

CFTC RULE 4.13(a)(3) POOL INVESTORS: THE \$1 MILLION POTATO

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1. WHAT ARE SPECULATIVE POSITION LIMITS?

The Commodity Futures Trading Commission (“CFTC”) has for many years imposed limits on the size of speculative position limits that any one person may hold in certain futures contracts and options on futures contracts. Post-Dodd-Frank, the CFTC has for not quite as many years attempted also to bring similar position limits to the over-the-counter swap markets, and appears poised to do so soon, on their fourth or fifth attempt—depending on how you count them.

Meanwhile, the futures exchanges set their own speculative position limits on

the futures and options on futures that they list for trading. The position limits set by the exchanges have a bigger impact than those set by the CFTC. While the CFTC currently sets limits only on a handful of grain contracts, the exchanges set limits on hundreds of other contracts.

Position limits are generally set for any single delivery month, all delivery months combined and the spot month—*i.e.*, the month in which a futures contract matures and becomes deliverable. Speculative position limits are generally set at a lower level in the spot month because that is when physical delivery is required and therefore, the spot month is the period during which large positions can have an inordinate impact on prices and lead to market volatility and disorderly markets.

The CFTC and the exchanges also provide exemptions from otherwise applicable position limits for bona fide hedgers and for spreads, straddles and similar offsetting positions.

Between the CFTC and the futures exchanges, there are position limits on the majority of physically delivered commodity futures contracts and many financially settled futures contracts. Violations of position limits can result in serious consequences, including exchange disciplinary proceedings, civil enforcement actions by the CFTC and potential criminal prosecutions.

2. WHAT IS AGGREGATION?

An important aspect of both CFTC-set and exchange-set position limits is aggregation. The position limits rules apply at the level of a “person,” whether a human person or a person created by legal fiction and existing as nothing more than a piece of paper in Delaware or somewhere similarly exotic. However, if a person could “juice” her or his speculative position in futures contracts through cleverly constructed corporate structures, trading in multiple accounts or by coordinating trading with her or his friend, Darth Trader, who lives down the block and is always looking to make a buck, the purposes of the speculative position limits would be thwarted.

The CFTC and the exchanges therefore, have rules requiring the “aggregation” of positions and exemptions to those aggregation rules. The rules determine which piles of futures contracts go together for position limits purposes, and which piles of futures contracts can, once pulled together, be pulled back apart. These aggregation exemptions are not the same thing as position limit exemptions, which “turn off” the position limits entirely with respect to a particular trader, contract and/or strategy.

The position aggregation rules are arguably just as important as the position limit rules themselves, as they can have an unexpected bite for unwitting market participants, including market participants that never trade a single futures contract directly. The aggregation rules and their exemptions therefore, warrant close attention. The rules are complex. This paper does not attempt a comprehensive view of those rules, but instead focuses on one quirk of the rules that, in our experience, comes as a surprise to those who encounter it. We’ll focus on the mechanics of the

CFTC’s aggregation rules because the exchanges largely follow the same aggregation principles as the CFTC.

3. WHO MUST AGGREGATE POSITIONS?

The CFTC’s aggregation rule is found in 17 CFR 150.4(a). That rule says several things:

- Aggregation based on control—Positions in accounts for which any person directly or indirectly controls trading must be aggregated with any other positions held and trading done by that person. This makes a lot of sense. If we could trade *solanum tuberosum*¹ futures contracts in 10 different accounts over which we exercise trading control, we could finally achieve our dream of cornering the potato market and achieving a \$1 million potato.
- Aggregation based on ownership—Positions in accounts in which any person holds a 10% or greater ownership or equity interest must be aggregated with any other positions held and trading done by the person. Now that makes a bit less sense in our opinion. If we own 11% interests in a bunch of different unrelated investment funds that are all potato-focused, we will have to rely on a lot of good fortune to ever get that gold-plated Yukon potato, yet we’re required to aggregate all of the potato futures positions of the investment funds nonetheless.
- “Darth Trader down the block” aggregation—In applying the control and ownership aggregation rules, the positions of two or more persons acting pursuant to an ex-

press or implied agreement or understanding are treated the same as if they were the positions of a single person. Sorry, Darth Trader.

