID-19 pandemic, in 2020 and 2021, NFA permitted Members to perform these inspections remotely. The initial 2020 relief was extended through 2021,[9] and again through the end of 2022.[10] Under this relief, Members were still required to conduct an annual inspection of their branch offices (and guaranteed IBs). Members should be aware that this relief expired on December 31, 2022. As a result, on-site inspections of branch offices are once again required.

Two exceptions exist to the annual on-site inspection requirement. The first exception requires a Member to promptly perform an on-site inspection of a branch office if the Member becomes aware of potential irregularities or misconduct involving the branch office, including disciplinary problems, customer complaints and operational issues. The second exception permits a Member to conduct an on-site inspection every second calendar year and examine the branch remotely in the other year. In making this determination, the Member must consider a number of factors, including the nature of the business conducted at the branch, the number of APs, the frequency and nature of customer complaints or other problems, revenue and whether the branch handles customer funds.

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[7] *See* NFA Interpretive Notice 9080 – NFA Compliance Rule 2-50: CPO Notice Filing Requirements (June 30, 2021), https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9080.
[8] *See* NFA Interpretive Notice 9019 - Compliance Rule 2-9: Supervision of Branch Offices and Guaranteed IBs https://www.nfa.futures.org/rulebooksql/rules.aspx?Section=9&RuleID=9019
[9] *See* NFA Notice to Members I-20-35 (October 1, 2020), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5287, and NFA Notice to Members I-21-25 (July 19, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5386.
[10] *See* NFA Notice to Members I-22-05 (February 1, 2022), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5446.

IV. NFA Survey of Common Deficiencies

In February 2023, NFA released a survey of common deficiencies as an educational tool for its Members.[11] NFA highlighted the following requirements and common deficiencies for Members:

- *Self-Examination Questionnaire*—Members are required to review their business on an annual basis, and in accordance with the most recent Self-Examination Questionnaire available on NFA's website;[12]

- *Digital Assets*—Members that engage in activities related to digital assets or their derivatives must comply with disclosure requirements specified in Interpretative Notice 9073;

- *Third-Party Service Providers*—Members must adopt and implement written policies and a supervisory framework designed to provide oversight with respect to any third-party service provider to which a Member outsources a regulatory function. The supervisory framework must address activities that include initial risk assessment, onboarding due diligence, ongoing monitoring, and termination. Members are also required to maintain records sufficient to demonstrate compliance with this supervisory requirement. It is worth highlighting that, as discussed in Section VIII, below, the SEC recently proposed Rule 206(4)-11, which would require registered investment advisers to conduct oversight of third-party service providers;

- *Cybersecurity*—Members are required to establish and maintain a written information systems security program, or ISSP, governing a firm's cybersecurity protocol. Additionally, Members must notify NFA upon the occurrence of certain cyber-related incidents via NFA's Cyber Notice Filing System. Cybersecurity training is required for employees both upon hiring and on an annual basis;

- *Pool Financial Reporting; Notification Requirements*—NFA highlighted a number of notice reporting requirements for Members, including: (1) notice with respect to a distress event (as described in Section I above), (2) changes in fiscal year end (for a year end other than the calendar year end), (3) changes in the CPO's independent CPA that has been engaged to audit pool financial statements, (4) extension requests with respect to filing a pool's financial statement, (5) notices regarding a pool's cessation of trading, including an update to the Annual Questionnaire and a final audit filing; and

- *Calculation of Financial Ratios*—NFA provided a reminder that CPOs and commodity trading advisors ("CTA") must use the accrual method of accounting and GAAP (or another internationally recognized accounting standard) when computing financial ratios.

[11] *See* NFA Notice to Members I-23-05 (February 6, 2023), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5532.
[12] *See* https://www.nfa.futures.org/members/self-exam-questionnaire.html.

Subject to a few exceptions, Members must release an annual report certified by an independent public accountant, to pool participants within 90 days of the pool's fiscal year end. Members must also submit Pool Quarterly Reports ("PQR") containing information about the firm and its pools, within 60 days of each calendar quarter end. NFA assesses fines on the CPO for late filings.

