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Division of Swap Dealer and
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Division of Swap Dealer and
Intermediary Oversight

Staff Advisory Concerning Commodity Trading Advisors and Swaps

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[1] ("Dodd-Frank Act") imposed a variety of new requirements on commodity trading advisors ("CTAs"), and amended the statutory definition of CTA in the Commodity Exchange Act ("CEA") to include any person who engages in the business of advising others on swaps.[2] As a result, provisions of the CEA and regulations of the Commodity Futures Trading Commission ("Commission") applicable to CTAs may, depending on the circumstances, result in new advisory obligations, and generally will apply to an expanded group of market participants. In addition, certain CTAs who were previously exempt from registration with the Commission are now required to register because of the Commission's rescission of Commission Regulation 4.13(a)(4)[3] and amendments to Commission Regulation 4.5.[4]

The Division of Swap Dealer and Intermediary Oversight ("Division") issues this advisory in a question and answer format to provide guidance on these potential new advisory obligations, and to inform the newly expanded class of CTAs and those previously exempt CTAs that are now subject to registration as to the general regulatory framework. Part I below

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1 Pub. L. No. 111-203, Title VII (the Wall Street Transparency and Accountability Act of 2010), §§ 701-774, 124 Stat. 1376 (enacted July 21, 2010) (to be codified at 7 U.S.C. §§ 1 *et seq*.).

2 CEA § 1a(12).

3 *See* Commission Regulation 4.14(a)(8). Prior to the Commission's rescission of Commission Regulation 4.13(a)(4), Commission Regulation 4.14(a)(8)(i)(D) exempted from registration as a CTA certain persons who advised commodity pool operators who were themselves exempt from registration under Commission Regulation 4.13(a)(4).

4 *See* Commission Regulation 4.14(a)(8)(i)(B) and 77 Fed. Reg. 11252 (Feb. 24, 2012). *See*, Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations (Aug. 14, 2012), available at: http://www.cftc.gov/ucm/groups/public/@newsroom /documents/file/faq_cpocta.pdf.

discusses the provisions of the CEA and Commission Regulations applicable generally to CTA activities; Part II addresses a CTA's advisory obligations with respect to swap risk disclosures; and Part III reviews the requirements relevant to CTAs that advise Special Entities on swap transactions.

I. CTAs – A General Framework

Question 1: What is a CTA?

Answer: A CTA is any person who, for compensation or profit, whether directly or indirectly, engages in the business of advising others, or as part of a regular business issues reports or analysis, as to the value of or the advisability of trading in, among other things, any futures contract or swap.[5] However, certain persons are excluded from the definition of a CTA. Generally, these exclusions apply to otherwise-regulated persons and persons engaged in certain professions whose advisory services are solely incidental to such persons' otherwise-regulated business or profession.[6]

Question 2: Are all CTAs required to register with the Commission?

Answer: CTAs are generally required to register with the Commission,[7] subject to a number of exemptions.[8] For example, a person is not required to register as a CTA if the person does not direct client accounts and does not provide commodity trading advice based on, or tailored to, the positions or other circumstances of particular clients.[9] In addition, a person is not required to register as a CTA if, during the course of the preceding 12 months, that person has not furnished commodity trading advice to more than 15 persons and it does not hold itself out generally to the public as a CTA.[10]

CTAs that are exempt from registration are nonetheless subject to certain regulatory requirements that apply to all CTAs.

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5 *See* CEA Section 1a(12) and Commission Regulation 1.3(bb). The CEA and the Commission's regulations may be accessed through the Commission's Web site: www.cftc.gov.

6 The excluded persons include, for example, a news reporter, lawyer, accountant, or teacher as well as a bank or trust company. *See* Commission Regulation 1.3(bb)(1). Commission Regulation 4.6 also excludes certain otherwise-regulated persons from the CTA definition, including, for example, a swap dealer (whether registered or exempt from registration) and a regulated insurance company.

