

Commodity Pool Operators

So You Don't Want to Take the Series 3 Exam? Alternatives to the General Proficiency Requirement for Associated Persons of Commodity Pool Operators and Commodity Trading Advisors

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Recent amendments to U.S. Commodity Futures Trading Commission (CFTC) rules have required many hedge fund firms to confront the prospect of registering with the CFTC as a commodity pool operator (CPO) and/or commodity trading advisor (CTA). Notably, the CFTC in February announced the rescission of Rule 4.13(a)(4), a CPO registration exemption that for years has allowed hedge funds to trade without limitation in CFTC-regulated “commodity interests” (i.e., futures contracts, options on futures, retail f/x transactions and, effective October 12, 2012, many types of swaps). Going forward, most U.S. hedge fund firms that operate funds for which they cannot rely on the alternative CPO registration exemption in Rule 4.13(a)(3) – which imposes significant limits on a fund’s commodity interest trading – will have little choice but to register with the CFTC.

For firms registered as investment advisers with the U.S. Securities and Exchange Commission (SEC), many aspects of the CFTC registration process, as well as certain ongoing recordkeeping, reporting and disclosure obligations, will be familiar. But one area where the CFTC requirements for registered CPOs and CTAs depart significantly from the norms of SEC investment adviser regulation is the general requirement that a CFTC registrant’s marketing personnel (so-called “associated persons” or APs) satisfy certain proficiency testing requirements – in general, timely passage of the “Series 3” examination.

This article briefly summarizes the scope of a CPO’s or CTA’s personnel who will be APs generally subject to the Series 3 proficiency requirement and highlights several exemptions and proficiency testing alternatives that can offer relief from that requirement.^[1]

AP Registration Generally

Who Are a Firm’s Associated Persons?

The CFTC rules generally define an “associated person” to include any individual who solicits commodity pool investors for a CPO or discretionary client accounts for a CTA, and any individual who supervises any person so engaged. Under that definition, an AP is, first and foremost, anyone who has contact with prospective investors of a CPO or discretionary clients of a CTA (collectively, “customers”) in a marketing capacity. Persons who participate in the marketing process on an ad hoc and indirect basis, such as portfolio managers, analysts, risk managers and legal, compliance and operations staff, generally are not viewed as APs solely on that basis, although this is a question of facts and circumstances. Notably, however, AP status extends to any person in the supervisory chain-of-command rising from the marketing staff to their immediate supervisor, to that supervisor’s supervisor, and so on, often extending up to the firm’s chief executive officer.

What Is the Associated Person Registration Process and What Does the Series 3 Entail?

AP registration generally requires the applicant to:

- Complete and submit Form 8-R via the online registration system of the National Futures Association (NFA), the self-regulatory organization to which the CFTC has delegated primary responsibility for processing CPO and CTA registration applications,
- Submit fingerprint cards to facilitate a criminal background check on the applicant,
- Pay a non-refundable \$85 application fee, and
- Satisfy certain proficiency testing requirements, which generally are achieved by passing the National Commodity Futures Examination (i.e., the Series 3 exam) or an acceptable alternative exam either (1) within two years prior to the date that the AP registration application is submitted or (2) more than two years prior to that submission date if, since the date the AP last passed the Series 3 or alternative exam, there has been no consecutive period of two years or more during which the individual was not an AP or NFA-approved principal of a CFTC registrant.

The Series 3 exam consists of two parts. The first part, consisting of 85 questions, tests the applicant's knowledge of commodity market fundamentals and includes questions on the following topics: (1) futures trading theory; (2) margins, limits and settlements; (3) orders, accounts and analysis; (4) basic hedging; (5) financial hedging; (6) spreads; (7) general speculation; (8) financial speculation; and (9) options. The second part, consisting of 35 questions, tests the applicant's knowledge of rules and regulations governing the commodity trading industry.

The Series 3 exam is offered regularly at designated testing centers around the world. Applicants have two-and-a-half hours to complete the exam and, to pass, must achieve a score of at least 70% on each of the exam's two parts. The exam is widely viewed as among the most difficult in the financial industry, and many applicants will spend as much as three months preparing for it. Adequate preparation is essential, in part because failure entails a mandatory "time-out" before the applicant can next schedule the exam. The time-out after each of an applicant's first two failures is 30 days. After a third failure, the time-out jumps to 180 days (and remains 180 days for any subsequent failure).