V. Current Digital Asset Activity

Digital Asset Market Structure Proposed Legislation (McHenry-Thompson Bill)

On June 2, 2023, U.S. House of Representatives Members Patrick McHenry and Glenn Thompson released a draft bill proposing a statutory framework[13] for the regulation of digital assets (the "Bill").[14] The current objectives of the Bill are to:

- Allow digital assets to be traded on conventional trading platforms.
- Outline clearer roles for the SEC and CFTC in the cryptocurrency space. Under the Bill, the SEC would regulate tokens that are a part of an investment contract or digital-asset securities, while the CFTC would regulate those tokens that are considered digital commodities. Both agencies would jointly issue rules on the definitions and oversight of dually registered exchanges.
- Provide guidance on how platforms can register at the SEC, CFTC, or both.
- Clarify what is considered a decentralized network, and how a token issuer can certify to the SEC that their blockchain is sufficiently decentralized.[15]
- Improve consumer protection without inhibiting innovation.

Although the Bill may be altered as legislative negotiations proceed, it offers insight into perspectives on digital asset regulation in the House of Representatives. On July 12, 2023, Senators Cynthia Lummis and Kirsten Gillibrand reintroduced legislation that they initially proposed last year on digital assets.[16] The new Senate bill expands on its 2022 counterpart while keeping the core tenets of fostering customer protection and encouraging innovation.

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[13] *See* McHenry, Thompson, Hill, Johnson Release Digital Asset Market Structure Proposal (June 2, 2023), https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408838.

[14] On June 6, 2023, Willkie Farr & Gallagher Senior Counsel and former CFTC Chairman J. Christopher Giancarlo provided testimony before the U.S. House Committee on Agriculture, addressing the future of digital assets and the necessity of clarity for digital asset spot markets: https://docs.house.gov/meetings/AG/AG00/20230606/116051/HHRG-118-AG00-Wstate-GiancarloJ-20230606.pdf.

[15] *See* Key House Republicans Unveil Crypto Market Structure Draft Bill (June 2, 2023), Bloomberg News, https://www.bloomberglaw.com/bloomberglawnews/crypto/X7CMG0IK000000?bna_news_filter=crypto#jcite.

[16] On June 7, 2022, Senators Lummis and Gillibrand introduced the "Responsible Financial Innovation Act" (the "Digital Assets Bill") aimed at providing a comprehensive regulatory framework to govern digital assets. The

The Senate proposal addresses registration of crypto asset exchanges, decentralized finance, consumer protection, including disclosures and limits on crypto asset lending. The bill also closes the wash sale loophole and codifies the criteria to determine which crypto assets are securities or commodities. The legislation also addresses the use of crypto assets in illicit finance, imposes new penalties for willfully violating money laundering laws, requires stablecoins to be issued by depository institutions and provides appropriations to federal agencies to implement the policies within the bill. The Senators noted that they incorporated substantial feedback from stakeholders into their legislative update, including the SEC and CFTC, experts in illicit finance, technologists and financial institutions.[17]

These proposals come in the wake of numerous enforcement actions against cryptocurrency exchanges including Coinbase and Gemini. These exchanges have publicly requested governmental clarification on the regulation of digital assets while also announcing plans for offshore operations.[18]

Other Crypto News

Following incredibly strong market conditions in 2021, the crypto market dropped precipitously in 2022. This decline was exacerbated by the collapse of FTX Trading Ltd. ("FTX") in November 2022. FTX was previously one of the world's largest crypto exchanges, and even advocated for the implementation of crypto legislation in the U.S. The company's perceived strength was evident when, in May 2022, it offered financing for several collapsing competitors following a $2 trillion decline in the crypto market.[19] While FTX initially seemed immune to the negative market conditions, it was soon uncovered that its founder, Sam Bankman-Fried, used FTX customer funds to repay loans taken out by FTX affiliate Alameda Research LLC ("Alameda"), another crypto trading firm founded by Bankman-Fried. Regulators and prosecutors also allege that funds of FTX and Alameda were commingled, which further put customer assets at risk. As these revelations surfaced, FTX experienced a virtual bank run by customers, until November 10, 2022, when the Bahamian authorities froze the company's assets.[20]

In the wake of the FTX scandal, federal agencies began filing charges against FTX and Bankman-Fried. On December 13, 2022, the CFTC filed charges against Bankman-Fried, FTX, and Alameda, alleging the defendants engaged in fraud and material misrepresentations in connection with the sale of digital commodities in interstate commerce, resulting in the loss of

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Digital Assets Bill addressed a number of regulatory areas and issues ranging from the tax treatment of digital assets and Digital Autonomous Organizations (DAOs), to consumer protection.