7 *See* CEA Section 4m and Commission Regulation 3.4 regarding the registration of CTAs. *See also infra* Question 4 for a discussion of when a registered CTA must also be a member of the National Futures Association ("NFA").

8 *See* CEA Section 4m and Commission Regulations 4.14 and 3.10(c)(3)(i).

9 *See* Commission Regulation 4.14(a)(9).

10 *See* Commission Regulation 4.14(a)(10).

Question 3: What are some of the regulatory requirements that apply to all CTAs regardless of registration status?

Answer: A CTA (whether registered or unregistered) may not refer to any testimonial or to any simulated or hypothetical performance of the CTA or any of its principals, unless certain disclosures are made in accordance with Commission regulations.[11] Additionally, CTAs (registered or unregistered) may not represent or imply that they have been recommended or approved, or that their abilities or qualifications have been passed upon by the Commission or the Federal government.[12] CTAs (registered or unregistered) also may not solicit or accept client funds or other property (or extend credit in lieu thereof) to purchase, margin, guarantee or secure any commodity interest of the client, including a swap.[13] This prohibition does not apply to a CTA who is also a registered futures commission merchant ("FCM"), or a registered swap dealer with respect to swaps not cleared through a derivatives clearing organization.[14]

Additionally, a CTA's advisory obligations could be impacted by the nature of the client relationship, such as factors that might give rise to a fiduciary relationship under common law,[15] and the general prohibition contained in CEA Section 4*o*(1)(B) against engaging in any transaction, practice, or course of business that "operates as a fraud or deceit upon a client or prospective client."[16]

Question 4: Are there additional regulatory requirements applicable to CTAs that are registered or required to be registered under the Act?

Answer: Yes. A CTA that is "registered or required to be registered under the Act" is subject to a number of regulatory requirements that are not imposed upon CTAs exempt from registration. Additionally, registered CTAs who are also members of NFA are subject to NFA rules. Although not all CTAs are currently required to be members of NFA,[17] the Commission recently proposed amendments to its regulations that would require *all* persons registered as

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[11] *See* Commission Regulation 4.41.

[12] *See* Commission Regulation 4.16; *see also* CEA § 4*o*(2).

[13] *See* Commission Regulation 4.30.

[14] The prohibition also does not apply to CTAs who are also other types of entities enumerated in Commission Regulation 4.30.

[15] *See* Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing With Counterparties, Including Special Entities, 77 Fed. Reg. 9734, 9739 ("Adopting Release") (stating that "a CTA, depending on the nature of the relationship, may also owe fiduciary duties to its clients under applicable case law" and citing *Commodity Trend Serv., Inc. v. CFTC*, 233 F.3d 981 (7th Cir. 2000)).

[16] There are other anti-fraud provisions within the CEA and the Commission's Regulations that are applicable to all persons.

[17] Currently, those registered CTAs who manage or exercise discretion over customer accounts generally must be members of NFA in order to do business with an FCM. Commission Regulation 170.15 requires all FCMs to be members of NFA. As NFA members, FCMs are prohibited by NFA Bylaw 1101 from carrying an account, accepting an order, or handling a transaction in commodity futures contracts for or on behalf of any non-member of NFA that is required to be registered with the Commission as a CTA, among others.

CTAs with the Commission to be members of NFA as well.[18] Therefore, all registered CTAs should consider the potential future impact of NFA rules.

Regulatory requirements applicable to registered CTAs

Regardless of NFA membership, all CTAs who are "registered or required to be registered under the Act" are subject to a number of regulatory requirements not imposed on CTAs exempt from registration.[19] For example, a registered CTA is required to maintain records concerning its clients, clients' accounts and transactions executed for them, trading records and account statements from FCMs, and advertising materials distributed to clients.[20] Furthermore, a registered CTA is required to diligently supervise the activities of its officers, employees and agents with respect to all accounts advised by the CTA.[21] In addition, under Commission Regulation 166.4, the branch office of a registered CTA must use the name of the firm for all purposes, and the CTA is responsible for the acts or omissions of any person acting for the CTA's branch office within the scope of the person's employment or office.