- Substantially identical trading—In applying the position limits, any person who holds or controls trading of futures positions in more than one account or pool with substantially identical trading strategies has to aggregate those positions with her or his other positions as well. So much for our dream of finally launching Nate and Michael Potato Capital Fund LP and Nate and Michael Potato Capital Fund (Cayman) Ltd. Maybe we'll have to settle for a long vacation in Boise.

4. WHAT ARE THE KEY AGGREGATION EXEMPTIONS FOR COMMODITY POOL INVESTORS?

There are a number of exemptions from the aggregation rules and those aggregation exemptions live in 17 CFR 150.4(b). We'll focus on two exemptions that are relevant to an investor in multiple potato-driven hedge funds, also known to the readers of this article as commodity pools. First, we're pretty serious about this \$1 million potato idea, so we decided to increase our passive ownership interest in each of the potato hedge funds from 11% to 26%. We're not messing around here. But if 11% is more than 10% (it is), then 26% is also more than 10% (even more so).

So we have to aggregate on the basis of our ownership in all these potato hedge funds. And here's where it gets starchy—we don't just have to count 26% of each fund's potato futures as our

own in determining our compliance with potato position limits. We have to count *all* of their potato futures positions. And that puts us way over the potato futures position limit, even though we're no closer to creating a \$1 million potato.

CFTC Rule 150.4(b)(1) solves our problem. That rule provides an exemption from the aggregation rules (other than the substantially identical trading rule) for any person who is a passive investor in a commodity pool (a "Passive Pool Participant") holding positions that she or he is required to aggregate based on ownership of 10% or more in a pool. 26% is more than 10%, but now we're just humble Passive Pool Participants in these funds. Rule 150.4(b)(1) disaggregates. But we should keep reading . . . Rule 150.4(b)(1) takes our aggregation exemption away. We see the word "except"—the Passive Pool Participant exemption from aggregation has its own exception. It's an exception from an exemption from an exception from a prohibition, which itself has an exemption. This is why we get up in the morning and schedule a call with our lawyer (wink).

And here's the exception that matters—the Passive Pool Participant aggregation exemption is not available to a person who has "by power of attorney or otherwise directly or indirectly, a 25% or greater ownership or equity interest in a commodity pool, the operator of which is exempt from registration under [CFTC Rule 4.13]." Rule 4.13 provides a number of exemptions from registration as a commodity pool operator ("CPO"), including Rule 4.13(a)(3), which is an exemption from registration as a CPO for operators of certain pools that engage in only a *de minimis* amount of futures commodity interest trading.

We forgot to mention that these potato-focused hedge funds don't just trade potato futures, which is what makes them commodity pools. They mostly trade stock in potato companies. You see, when the price of potatoes goes up, potato agribusiness (aka Big Potato) tends to do very well. The funds' potato futures represent only a small portion of their overall assets. They are not unique in relying on Rule 4.13(a)(3)—the operators of many hedge funds rely on Rule 4.13(a)(3) to avoid regulation as CPOs.

So we are back to having an aggregation problem. We own 26% of a bunch of 4.13(a)(3) potato commodity pools and the Passive Pool Participant exemption from the ownership aggregation rule is no longer available, so all those potato futures held by the potato pools are aggregated to us and count as our own positions. We are again way over the legal limit and expect to get a nasty letter from the CFTC or an exchange. This is turning out to be more difficult than it seemed when we came up with the idea over buds and spuds.

5. WHAT IS THE INDEPENDENT ACCOUNT CONTROLLER AGGREGATION EXEMPTION?

We're back at square one on our speculative position limit problem. Because we invested in 4.13(a)(3) commodity pools, the Passive Pool Participant exemption from aggregation turned out to be a mirage, at least for us. But we did say that Rule 150.4(b) includes a number of different exemptions from the aggregation rules, so let's see what else is in there. And we find Rule 150.4(b)(4), which says:

“An eligible entity need not aggregate its positions with the eligible entity's client positions or

accounts carried by an authorized independent account controller, . . . except for the spot month in physical-delivery commodity contracts, provided that the eligible entity has complied with the requirements of [Rule 150.4(c)], and that the overall positions held or controlled by such independent account controller may not exceed the [position] limits[.]”