[17] *See* https://www.gillibrand.senate.gov/news/press/release/lummis-gillibrand-reintroduce-comprehensive-legislation-to-create-regulatory-framework-for-crypto-assets/

[18] *See* Crypto Bill from Republicans Lays Out Clear Roles for SEC and CFTC (June 2, 2023), CNBC, https://www.cnbc.com/2023/06/02/crypto-bill-from-republicans-to-define-roles-of-sec-cftc.html.

[19] *See* Why Did FTX Collapse? (Nov. 10, 2022), *The New York Times*, https://www.nytimes.com/2022/11/10/technology/ftx-binance-crypto-explained.html.

[20] *See* The FTX Collapse Explained (Nov. 18, 2022), NBC News, https://www.nbcnews.com/tech/crypto/sam-bankman-fried-crypto-ftx-collapse-explained-rcna57582.

over $8 billion in FTX customer deposits. The agency stated that it would be using the "full scope of our enforcement authority to hold such fraudsters accountable."[21] On that same day, the SEC charged Bankman-Fried with securities fraud, alleging that he orchestrated a scheme to defraud equity investors.[22] Also on December 13, the U.S. Attorney for the Southern District of New York unsealed an indictment charging Bankman-Fried with wire fraud, commodities fraud, securities fraud, and money laundering. On February 13, 2023, a U.S. judge put a hold on CFTC and SEC lawsuits until the conclusion of the Department of Justice's criminal case against Bankman-Fried.[23] Bankman-Fried's criminal trial is set to begin in October 2023.

Despite the recent headwinds, the market for crypto and other digital assets continues to develop. Large financial institutions signal increased interest in the crypto space. On June 15, 2023, Blackrock filed an application with the SEC to launch a Bitcoin spot exchange-traded fund ("ETF"). The SEC accepted Blackrock's application in July, the first step in the SEC's process for determining whether to approve the application. The SEC has previously approved futures-based crypto ETFs, but has consistently rejected applications for a spot Bitcoin ETF such as the one Blackrock has proposed. As a response to the renewed interest from Blackrock and other large institutions, the market price of cryptocurrencies such as Bitcoin and Ethereum have improved throughout the first half of 2023.[24]

At the same time, CFTC and SEC have engaged in more aggressive oversight of crypto exchanges and digital assets. On March 27, 2023, CFTC charged Binance Holdings Ltd. ("Binance") and its founder Changpeng Zhao with willful evasion of federal law and operating an illegal digital asset derivatives exchange.[25] On June 5, 2023, the SEC filed similar charges against Binance and Zhao, alleging the operation of unregistered exchanges, broker-dealers and clearing agencies, misrepresentation of trading controls and oversight, and the unregistered offer and sale of securities.[26] The next day, on June 6, 2023, the SEC filed charges against Coinbase, Inc. ("Coinbase"), alleging the company operated as an unregistered securities exchange broker and clearing agency.[27] In its response to the allegations, Coinbase accused the SEC of failing to provide clear rules for the crypto industry.[28] Others in the crypto space have echoed Coinbase's assertions, arguing that the SEC's actions exceed its authority. Despite this, the SEC's actions have signaled that it considers everything from crypto trading platforms to cryptocurrencies and tokens under its jurisdiction.

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[21] *See* CFTC Press Release 8638-22 (Dec. 13, 2022), https://www.cftc.gov/PressRoom/PressReleases/8638-22.
[22] *See* SEC Press Release 2022-219 (Dec. 13, 2022), https://www.sec.gov/news/press-release/2022-219#:~:text=%22FTX%20operated%20behind%20a%20veneer,and%20detailed%20terms%20of%20service.
[23] *See* U.S. Judge Puts SEC, CFTC Cases Against FTX's Sam Bankman-Fried on Hold, Reuters, https://www.reuters.com/legal/us-judge-puts-sec-cftc-cases-against-ftxs-sam-bankman-fried-hold-2023-02-13/.
[24] *See* July 2023 Crypto Market Outlook Forecast (June 30, 2023), Forbes Advisor, https://www.forbes.com/advisor/investing/cryptocurrency/crypto-market-outlook-forecast/.
[25] *See* CFTC Press Release 8680-23 (March 27, 2023), https://www.cftc.gov/PressRoom/PressReleases/8680-23.
[26] *See* SEC Press Release 2023-101 (June 5, 2023), https://www.sec.gov/news/press-release/2023-101.
[27] *See* SEC Press Release 2023-102 (June 6, 2023), https://www.sec.gov/news/press-release/2023-102.
[28] *See* July 2023 Crypto Market Outlook Forecast (June 30, 2023), Forbes Advisor, https://www.forbes.com/advisor/investing/cryptocurrency/crypto-market-outlook-forecast/.