Additionally, certain disclosure obligations may arise when a registered CTA seeks to direct a client's commodity interest account or to guide the client's commodity interest trading pursuant to a trading program.[22] The CTA must provide the client with a disclosure document containing certain information, as discussed in response to Question 5 below. Additionally, each registered CTA must file with NFA annually a Form CTA-PR, which includes required disclosures regarding the CTA's trading programs and the assets directed by the CTA.[23] A registered CTA may claim relief from the disclosure and recordkeeping requirements that would otherwise apply to it with respect to the client account of a qualified eligible person ("QEP"), subject to certain conditions.[24]

Impact of NFA rules on registered CTAs who are also required to be NFA members

NFA-member CTAs are subject to NFA rules, some of which are generally applicable to all NFA members, and others of which are specific to CTAs.[25] For example, under NFA rules,

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[18] *See* Membership in a Registered Futures Association, 78 Fed. Reg. 67078 (Nov. 8, 2013).

[19] References to "registered CTA" in this section include CTAs "registered or required to be registered" pursuant to the CEA.

[20] *See* Commission Regulation 4.33.

[21] *See* Commission Regulation 166.3.

[22] *See* Commission Regulations 4.31 and 4.10 (which defines the terms "trading program" and "direct").

[23] *See* Commission Regulation 4.27(c).

[24] *See* Commission Regulation 4.7(c), (d). The list of QEPs includes, *inter alia*, certain commodity pools, governmental entities and agencies, and certain employee benefit plans. *See* Commission Regulation 4.7(a)(3)(xi), (a)(3)(xii), and (a)(3)(v).

[25] NFA rules may be found at: https://www.nfa.futures.org/nfamanual/NFAManual.aspx. These rules include, for example, testing and proficiency requirements for individual CTAs and associated persons ("APs") of a CTA. *See* NFA Registration Rule 401 and NFA Bylaw 301. In addition, NFA rules provide that NFA-member CTAs and their APs that engage in activities involving swaps must be approved by NFA as, respectively, a "swaps firm" or a "swap associated person." Under current NFA rules, an AP of a CTA whose activities are limited to swaps may satisfy the

generally NFA members are required to "observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business."[26] NFA members generally are also prohibited from exercising discretion over a customer's account unless authorized in writing, and must maintain written procedures that provide for supervisory review of such trading.[27] CTAs that are NFA members are additionally required to obtain certain information from all individual customers and any other customers who are not "eligible contract participants,"[28] including information regarding a customer's assets, income and previous investment and futures trading experience, and, in light of the information it obtains from a customer, disclose to the customer the risks of futures trading.[29] Moreover, as of September 30, 2013, NFA Compliance Rule 2-46 requires all NFA member CTAs to file quarterly reports electronically through NFA's EasyFile system.

Question 5: What information must a *registered* CTA provide in its disclosure document under CFTC regulations?

Answer: In situations where a registered CTA is required to provide a disclosure document to a client, there are numerous specific disclosures that must be made,[30] and that disclosure document must be filed with NFA prior to its use.[31] Among other things, the CTA's disclosure document must include a description of the CTA's trading program,[32] information concerning the business background of the CTA and its principals, the CTA's fees, conflicts of interest, litigation, and if the CTA or any principal will trade for its own account, whether clients will be permitted to inspect those trades and the policies related to that trading.[33] In addition, the disclosure document must include performance disclosures, presented in a specified format, intended to assist a prospective client's comparison of one CTA to another.[34] The disclosure document must also include both a standardized (*i.e.*, boilerplate) Risk Disclosure Statement,[35] including disclosures specific to the risks associated with swaps if the CTA may engage in

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proficiency requirements under NFA Registration Rule 401 without taking the National Commodity Futures Examination ("Series 3"). *See* NFA Registration Rule 401(e).

[26] *See* NFA Compliance Rule 2-4. NFA-member CTAs are subject to additional restrictions and conditions on the use of advertising and promotional materials. *See* NFA Compliance Rule 2-29.

