

Institutional Investor Insight

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Is a University a Commodity Pool Operator? The Saga Continues

On April 4, 2017, the Commodity Futures Trading Commission advised a university that it is not a “commodity pool operator.”

This might sound hardly noteworthy if not banal, as if a government agency were informing a university that it isn’t a Martian or a marsupial. After all, how could a university ever be said to be in the commodities business?

The answer lies in the complex tangle of U.S. investment management laws, where there is a hole between the securities and commodities laws, on the one hand, and the laws governing nonprofits, including universities, on the other. This hole, believe it or not, treats all nonprofits that engage in many typical forms of hedging—say, a hedge on an appreciated investment or foreign currency exposure—as being commodity pool operators (CPOs), barring an exemption. In addition, a nonprofit may be a CPO if its third-party investment advisers engage in certain hedging or derivative transactions. This hole has yet to be patched, though the CFTC’s action last week might be a first step.

In passing the Dodd-Frank Act in 2010, Congress failed to merge the CFTC into the Securities and Exchange Commission, as many had argued for, and while traditionally the CFTC had a rather limited jurisdiction over traditional commodity products, Dodd-Frank expanded the CFTC’s authority to regulate a variety of hedging instruments, including futures, forwards and securities-based swaps. This is where philanthropies come into the picture. For example, a university might seek to hedge a frothy market by shorting a securities futures index to ensure adequate capital for next year’s budget, or hedge exposure to the Euro in order to cover the costs of a semester-abroad program. After 2010, the CFTC assumed jurisdiction from the SEC on many of these hedging strategies.

And this is where the problem arises. In expanding the CFTC’s portfolio into securities-related products, Congress failed to incorporate into the commodities law the same exemption of nonprofits that Congress enacted under the Philanthropy Protection Act of 1995. Thus, while philanthropies are exempted from investment company rules under the Securities Exchange Act, no such exemption exists under the commodities laws. Dodd-Frank also cut back other exemptions from CPO registration affecting all investment managers, and these leaner exemptions now are the sole avenue by which to escape regulation. The full story is more complicated than this, as often is the case with U.S. law, but this summary gives a flavor of the problem.

Endowments and their advisers, including Hirschler lawyers, have studied their potential exposure as CPOs. The analyses have been very fact specific, as evidenced in last week’s CFTC action. There, the CFTC granted exemptive relief based on the specific manner in which the endowment assets are managed on behalf of an unidentified university and organizations

that support its mission. As noted, this is a good outcome, but a limited one. First, unlike the SEC's approach, the CFTC's guidance here is expressly limited only to the party and the facts presented. It purports to have no precedential effect. Second, needless to say, the CFTC's action does nothing to fix the legislative hole exposing nonprofits to CPO status. Thus, nonprofit organizations must either file notices with the CFTC declaring themselves to be CPOs but exempt under one of the narrow rules still in place, or "fly naked" and make no such filing. This should mean, then, that the institution is willing to defend, if necessary, an allegation that it's breaking the law by failing to register.

Efforts to fix the problem continue in Congress, and tea leaves suggest that the CFTC is both aware of the problem and seeking a solution.

In the meantime, CFTC regulation is a trap not only for unwary endowments but also for all institutional investors and money managers who may improperly assume that their trading in securities-related products has nothing to do with the commodities laws.

For this reason, most active traders should be carefully reviewing their status with the CFTC.

Contact

Edward H. Klees
Partner
(434) 202-0281
eklees@hf-law.com