This is the independent account controller aggregation exemption (“IAC Exemption”) and it looks promising. Are we an “eligible entity?” Is our investment in Tater Tot Capital LP an “account” carried by an authorized “independent account controller?” We need to look at the definitions in Rule 150.1.

The IAC Exemption, written by the same CFTC staffers who wrote the Passive Pool Participant exemption, says that an “eligible entity” includes a “limited partner, limited member or shareholder in a commodity pool the operator of which is exempt from registration under [Rule 4.13]” that satisfies the following criteria:

- We must authorize an independent account controller “independently to control all trading decisions with respect to [our] client positions and accounts that the independent account controller holds directly or indirectly, or on [our] behalf, but without [our] day-to-day direction;”
- We must maintain “[o]nly such minimum control over the independent account controller as is consistent with [our] fiduciary responsibilities to the managed positions and accounts, and necessary to fulfill [our] duty to supervise diligently the trading done on [our] behalf;” and
- Because we are a limited partner in Tater Tot Capital LP, which is a 4.13 commodity

pool, we can only maintain “such limited control as is consistent with” our status as a limited partner.

All of this looks okay to us. We’re just a Passive Pool Participant in Tater Tot. Even though we’re a big investor—26% of the fund—we don’t believe in special treatment for anyone, so we didn’t get a side letter giving us special rights with respect to Tater Tot’s investments. We’re just a plain vanilla limited partner, along for the ride. So we’re an eligible entity.

But is our investment in Tater Tot an “account” carried by an authorized “independent account controller?” Back to the definitions. . .

An “independent account controller” (“IAC”) includes, among others, a person:

- “Who specifically is authorized by an eligible entity . . . independently to control trading decisions on behalf of, but without the day-to-day direction of, the eligible entity;”
- “Over whose trading the eligible entity maintains only such minimum control as is consistent with its fiduciary responsibilities for managed positions and accounts to fulfill its duty to supervise diligently the trading done on its behalf or as is consistent with such other legal rights or obligations which may be incumbent upon the eligible entity to fulfill;”
- “Who trades independently of the eligible entity and of any other independent account controller trading for the eligible entity;”
- “Who has no knowledge of trading deci-

sions by any other independent account controller;” and

- “Who is: . . . [a] general partner, managing member or manager of a commodity pool the operator of which is excluded from registration under . . . [Rule 4.13], provided that such general partner, managing member or manager complies with the requirements of [Rule 150.4(c)].”

This all seems doable. It’s a little odd to refer to an investment in a fund as an “account,” but the final prong of the IAC definition (manager, etc., of a 4.13 pool) seems to clear that up. The rest of the IAC definition focuses on our lack of control and the fund manager’s independence. This is consistent with our role as a limited partner, and if we think that’s not enough, we can always ask the manager for some additional assurances via side letter to prove up the manager’s status as an IAC. A representation from the manager that it’s an IAC would be a good idea. The manager may ask us for a representation that we’re an eligible entity, which we are because we are limited partners in a 4.13 pool, and that seems like a fair trade.

The reference to Rule 150.4(c) requires some thought, because that rule requires us to file a notice with the CFTC in order to rely on the IAC Exemption, and we haven’t filed anything yet and, frankly, we hate paperwork. The CFTC staff provided some relief from the advance notice filing requirement (as well as, other relief) in No-Action Letter No. 17-37, which turns the advance notice requirement under Rule 150.4(c) into an after-the-fact notice requirement.

A person relying on the IAC Exemption or other exemptions requiring an advance notice fil-

ing under Rule 150.4(c) will not be in violation of the notice filing requirement as long as she or he files a notice within five business days of receiving a request from the CFTC, CFTC staff, an exchange or exchange staff to file such a notice.

