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CFTC Penalizes an Inadvertent Commodity Trading Advisor

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Once in a while, a Commodity Futures Trading Commission ("CFTC") enforcement action confirms market participants' worst fears that the CFTC is prepared to, and is able to, find violations of the Commodity Exchange Act ("CEA") where no such violations had previously existed. The July 19, 2022 CFTC settlement order involving Powerline Petroleum and its principals is one such case.

The facts of this case are generally similar to other enforcement actions involving commodity trading advisors ("CTAs") – for example, the 2016 Angus Partners order. An entity that provides either consulting services relating to physical energy commodity transactions (Angus) or acts as a registered introducing broker ("IB") (Powerline) provides some additional service to clients that, in the view of CFTC's division of enforcement, inadvertently or intentionally becomes an advisory service that requires (a) registration as a CTA and (b) making certain disclosures under CFTC Part 4 regulations. As the Angus and Powerline orders illustrate, the line separating an unregulated or exempted advisory activity from the regulated CTA activity is very blurry and continues to shift, as noted in CFTC Commissioner Mersinger's dissent.

Powerline is a small business that for 20 years has been registered with the National Futures Association ("NFA") as an IB in good standing and, in this capacity, assisted retail gas station operators in hedging their market exposure to RBOB gasoline, mainly by executing block trades in CME futures. The CFTC notes that a registered IB can be exempted from also registering as a CTA if the advisory services are "solely in connection with" its brokerage business (CFTC Part 4.14(a)(6) Regulations). In this case, the CFTC concluded that Powerline's advisory services were beyond the "solely in connection" boundary because Powerline also had marketed itself as a consultant and advisor in the fuel industry.

Having concluded that Powerline was an unregistered CTA, the CFTC proceeded to claim that the company had failed to make several required disclosures, mainly in

connection with charging the markup on client block trades and failing to disclose that it had actually acted as a principal vis-à-vis its customers.

Further, Powerline admitted that it had provided materially misleading information to the CME in connection with its trading, which constituted fraud. As part of the settlement, Powerline was ordered to pay $875,000 in penalties and restitution to its customers (for charging them a hidden markup and not disclosing to them Powerline's principal status in block trades) and was prohibited from registering with the NFA for a period of three months (presumably as a CTA to remedy its violations).

There are several takeaway points from this order: (a) business practices involving hedging, particularly relating to energy commodities, should be periodically reviewed for potentially regulated CTA services; (b) any exemptions or exceptions from CTA (or any other) registration will be interpreted by the CFTC very narrowly; and (c) deficiencies in disclosure or communications with the regulated exchange are likely to lead to further investigation and potentially a CFTC enforcement action.