[27] *See* NFA Compliance Rule 2-8.

[28] The term "eligible contract participant" is defined in CEA Section 1a(18).

[29] *See* NFA Compliance Rule 2-30 and NFA Interpretive Notice 9004. The risk disclosure required by the NFA is in addition to any disclosure required under Commission Regulations, including Commission Regulation 4.34.

[30] *See* Commission Regulation 4.34 and 4.35.

[31] *See* Commission Regulation 4.36(d).

[32] A description of the trading program must include, *inter alia*, "the types of commodity interests and other interests the commodity trading advisor intends to trade, with a description of any restrictions or limitations on such trading established by the trading advisor or otherwise." *See* Commission Regulation 4.34(h).

[33] *See* Commission Regulation 4.34.

[34] *See* Commission Regulation 4.35.

[35] *See* Commission Regulation 4.34(b).

swaps,[36] as well as a non-standardized discussion of the principal risk factors of the CTA's particular trading program.[37] Furthermore, a CTA must disclose all material information to existing or prospective clients, "even if the information is not specifically required" by the Commission's regulations.[38]

II. CTAs and Swap Risk Disclosures

Question 6: How has the new information available in connection with some swap transactions impacted the risk disclosure obligations of registered CTAs?

Answer: With respect to a swap transaction, a CTA with disclosure obligations must disclose to its clients those risks that constitute either "principal risk factors" or "material information." As discussed below, in light of Dodd-Frank reforms to the swaps market, new information may be available to CTAs representing counterparties to swap dealers and major swap participants. As a result, registered CTAs should assess that information, and then must disclose such information to their clients in appropriate circumstances.

Swaps regulations now make available important information regarding the material risks of certain swaps transactions. Commission Regulation 23.431(a) requires a swap dealer or major swap participant to disclose to its counterparties (other than swap dealers and major swap participants) "material information concerning the swap" at a reasonably sufficient time prior to entering into the transaction. That "material information" includes, among other things, the "material risks of the particular swap . . . ."[39] Additionally, prior to entering into the swap, the counterparty may "request and consult on the design of a scenario analysis to allow the counterparty to assess its potential exposure in connection with the swap," along with other information.[40]

A CTA with disclosure obligations should assess the risks of particular swap transactions that are part of its trading program, including those disclosed in accordance with Commission Regulation 23.431(a);[41] the CTA must then disclose to its clients those risks that constitute either

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[36] *See* Commission Regulation 4.34(b)(4).

[37] *See* Commission Regulation 4.34(g). The discussion of principal risk factors under Commission Regulation 4.34(g) "must include, without limitation, risks due to volatility, leverage, liquidity, and counterparty creditworthiness, as applicable to the trading program and the types of transactions and investment activity expected to be engaged in pursuant to such program (including retail forex and swap transactions, if any)."

[38] *See* Commission Regulation 4.34(*o*).

[39] *See* Commission Regulation 23.431(a)(1).

[40] *See* Commission Regulation 23.431(b). These new disclosure obligations of swap dealers and major swap participants do not apply to transactions made available for trading on a designated contract market or swap execution facility. Commission Regulation 23.431(c).

[41] There may be circumstances where disclosures in accordance with Commission Regulation 23.431(a) are delivered directly to the client, rather than to the CTA. In situations where the CTA has disclosure obligations, the CTA may well desire to obtain that information in order to assess the risks of such swaps in the context of its trading program. Even where the CTA does not have disclosure obligations, however, it may be appropriate, depending on the nature of the advisory relationship, for the CTA to advise its client regarding the availability of the disclosures and scenario analyses under Commission Regulation 23.431, and request a copy of such information from the client.