But are we able to use the IAC Exemption if we failed the Passive Pool Participant exemption because we invested in 4.13 pools? In the 2016 Federal Register release in which the CFTC adopted the final Rule 150.4 exemptions, the CFTC staff advised that the aggregation exemptions in their proposed Rule 150.4 were set forth as alternatives so that the applicability of one aggregation exemption would not affect the applicability of a separate exemption from aggregation, *e.g.*, the IAC Exemption. Therefore, trying, but failing to qualify for the Passive Pool Participant exemption is not the end of our effort. As an alternative, we can turn to the IAC Exemption.

It's good to load up on potato carbs for the energy to research the CFTC's rules. The IAC Exemption works perfectly for us. Or almost perfectly—it does not provide an exemption from aggregation with respect to the spot month in physical delivery commodity contracts. That's a problem for us because we focus on investing in potato pools that invest heavily in the spot month. Why? Well, that's the best way to unlawfully corner the potato market and at last achieve our \$1 million potato. Of course, that's a joke. We are law abiding citizens and *solanum tuberosum* connoisseurs.

But we do have a problem now because all of the spot month potato positions “leak through” the IAC Exemption and land in a giant pile at our feet. That's a tricky problem because, as we discussed, we are just a humble limited partner in

these potato funds and have (a) no ability to control the spot month positions (so much for our plan to manipulate the market) and (b) no visibility into the funds' spot month positions (so we may violate the position limits without having any idea that we've done so).

6. WHAT CAN WE DO ABOUT THE SPOT MONTH POSITIONS THAT LEAK THROUGH THE IAC EXEMPTION?

Previously on “Lost in the Limits,” we had to aggregate our potato futures on the basis of our ownership of 10% or more in the potato funds; we looked at the Passive Pool Participant exemption from aggregation, but that didn't work because we own more than 25% in a bunch of 4.13 commodity pools; we stumbled onto the IAC Exemption and it works great for our potato futures. . . other than in the spot month. What are we supposed to do about those spot month positions? There are a few options we've considered. There are other ways to do this, but the three listed below are good starting points.

- Prohibit—Only invest at a level exceeding 25% in 4.13 funds that do not hold physically delivered commodity futures contracts into the spot month. If that's not already the case, we're a big investor and maybe we can get the manager to agree not to hold those positions in the fund. Let's ask for a side letter. Of course, we need to be careful that doing this doesn't cause us to have a level of control, and undermine the manager's independence, in a manner that would make the IAC Exemption unavailable.
- Monitor—Monitor trading in all funds where the spot month positions leak

through so that we know when we're approaching our aggregate spot month limit.² Of course, knowing that we're about to violate a position limit isn't all that helpful if we can't intervene, such as by instructing one or more of the underlying managers to reduce their positions. Once again, we have to ask whether this would be too much control for us and too little independence for the manager.

- Allocate—If the spot month limit is 1,000 contracts and we are invested in four funds where the spot month positions leak through, we could tell each of the fund managers that they cannot hold more than 250 contracts in the spot month. There are variations on this theme, including requiring notice if a fund goes over 250 contracts, at which point we're back to the problems associated with monitoring positions, as described above.

Please forgive our lame attempts at humor. The issues described above are serious, and, in our experience, many large investors are surprised to

learn of them.. There are practical solutions, but passively waiting to learn that we violated a position limit is not a solution. Position limit violations can lead to serious repercussions. These issues will only become more important as the CFTC attempts to expand its position limit regime to cover over-the-counter derivatives.

ENDNOTES:

¹Potatoes are "commodities," as defined in Section 1a(9) of the Commodity Exchange Act.

²A fund manager providing trade transparency to the fund's investors is inimical to the opacity required by the IAC Exemption. Moreover, managers of 4.13 funds will be reluctant to provide such spot month trade information because (i) the selective disclosure of fund position information to only certain investors could raise legal liability issues under the federal securities laws; (ii) certain investors could utilize position information provided by the manager of the fund to deduce proprietary and confidential investment strategies of the manager; and (iii) the operational burdens associated with the fund providing such information to only certain investors, to the extent not legally prohibited, may be too costly.