The general requirement that each AP of a firm pass the Series 3 exam – coupled with the fact that the definition of an AP, with its "up the chain" nature, might capture many people at a firm – typically makes AP registration the single most burdensome aspect of the CPO/CTA registration process. Accordingly, it is time well spent for a firm to closely review whether one or more of its APs might qualify for an exemption from AP registration (noting, however, that CPO/CTA registrants are required to have at least one registered AP) or satisfy the AP proficiency testing requirements other than by taking and passing the Series 3 exam.

Exemptions from AP Registration

The CFTC rules include several exemptions from AP registration for APs of a registered CPO or CTA. The following three exemptions are generally the most likely to be available to APs of a hedge fund firm.

CFTC Rule 3.12(h)(1)(ii) – APs of a CPO Who Are also FINRA Registrants

CFTC Rule 3.12(h)(1)(ii) exempts from AP registration any individual who (1) engages in AP-related activities consisting solely of soliciting investors for commodity pools or supervising persons so engaged, (2) is registered with the Financial Industry Regulatory Authority (FINRA), and engages in such AP-related activity in his or her capacity as a registered representative, a registered principal, a limited representative or a limited principal of a FINRA-member firm, and (3) does not engage in any other activity subject to regulation by the CFTC.

CFTC Rule 3.12(h)(1)(iii) – Supervisory Persons of Registrants Engaged in De Minimis Commodity Interest Activity

CFTC Rule 3.12(h)(1)(iii) exempts from AP registration certain persons in the supervisory chain-of-command of a firm that derives no more than 10% of its total revenue on an annual basis from commodity-interest-related activity. The exemption requires, among other things, that the firm file resolutions with the NFA to the effect that the supervisory person (1) is not authorized to solicit customers on behalf of the firm or to supervise any AP, and (2) has no authority regarding personnel matters (such as hiring and firing decisions) involving individuals engaged in activities subject to regulation under the Commodity Exchange Act.

In practice this exemption often proves unworkable both at the firm level and for the individuals involved. First, it may be far from straightforward for a CPO or CTA to determine with any precision the extent to which its activities in respect of particular asset classes ultimately contributed to its revenue for a given year. Second, and particularly for smaller firms, it is often impractical to insulate completely from hiring and firing decisions the categories of senior supervisory personnel who typically would seek to rely on this exemption.

CFTC Rule 3.12(h)(1)(iv) – Non-U.S. APs

CFTC Rule 3.12(h)(1)(iv) exempts from AP registration any individual who (1) conducts AP activities solely while located outside the United States and (2) does not act as an AP with respect to any customers located in the United States (whether directly or indirectly, so that, for example, the exempt individual generally should not supervise an AP who is located in the United States or markets to persons located in the United States).

Exemptions from AP Proficiency Testing Requirements

APs who cannot qualify for an exemption from AP registration still may qualify for an exemption from AP proficiency testing under one of the following NFA Registration Rules.

NFA Registration Rule 401(b) – FINRA General Securities Representatives

Under NFA Registration Rule 401(b), a person who is registered with FINRA as a general securities representative (GSR) of a CPO or CTA will be deemed to have satisfied the AP proficiency requirements if that GSR's sole AP-related activities are limited to (1) referring customers to another AP of the CPO or CTA who has satisfied his or her AP proficiency requirements, provided that these referrals are made solely incidental to the GSR's activities as a GSR of the CPO or CTA, or (2) supervising other GSRs who are so engaged. This proficiency-testing exemption generally requires that the CPO or CTA with which a person is associated be a FINRA-member firm.

NFA Registration Rule 402 – Waiver of Testing Requirements

NFA Registration Rule 402 enables the NFA Vice President of Registration and Membership to issue application-based waivers from the requirement to take the Series 3 exam under circumstances approved by the NFA's Board of Directors. The Board has authorized granting waivers in respect of APs of CPOs if both (1) the CPO or the applicable pool is subject to regulation by a federal or state regulator, or interests in the applicable pool are privately offered under the Securities Act of 1933, and (2) the applicable pool (a) engages principally in securities transactions, (b) commits only a small percentage of its assets (for this purpose, generally interpreted to mean 10% or less of the pool's liquidation value) to initial margin deposits for futures transactions and premiums for options on futures, and (c) uses futures and options on futures solely for hedging and risk management purposes.^[2]

Similarly, the NFA's Board of Directors has authorized granting waivers in respect of APs of CTAs if both (1) the CTA is subject to regulation by a federal or state regulator and (2) the CTA provides commodity trading advice to clients solely incidental to its securities advisory services and solely for hedging or risk management purposes.