"principal risk factors" or "material information." As discussed above, in certain circumstances registered CTAs have obligations to disclose the "principal risk factors" of their trading programs,[42] and all material information, even if the information is not specifically required by Commission regulations 4.31, 4.34, 4.35, or 4.36.[43] Additionally, if the registered CTA "knows or should know that the Disclosure Document is materially inaccurate or incomplete in any respect, it must correct that defect and must distribute the correction to" all existing clients and previously solicited prospective clients.[44] For example, where a registered CTA is obligated to provide a disclosure document to a commodity pool whose account it directs, that CTA should assess the risks disclosed by a swap dealer in connection with Commission Regulation 23.431(a); the CTA must then disclose those risks if they constitute either "principal risk factors" or "material information," and also disclose any material changes to the trading program or strategy that may result from those swap transactions.[45] The CTA's disclosure obligations could also be impacted by other circumstances of the client relationship, such as factors that might give rise to a fiduciary relationship under common law,[46] and the general prohibition against engaging in any transaction, practice, or course of business which "operates as a fraud or deceit upon any client or participant or prospective client or participant."[47]

III. CTAs That Advise Special Entities on Swaps

Swap dealers or major swap participants who offer to enter or enter into swap transactions with Special Entities[48] must have a reasonable basis to believe that the Special Entity is being advised by an independent representative that satisfies certain qualifications, and assumes certain duties, as discussed below. Moreover, by virtue of its role advising the Special Entity with respect to the swap, the independent representative must also be registered as a CTA, unless otherwise excluded from the CTA definition or exempt from registration, as discussed above.

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42 *See* Commission Regulation 4.34(g).

43 *See* Commission Regulation 4.34(*o*).

44 *See* Commission Regulation 4.36(c)(1).

45 *See* Commission Regulation 4.34(*o*). Additionally, under 4.36(c) "[i]f the commodity trading advisor knows or should know that the disclosure document is materially inaccurate or incomplete in any respect, it must correct that defect and must distribute the correction" to all existing clients in the trading program and each previously solicited prospective client for the trading program in the manner prescribed under Commission Regulation 4.36(c).

46 *See supra* note 15.

47 *See* CEA Section 4*o*; *see also supra* Question 3 discussion of regulatory requirements applicable to CTAs.

48 Commission Regulation 23.401(c) defines the term "Special Entity" as: a Federal agency; a State, State agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State; any employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"); any governmental plan, as defined in Section 3 of ERISA; any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986; or any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a Special Entity, that elects to be a Special Entity by notifying a swap dealer or major swap participant of its election prior to entering into a swap with the particular swap dealer or major swap participant.

Question 7: Should Special Entities be independently represented in connection with swap transactions where their counterparties are Swap Dealers or Major Swap Participants?

Answer: Yes. Whenever a swap dealer or major swap participant offers to enter or enters into a swap with a "Special Entity," that swap dealer or major swap participant must have a reasonable basis to believe that Special Entity is being advised by an independent representative that has certain qualifications specified by Congress and the Commission.[49] The purpose of this requirement is to ensure that "Special Entities have a sufficiently knowledgeable and independent representative that is capable of providing disinterested, expert advice."[50]

Question 8: What are the required qualifications of an independent representative to a Special Entity?

Answer: The qualifications of the independent representative are set forth both in CEA Section 4s(h)(5) and Commission Regulation 23.450(b)(1) and (b)(2). They include: having sufficient knowledge to evaluate the transaction and risks;[51] not being subject to a statutory disqualification;[52] being independent of the swap dealer or major swap participant;[53] undertaking a duty to act in the "best interests" of the Special Entity;[54] making appropriate and timely

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[49] CEA § 4s(h)(5); Commission Regulation 23.450(b)(1), (2).

[50] *See* Adopting Release, 77 Fed. Reg. 9734, 9793 (Feb. 17, 2012).