***SEC v Ripple Labs Inc.* (No. 20-CV-10832; (AT) SDNY);**
***SEC v Terraform Labs Pte. Ltd.* (No. 23-CV-1346; (JSR) SDNY)**

In 2020, the SEC brought an action against Ripple Labs premised on the fact that Ripple's token, XRP, was a security. On July 13, 2023, Judge Analisa Torres of the U.S. District Court for the Southern District of New York, ruled in a motion for summary judgment that XRP, in certain circumstances, is not a security.[29] In granting the motion for summary judgement, in part, and denying in part, Judge Torres engaged in a lengthy analysis of what constitutes an investment contract, and therefore a security, under *SEC v Howey Co.* (328 U.S. 293 (1946)), the seminal U.S. Supreme Court case that provided a four-part test to determine when an investment contract is a security, and therefore subject to regulation under the Securities Act of 1933. Judge Torres applied the *Howey* test to distinguish certain of the Ripple Labs transactions that involved the sale of XRP from more traditional investment contracts and securities.

Following Judge Torres's decision in *Ripple*, later that same month, on July 31, 2023, in *SEC v Terraform Labs Pte. Ltd.* (No. 23-CV-1346; (JSR) SDNY), another judge in the Southern District of New York, Judge Jed Rakoff came to the opposite conclusion in ruling on a motion for summary judgement.[30] In *Terraform*, Judge Rakoff held that the SEC's claims were sufficient to defeat a motion for summary judgment on the issue of whether Terraform's crypto assets constituted securities under *Howey*.

These decisions, while not dispositive in resolving the SEC's actions against either of Ripple Labs or Terraform, serve to highlight the uncertainty in the courts regarding crypto assets, and a growing need for regulatory action to provide greater clarity. The regulatory uncertainty has prompted calls for Congress to develop a clear regulatory framework for the crypto industry, and has placed additional focus on the legislative proposals discussed above. Until digital asset oversight is clarified through federal legislation, however, the SEC has indicated that it intends to continue to fill the regulatory void.[31]

VI. Categorization of Market Participants (CTAs, CPOs) as SEFs

In September 2021, the CFTC Division of Market Oversight ("DMO") published an Advisory that addressed activities that may render an entity a swap execution facility ("SEF"). The Commodity Exchange Act ("CEA") defines a SEF as: (1) a trading system or platform (2) in which multiple participants have the ability to execute or trade swaps by accepting bids and offers (3) made by multiple participants in the facility or system (4) through any means of

[29] Sec. & Exch. Comm'n v. Ripple Labs, Inc., No. 20-CV-10832 (AT), 2023 WL 4507900, at *1 (S.D.N.Y. July 13, 2023); https://www.nysd.uscourts.gov/sites/default/files/2023-07/SEC%20vs%20Ripple%207-13-23.pdf.
[30] Sec. & Exch. Comm'n v. Terraform Labs Pte. Ltd., No. 23-CV-1346 (JSR), 2023 WL 4858299 (S.D.N.Y. July 31, 2023).
[31] *See* Gensler Asserts SEC Authority Over Crypto as Opponents Waver (July 11, 2023), Bloomberg, https://www.bloomberg.com/news/articles/2023-07-11/gensler-claims-more-crypto-turf-in-washington-as-dissent-dithers.

interstate commerce, including any trading facility, that — facilitates the execution of swaps between persons, and is not a designated contract market.[32]

Key to the SEF definition is the requirement that a SEF provide *multiple participants with the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system* – sometimes referred to as the "multiple-to-multiple" prong of the SEF definition. All entities that meet the definition of SEF in the CEA must register with the CFTC. Unlike other categories of CFTC registrants, no exemptions exist from the SEF registration requirement in CEA section 5h(a)(1) for a person that otherwise meets the definition.