Proposed Swaps Exemption

Until recently, the primary categories of commodity interests around which AP activity centered were futures contracts and options on futures. In light of this, the Series 3 exam evolved to focus on these types of instruments and currently does not cover market fundamentals or regulatory requirements specific to swaps. Given this lack of swaps coverage, the NFA recently proposed revisions to its Registration Rule 401 that, among other things, would exempt from the requirement to pass the Series 3 exam an AP whose sponsor CPO or CTA is required

to be registered with the CFTC in respect of the funds or discretionary accounts for which the individual serves as an AP solely due to the firm's swap-related activities on behalf of such funds or accounts.^[3]

Specifically, an AP of a CPO would not be required to pass the Series 3 exam under the NFA proposal if he or she were to serve as an AP solely with respect to a fund that:

- Trades in no commodity interests other than swaps; or
- Would allow the CPO to satisfy the *de minimis* commodity interest trading limit under Rule 4.13(a)(3) or amended Rule 4.5 (as applicable), if (for this purpose only) the fund's swap positions were disregarded in determining the firm's compliance with the limit.

Similarly, an AP of a CTA would not be required to pass the Series 3 exam if he or she were to serve as an AP solely with respect to the solicitation of discretionary client accounts that engage in no commodity interest trading activity other than trading in swaps.

There have been conflicting reports over the past several weeks about the status of the proposal – most recently indicating that the CFTC has permitted the NFA to adopt the rule change largely as proposed – but we currently await official confirmation of its status. It also should be noted that once the Series 3 exam is overhauled to include swaps or an alternative swaps-based exam is developed, an exemption such as this may be amended or withdrawn. Finally, and to be clear, this NFA rule change would not establish a swaps-based exemption from CFTC registration at the firm level or at the AP level. The exemption extends only to the proficiency testing requirements applicable to registration as an AP.

Proficiency Testing Alternatives to the Series 3 Exam

APs who cannot qualify for an exemption from AP registration or an exemption from proficiency testing generally still may qualify for a proficiency testing alternative to the Series 3 exam. These testing alternatives generally entail an exam that is significantly less challenging than the Series 3. Below is a summary of two possible alternatives.

NFA Registration Rule 401(c) – Futures Managed Funds Examination – Series 31

A person registered with FINRA as a GSR of a CPO or CTA whose sole activities are limited to the solicitation of customers on behalf of the firm, or the supervision of those persons whose activities are so limited, may take the Series 31 exam (Futures Managed Funds Examination) in place of the Series 3 exam. The Series 31 exam, which consists of 45 questions, tests the applicant's general knowledge of the commodity markets, the CFTC's Part 4 rules (which deal with CPO and CTA regulation generally), and pertinent advertising and disclosure rules. Applicants have one hour to complete the exam. This alternative to the Series 3 exam generally requires that the CPO or CTA with which a person is associated be a FINRA-member firm.

NFA Registration Rule 401(e) – Limited Futures Examination-Regulation – Series 32 – Foreign Proficiency Exams

NFA Registration Rule 401(e) affords an alternative to the Series 3 exam for applicants who are registered or licensed to solicit customers in a jurisdiction outside the United States in which the commodity market proficiency testing requirements are comparable to those of the Series 3, as determined by the NFA. Currently, the only jurisdictions

deemed to meet those standards are the United Kingdom and Canada. Individuals who satisfy the alternative criteria are eligible to take the Series 32 exam (the Limited Futures Examination) instead of the Series 3. The Series 32 exam consists of 35 questions that relate primarily to U.S. regulation of commodity market intermediaries. Applicants have 45 minutes to complete the Series 32 exam.

Conclusion

Exemptions from the AP registration requirements are limited, as are the available testing exemptions and alternatives to the Series 3 exam. But if relief is available, it will save an AP (and his or her firm) significant time and resources in the course of a firm's registration with the CFTC as a CPO and/or CTA. This makes exploring each of the exemptions and alternative tests covered in this article a potentially high-value exercise.

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^[1] Certain APs of a CPO or CTA may be subject to proficiency testing requirements in addition to the Series 3 exam. These include the Series 30 exam (for APs who are also “branch office managers”) and the Series 34 exam (for APs who are “retail forex” APs). This article does not address such additional AP examination requirements.

^[2] Public NFA interpretive guidance with respect to these waivers does not address the treatment of swaps or retail f/x transactions.

^[3] See the NFA's Proposed Amendments to NFA Bylaw 301 and Registration Rules 401 and 402 (Aug. 22, 2012).