[51] The Adopting Release provides "illustrative guidance" regarding the criteria a swap dealer or major swap participant should consider when assessing whether an independent representative has "sufficient knowledge to evaluate the transaction and risks" under Commission Regulation 23.450(b)(1)(i), including:

> (1) The representative's capability to make hedging or trading decisions, and the resources available to the representative to make informed decisions; (2) the use by the representative of one or more consultants; (3) the general level of experience of the representative in financial markets and specific experience with the type of instruments, including the specific asset class, under consideration; (4) the representative's ability to understand the economic features of the swap involved; (5) the representative's ability to evaluate how market developments would affect the swap; and (6) the complexity of the swap or swaps involved. Additional considerations may also include the representative's ability to analyze the credit risk, market risk, and other relevant risks posed by a particular swap and its ability to determine the appropriate methodologies used to evaluate relevant risks and the information which must be collected to do so.

Adopting Release, 77 Fed. Reg. 9734, 9795. However, "[t]he Commission does not intend to imply that each consideration is necessarily a prerequisite for a swap dealer or major swap participant to form a reasonable basis to believe the representative is sufficiently knowledgeable." *Id.* at n.850.

[52] Commission Regulation 23.450(b)(1)(ii).

[53] Commission Regulation 23.450(b)(1)(iii). Whether an independent representative is sufficiently "independent" is addressed in Commission Regulation 23.450(c), and explained by the Commission in its Adopting Release at 77 Fed. Reg. 9734, 9795-96.

[54] CEA § 4s(h)(5)(A)(i)(IV); Commission Regulation 23.450(b)(1)(iv); *see also infra* Question 9.

disclosures;[55] evaluating and providing written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction;[56] and in the case of ERISA plans, being an ERISA fiduciary.[57]

Question 9: How does an independent representative to a Special Entity satisfy its "best interests" duty?

Answer: The "best interests" duty is "the duty to act in good faith, make full and fair disclosure of all material facts and conflicts of interest, and to employ reasonable care to advance the Special Entity's stated objectives."[58]

The Commission elaborated on the independent representative's duty to disclose all conflicts of interest in the context of the independent representative's qualifications as follows:

> A representative should establish and comply in good faith with written policies and procedures that identify, manage and mitigate material conflicts of interest including, where appropriate, those arising from

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[55] The requirement to make "appropriate and timely disclosures" under Commission Regulation 23.450(b)(1)(v) is the duty to fully and fairly disclose all material facts and conflicts of interest, as discussed below in Question 9. In its discussion of what constitutes "appropriate and timely disclosures," the Commission explained that "appropriate disclosures will be assessed in the context of the Special Entity–independent representative relationship. 77 Fed. Reg. 9734, 9796. For instance, an independent representative would be expected to disclose "all compensation it receives, directly or indirectly, with respect to the swap, and it would be expected to disclose all conflicts of interest." *Id.* at 9796-97. "Disclosures should also include all fees and compensation structures in a manner that is clearly understandable to the Special Entity." *Id*. at 9797. An independent representative that is a Special Entity's employee is expected to disclose "material information not otherwise known to a Special Entity through the employment relationship such as any material compensation the representative receives from a third party or where the representative trades for its own account in the same or a related market." *Id.* With regard to the requirement to make "timely disclosures," the Commission stated that it expects the independent representative to "timely disclose to the Special Entity (or to appropriate supervisors in the case of an employee), where appropriate, unexpected gains or losses, unforeseen changes in the market place, compliance irregularities or violations, and other material information." *Id.*

[56] Under CEA Section 4s(h)(5)(A)(i)(VI), a swap dealer or major swap participant must have a reasonable basis to believe that the counterparty that is a Special Entity has an independent representative that "will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction . . . ." Commission Regulation 23.450(b)(1)(vi) implements the statute by requiring that a swap dealer or major swap participant have a reasonable basis to believe that the counterparty that is a Special Entity has an independent representative that "[e]valuates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap . . . ." *See* Adopting Release, 77 Fed. Reg. 9734, 9797. The Commission provided guidance with respect to this requirement in the Adopting Release, stating that when the independent representative is given discretionary trading authority, for example, such representative could undertake in an agreement to ensure that it "will evaluate pricing and appropriateness of each swap consistent with any guidelines provided by the Special Entity prior to entering into the swap." *Id*. The independent representative would be expected, however, "to prepare and maintain adequate documentation of its evaluation of pricing and appropriateness to enable both the representative and Special Entity to audit for compliance with the duty." *Id*.