The Advisory

In the Advisory, DMO further interprets the multiple-to-multiple requirement in a manner that many in the industry view as overbroad. For example, the Advisory states that one-to-many and bilateral communications can satisfy the multiple-to-multiple prong. DMO also states that if more than one participant can submit a request for quote ("RFQ") to multiple participants on an entity's system or platform, that may satisfy the multiple-to-multiple prong of the SEF definition. Moreover, the Advisory states that multiple participants do not need to be able to simultaneously make or accept bids or offers. This indicates that what would have once been viewed as a one-to-many communication between a single client and multiple potential counterparties is transformed into a multiple-to-multiple arrangement because the CTA or IB has multiple clients. Therefore, even though the CTA engages only in bilateral negotiations between one client and multiple prospective counterparties as agent on behalf of that one client, the fact that the CTA has more than one client satisfies the multiple-to-multiple prong, depending upon the facts and circumstances of the activity. This appears to be what occurred with ARM (discussed below). The Advisory does not address why an employee of a counterparty contacting a dealer directly is any different from a CTA acting as an agent of the counterparty contacting the dealer.

The Symphony Settlement

On the same day the Advisory was issued, the CFTC settled an enforcement action with Symphony Communication Services, LLC ("Symphony") for failing to register as a SEF.[33] Symphony was not registered in any capacity with the Commission.[34] The CFTC found that Symphony operated a communications platform, the "SPARC Tool," that permitted multiple swap market participants to prepare and send RFQ messages to multiple other swap market participants. Recipients of the RFQ were then able to negotiate prices that could be confirmed via the SPARC Tool. The CFTC found that Symphony had operated a multiple-to-multiple platform designed to facilitate the trading of swaps, and thus should have been registered as a SEF or a designated contract market.

[32] CEA Section 1a(50).

[33] *In the Matter of Symphony Communication Services, LLC*, CFTC Docket No. 21-35 (Sept. 29, 2021).

[34] As the Advisory states, registration with the Commission in one capacity does not mean that a party is not required to register in another category.

The Asset Risk Management ("ARM") Settlement

ARM, a registered CTA, provided commodity trading advice to oil and natural gas producers. According to the settlement order, ARM recommended to its clients swap transactions that were intended to mitigate energy market price risks. Clients could ask ARM to obtain pricing for a particular type of commodity swap and ARM would then check with counterparties with whom the client had an ISDA agreement in place to determine potential pricing. Sometimes the client requested pricing from only one potential counterparty; other times, ARM would approach multiple counterparties for pricing. If the client gave ARM discretion to execute swap transactions on its behalf, then ARM would approve or reject any proposed pricing based upon the client's parameters. Sometimes this execution would occur over chat or email between ARM and the counterparty. ARM would then confirm the terms of the swap transaction with the client. If ARM did not have discretion, ARM would typically join the client on a call with the counterparty during which the client would agree to the terms of the deal. The ARM order states that the CFTC found that "ARM operated a multiple-to-multiple trading system or platform designed to facilitate the execution of swaps," and thus should have been registered as a SEF.[35]

Potential Implications on the Standard Operations of CTAs and CPOs

It is difficult to know with certainty whether traditional CTA or CPO activities would trigger a SEF registration requirement, but the 2021 Advisory and ARM suggest that they might. CTAs generally have multiple clients and CPOs often have multiple pools. Clients and pools often have ISDAs with multiple counterparties. Which counterparty to use for any given transaction may depend on the strength of the counterparty in a given market, its relative creditworthiness and other factors.

The ARM order creates an apparent anomaly. Clients of a CTA expect the CTA to obtain the best price available for a contemplated position. The only way a CTA can determine whether one dealer may offer a better price than another dealer is to ask both dealers. Seeking the best available price for transactions on behalf of its clients exemplifies the CTA exercising its fiduciary duty. Yet the ARM order suggests that a CTA is a SEF if the CTA (i) manages multiple clients pursuant to a given strategy (which is commonplace), (ii) determines to establish a position for those clients, (iii) requests quotes from multiple counterparties, and (iv) causes each such client to execute a transaction with the client's relevant counterparty (*i.e.*, potentially more than one counterparty). A CTA, when advising on the value or advisability of trading in commodity interests, is not generally thought of as operating a trading facility or platform. In the context of a CTA, moreover, the term "system" usually refers to the CTA's trading or investment strategy.