[57] Commission Regulation 23.450(b)(2).

[58] *See* Adopting Release, 77 Fed. Reg. 9734, 9786, 9796. The nature of the independent representative's relationship with the Special Entity might even give rise to a fiduciary duty. *See supra* note 15.

> (1) compensation or incentives for employees that carry out the representative's obligations to the Special Entity, and (2) lines of business, functions and types of activities conducted by the representative for the swap dealer or major swap participant.[59]

In satisfying the duty to employ reasonable care to advance the Special Entity's stated objectives, an independent representative may find a wide variety of information useful, and should make reasonable efforts to obtain information such as: the financial status, future funding needs, and tax status of the Special Entity; hedging, investment, financing, or other objectives of the Special Entity; the experience of the Special Entity with respect to entering into swaps generally, and swaps of the type and complexity being recommended; and whether the Special Entity has the financial capability to withstand changes in market conditions during the term of the swap.[60] The independent representative should endeavor to obtain a complete picture of all relevant information, including such other information as is relevant to the particular facts and circumstances of the Special Entity, market conditions, or type of swap or trading strategy being recommended.[61]

Question 10: Is an independent representative of a Special Entity required to register as a CTA?

Answer: In many cases, an independent representative of a Special Entity must be registered as a CTA. The Commission stated in the Adopting Release that "an independent representative under [CEA] Section 4s(h)(5) that advises State and municipal Special Entities will be subject to registration with the Commission as a CTA, except for those independent representatives who are employees of such entity or otherwise excluded or exempt under the CEA or Commission rules."[62] For both registered CTAs and exempt CTAs, however, the person acting as an independent representative of a Special Entity has a duty to act in the "best interests" of the Special Entity[63] and must satisfy the other requirements applicable to independent representatives.[64]

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[59] *Id*. at 9796 (discussing the requirement under Commission Regulation 23.450(c)(3) that the representative of a Special Entity be independent of the swap dealer or major swap participant that is the counterparty to that Special Entity) (footnote omitted).

[60] *See generally* Commission Regulation 23.440(c)(2) (listing the type of information a swap dealer that acts as an advisor to a Special Entity must make reasonable efforts to obtain to make a reasonable determination that a recommended swap is in the best interests of a Special Entity).

[61] *Id.*

[62] Adopting Release, 77 Fed. Reg. 9734, 9738-39. *See* discussion of CTA exclusions and exemptions *supra* Questions 1 and 2.

[63] *See* CEA § 4s(h)(5)(A)(i)(IV). *See also* Commission Regulation 23.450(b)(1)(iv). The nature of the CTA's relationship with the Special Entity might give rise to a fiduciary duty, as noted above. *See supra* note 15.

[64] *See* discussion of independent representative qualifications *supra* Question 8.

Question 11: Are there other situations where a CTA might owe a heightened duty to a Special Entity?

Answer: Yes. Even though the "best interest" regime established under CEA Section 4s(h)(5) is limited to situations where the CTA advises a Special Entity in connection with a swap transaction where the counterparty is a swap dealer or major swap participant, that is not the only situation where the CTA might owe a heightened duty to the Special Entity it advises. As discussed in response to Question 3, a CTA might assume fiduciary duties under common law with respect to an entity it advises, including Special Entities, under any number of circumstances, depending on the nature of their relationship.[65]

Question 12: Do registered CTAs that provide advice to Special Entities that are municipalities still fall within the Commission's jurisdiction?

Answer: Yes. "[A]ny commodity trading advisor registered under the Commodity Exchange Act . . . or persons associated with a trading advisor who are providing advice related to swaps" are expressly excluded from the definition of "municipal advisor" under Securities Exchange Act of 1934 ("Exchange Act") Section 78*o*-4(e)(4)(C).[66] Nonetheless, the Commission noted that "[t]o the extent that a registered CTA engages in any municipal advisory activities other than advice related to swaps, registration may still be required with the SEC."[67] CTAs in such situations should consult with the appropriate agencies and self-regulatory organizations.