The same could be true for a CPO that operates and advises multiple commodity pools. The strategy for various of the CPO's pools may at times call for a similar position to be established. Thus, the CPO may reach out to multiple counterparties for pricing and execute transactions for each pool, perhaps with more than one counterparty. Is that multiple-to-multiple

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[35] ARM at 4.

activity?[36] In seeking to establish a position for one pool, a CPO may request quotes from multiple dealers. Is that a one-to-many communication that implicates the SEF definition as appears to be contemplated in ARM and Symphony?[37]

Open Questions

Certain fact patterns and definitions are not directly addressed in either the Advisory or the ARM settlement. The Advisory does not appear to contemplate that a CTA is acting as an agent for its client. Legally, this is no different from an employee of the client reaching out to multiple counterparties to execute a swap.[38] In this case, instead of employing internal advisory personnel, the client has chosen to utilize the services of a professional advisor as its agent to negotiate the swap. Similarly, a CPO acts as agent for its pools. And notably, a pool generally does not have employees; it is a passive investment vehicle. Importantly, neither the Advisory nor the ARM settlement directly addresses what it means to be a "trading system or platform," which is also an essential component of the SEF definition. Instead, both focus on what it means to have the "ability to execute or trade swaps" with multiple participants. The term "system," like platform, is also not defined.[39]

As the Advisory correctly observes, registration in one category does not absolve a party from its obligation to register in another category, if its activities fall within the definition of such other category, absent a statutory or rule-based exclusion or exemption. Registration as a SEF would involve a fundamental change to a traditional advisory firm's business model. A SEF has substantial obligations, among others, the supervisory responsibilities of a self-regulatory organization, order book functionality, and audit trail requirements. Moreover, even assuming a CTA registers as a SEF, in the case of a commodity asset class where swap transactions are highly customized and priced according to the creditworthiness of the relevant parties because they are uncleared, it may be difficult to actually operate an order book.

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[36] *See* ARM at 3; Symphony at 3.

[37] *See* ARM at 3-4 and Symphony at 3.

[38] CEA section 2(a)(1)(B) provides that "[t]he act, omission, or failure of any . . . agent . . . acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office shall be deemed the act, omission, or failure of such individual, association, partnership, corporation, or trust, as well as of such official, agent, or other person." In other words, under the CEA, an agent and its principal are treated as the same person.

[39] The term "trading facility" is defined under CEA section 1a(51) and provides that the term does not include a "person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm…."

VII. CFTC No-Action Letters –Final Agency Action?

***Clarke et al. v. CFTC* (Fifth Circuit, July 21, 2023)**

In July 2023, the Fifth Circuit Court of Appeals reviewed the CFTC's prior grant of no-action relief to an online event contract market that allows users to trade on the anticipated outcome of certain political events.[40] CFTC Staff had previously granted no-action relief to the market in 2014. Following a number of perceived violations, CFTC Staff rescinded the prior relief in 2022. Certain users of the market challenged the CFTC Staff's rescission of the no-action relief.

In *Clarke*, the Fifth Circuit ultimately found, among other things, that the Staff's issuance and subsequent revocation of the no-action relief constituted a "final agency action," and was therefore reviewable by the court. This holding appears to be in conflict with prior federal circuit court decisions determining what constitutes final agency action, and the reviewability of agency determinations.

The Fifth Circuit decision has the potential to impact no-action relief generally, rather than just the CFTC's use of no-action relief. Federal agencies typically rely upon the no-action relief process as an informal mechanism to address complicated regulatory issues in an expedited manner relative to using an agency order or rulemaking. To the extent the Fifth Circuit's reasoning holds, and the withdrawal of staff no-action relief is found to constitute final agency action, one potential by-product may be that no-action relief becomes rarer and will take longer to obtain, as agencies consider the possibility of increased judicial examination.

VIII. SEC Proposes Supervisory Requirements Regarding Third-Party Service Providers

In October 2022, the SEC proposed Rule 206(4)-11, which would require registered investment advisers to conduct oversight of third-party service providers. The proposed rule reflects recent SEC initiatives to expand registered investment advisers' obligations through prescriptive rules under the Advisers Act, and mirror recent efforts by the NFA regarding oversight of third parties who perform certain functions for the advisor.[41]

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[40] https://complianceconcourse.willkie.com/articles/court-to-cftc-take-no-action-on-predictit-event-contract-no-action-relief/.

[41] NFA Interpretive Notice 9079 – NFA Compliance Rules 2-9 and 2-36: Members' Use of Third-Party Service Providers (Sept. 30, 2021), https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9079; Effective on September 30, 2021, Interpretive Notice 9079 requires a Member that outsources regulatory functions to adopt and implement a supervisory framework that is designed to mitigate outsourcing-related risks. NFA Compliance Rules 2-9 and 2-36 place a continuing responsibility on a Member to diligently supervise its employees and agents in all aspects of their commodity interest activities; *see* NFA Notice to Members I-21-13 (Mar. 24, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5342; *see* Proposed Interpretive Notice entitled NFA Compliance Rules 2-9 and 2-36: Members' Use of Third-Party Service Providers (Feb. 26, 2021), https://www.nfa.futures.org/news/PDF/CFTC/022621-ProposedInterpNoticeCRs2-9and2-36-MembersUse3rdPartyServiceProviders.pdf.

Many investment advisers outsource functions to third parties in providing services to their clients. Commonly outsourced functions include data and record management, software services, the creation of specific indices or trading models and tools, trading desks, accounting and valuation services, risk management, artificial intelligence tools developed for trading, and cybersecurity, and administrative (*e.g.*, email, real estate leases, and licenses for off-the-shelf software). The SEC's proposal seeks to address the risk of third-party service failures that would impair an adviser's ability to perform required advisory functions. If adopted, Rule 206(4)-11 would require advisers to:

- Conduct due diligence before outsourcing, monitor service provider performance, and periodically reassess whether to retain each service provider;
- Make and/or keep books and records related to the due diligence and monitoring requirements;
- Amend Form ADV to collect census-type information about advisers' use of service providers, including their relationship to the adviser and the type of services rendered; and
- Conduct due diligence and monitoring of third-party record keepers and to obtain reasonable assurances that they will meet certain standards of service.

Definition of a "Covered Function"

Proposed Rule 206(4)-11 would establish an oversight framework for advisers who outsource a "covered function." A covered function is defined as a function or service that: (1) is necessary to provide advisory services in compliance with the Federal securities laws, and (2) if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services. The definition of covered function would exclude clerical, ministerial, utility, or general office functions or services; it would include compliance functions, including outsourcing a compliance consultant or a CCO.[42]

Changes to Form ADV

Form ADV would be amended to add a list of "covered functions." The items in the list include the following:

- adviser/subadviser;
- client servicing;
- cybersecurity;
- investment guideline/restriction compliance;

[42] See proposed Rule 206(4)-11(b) from Proposing Release at 22-23, 226-27.

- investment risk;
- portfolio management;
- portfolio accounting;
- pricing;
- reconciliation;
- regulatory compliance;
- trading desk;
- trade communication and allocation;
- valuation; and
- "other"

Persons performing "one or more covered functions" who are not "supervised persons" of the investment adviser, as defined in Section 2(a)(25) of the Advisers Act, would be deemed "service providers" under the proposed rule and would need to be disclosed on Form ADV. The Form ADV disclosures would require disclosure of the service provider's name, location, a description of the services provided, identification of the service provider as a related person of the adviser (an adviser affiliate or a person under common control with the adviser), if applicable, and the date the service provider began providing service to the adviser.[43] Service providers who are supervised persons of the adviser, however, are covered under Form ADV already and would not need to be disclosed again.[44]

Nature of the Diligence and Monitoring Requirements

Responsibility for the outsourced functions would remain with the adviser. Firms outsourcing a covered function to a service provider would be required to conduct initial due diligence before retaining the third-party provider. Advisers would need to develop processes to monitor service providers for the duration of their engagement.[45] The proposal expects advisers to familiarize themselves with each service provider's organizational controls, operating principles, and on-site implementation of covered functions to ensure that the service provider can deliver the

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[43] *See* Proposing Release at 74.

[44] *See* proposed Rule 206(4)-11(b) in Proposing Release at 226-27. A supervised person is defined in section 2(a)(25) of the Advisers Act as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an adviser, or other person who provides investment advice on behalf of the adviser and is subject to the supervision and control of the adviser. 15 U.S.C. § 80b-2(a)(25).

[45] Other regulators have put in place parallel processes requiring diligence and oversight over third-party service providers intended to minimize service disruptions. NFA requires Member to "adopt a written supervisory framework relating to outsourcing functions to a Third-Party Service Provider that is tailored to a Member's specific needs and business." *See* NFA's Interpretive Notice 9079, NFA's Compliance Rules 2-9 and 2-36: Members' Use of Third-Party Service Providers, (Board of Directors, Feb. 18, 2021; effective Sept. 30, 2021), available at https://www.nfa.futures.org/rulebooksql/rules.aspx?Section=9&RuleID=9079. Broker-dealers, likewise, have similar duties to monitor service providers under FINRA Rule 3110 (Supervision) and FINRA Rule 3120 (Supervisory Control System). *See* FINRA Rules 3110-20; *see also* FINRA Regulatory Notice 21-29, (2021), available at https://www.finra.org/sites/default/files/2021-08/Regulatory-Notice-21-29.pdf.

covered functions. Documentation reflecting this diligence and oversight would have to be maintained for the duration of the service provider's relationship with the investment adviser and for at least five years after terminating an outsourced service provider.