IV. Summary

CTAs are subject to numerous regulatory requirements, some of which are imposed on all CTAs, and others of which are applicable only to those CTAs that are required to register. Regardless of whether a CTA is required to register, a CTA may not do the following: (1) refer in any advertising materials to any testimonial, or any simulated or hypothetical performance of the CTA or its principals, unless certain disclosures are made; (2) represent or imply that the CTA has been recommended or approved, or that the Commission or Federal government have passed upon its abilities or qualifications; or (3) solicit or accept client funds or other property to purchase, margin, or secure any commodity interest, including a swap, of the client. Further, irrespective of registration status, CTAs are prohibited from engaging in any transaction, practice, or course of business which operates as a fraud or deceit. Unless subject to an exemption, a CTA must also register with the Commission and comply with additional regulatory requirements, such as: delivering a disclosure document to a prospective client in certain circumstances; maintaining client records; diligently supervising the activities of its officers, employees and agents; and filing an annual Form CTA-PR with NFA. Moreover,

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65 *See supra* note 15.

66 15 U.S.C. § 78*o*-4(e)(4)(C). Section 78*o*-4(e) of the Exchange Act states as follows: "Definitions. For purposes of this section . . . (4) the term 'municipal advisor' . . . (C) does not include . . . any commodity trading advisor registered under the Commodity Exchange Act [7 USCS §§ 1 et seq.] or persons associated with a commodity trading advisor who are providing advice related to swaps . . . ."

67 Adopting Release, 77 Fed. Reg. 9734, 9739 n.67.

registered CTAs who manage or exercise discretion over customer accounts generally must be members of NFA.

The disclosure obligations of CTAs depend, in part, on the nature of the advisory relationship. Thus, a CTA that is registered or required to be registered, that seeks to direct a client's commodity interest account or to guide the client's commodity interest trading pursuant to a trading program, and that cannot claim relief from the disclosure and recordkeeping requirements, must deliver a disclosure document to the client that includes a discussion of "all material information" and the "principal risk factors" of its trading program, including risks associated with swap transactions that are part of the CTA's trading strategy. Given those responsibilities, a CTA may be well advised to obtain the risk disclosures set forth in Commission Regulation 23.431(a) and, depending on the relevant circumstances, the scenario analyses provided for in Commission Regulation 23.431(b), to assess the relevant risks in the context of its trading program in order to assure that the CTA is sufficiently informed and able to disclose to its clients risks that constitute either "principal risk factors" or "material information." The CTA also is obligated to update its disclosure to the client with respect to any material information which, for example, could include disclosures describing any changes to its trading program or strategy. The CTA's disclosure obligations could also be impacted by circumstances that give rise to a fiduciary relationship under common law, or even the general prohibition against engaging in any transaction, practice, or course of business which operates as a fraud or deceit.

Additionally, CTAs who act as independent representatives to Special Entities in connection with a swap transaction where the counterparty is a swap dealer or major swap participant must satisfy certain qualifications, and must undertake a duty to act in the "best interests" of the Special Entity. Further, as noted more generally above, a CTA might owe a fiduciary duty to an entity it advises, such as a Special Entity, depending on the nature of the relationship. Consequently, it is important for a CTA to understand the nature of the relationship that it has with its client and to comply with the duties and obligations that arise from that relationship.

This advisory represents the position of the Division only and does not necessarily represent the views of the Commission or any other division or office of the Commission. For further information regarding this advisory, please contact the undersigned at (202) 418-5977, or the following: Brian G. Mulherin, Associate Director, at (202) 418-6622; Amanda Olear, Associate Director, at (202) 418-5283; Vickie Olafson, Special Counsel, at (202) 418-6771; or Israel Goodman, Special Counsel, at (202) 418-6715.

Very truly yours,

Gary Barnett, Director
Division of Swap Dealer and
Intermediary Oversight