The documented diligence inquiry would require advisers to:

(i) Identify the nature and scope of the covered function the service provider is to perform;

(ii) Identify and determine how it would mitigate and manage the potential risks to clients or to the investment adviser's ability to perform its services as a result of engaging this service provider;

(iii) Determine that the service provider has the competence, capacity, and resources necessary to perform the covered function in a timely and effective manner;

(iv) Determine whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the covered function, and identifying how the investment adviser will mitigate and manage potential risks therefrom;

(v) Obtain reasonable assurance from the service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with the Federal securities laws; and

(vi) Obtain reasonable assurance from the service provider that it is able to, and will, provide a process for orderly termination of its performance of the covered function.[46]

Monitoring requirements under the proposed rule track the diligence requirements and include an evaluation of the same elements as the initial diligence to determine whether the covered function should remain outsourced with the specific provider. Advisers may consider performance reports received from the service provider; the time, location, and summary of findings of any financial, operational, or third-party assessments of the service provider; identification of any new or increased service provider risks and a summary of how the adviser will mitigate or manage those risks; amendments to written agreements with a service provider; and any records of service failures that could affect performance.

The release discusses the need for advisers to learn how their service providers will execute functions on behalf of advisory clients to mitigate risk.

[46] *See* proposed Rule 206(4)-11(a)(1)(i)–(vi) in Proposing Release at 226-27.

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To conduct required diligence and to ensure service continues without interruptions, the SEC recommends that investment advisers communicate with their service providers to ensure that mitigation plans are in place and that service provider and adviser databases are mutually compatible for sharing data related to recordkeeping. The SEC also noted that advisers and service providers would be expected to coordinate their efforts to meet the adviser's compliance obligations under the rule.

Recordkeeping Requirements

The proposed amendments would change the Advisers Act books and records rule, Rule 204-2, to require advisers to make and retain specific records related to diligence and ongoing monitoring assessments. The rule also would require advisers to retain copies of written agreements (*e.g.*, amendments, appendices, exhibits, and attachments) entered into with a service provider regarding covered functions.

Outsourced Recordkeepers

The proposed amendments to Rule 204-2 would impose a comprehensive oversight framework on outsourced recordkeepers; in addition to the diligence and periodic monitoring requirements discussed above, an adviser would be required to obtain reasonable assurances that its third-party recordkeeper could:

(i) Adopt and implement internal processes and/or systems for making and/or keeping records that meet the requirements of the recordkeeping rule applicable to the adviser;

(ii) Make and/or keep records that meet all of the requirements of the recordkeeping rule applicable to the adviser;

(iii) Provide access to electronic records; and

(iv) Ensure the continued availability of records if the third party's operations or relationship with the adviser cease.

Documentation and risk mitigation strategies likely would vary across different record storage and management systems. Advisers would have to understand the recordkeeping system and have mitigation policies and procedures in place that, among other things, would permit prompt retrieval and access, including upon the SEC's request. Under the proposal, the adviser would have to monitor the recordkeepers' internal processes and retain its own oversight regime to prevent gaps or delays in record retrieval.

Comment Period and Compliance Date

In addition to specific proposals, the SEC posed 86 questions to solicit additional public feedback. The comment period on the Proposing Release ended on December 27, 2022. Many of the comments indicate that industry participants are concerned about the implications of the rule.[47] Managed Funds Association expressed concern over the scope of the proposed rule, stating that the proposal is not "necessary or appropriately tailored to address actual or potential risks of 'outsourcing' by investment advisers."[48] Similar concerns were echoed by others, including Blackrock, Inc., Kroll, Inc., and The Money Management Institute. As of the date of this paper, a final rule has not yet been adopted. The proposal includes a period of 10 months for advisers to come into compliance.

August 18, 2023

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[47] *See* https://www.sec.gov/comments/s7-25-22/s72522.htm.
[48] *See* https://www.sec.gov/comments/s7-25-22/s72522-20153177-320682.pdf.