

# Life After CPO Registration: Select CFTC and NFA Compliance Obligations that Lie Ahead\*

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## Introduction

Over the last few months, an exceptional number of investment management firms have either registered or prepared to register with the Commodity Futures Trading Commission (“CFTC”) as “commodity pool operators” (“CPOs”). Many of these firms, which operate investment funds (or “pools”) that participate directly or indirectly in CFTC-regulated “commodity interests” (such as commodity futures contracts, options on such contracts, and swaps), have been goaded toward registration by 2012 CFTC rulemaking that greatly narrowed the scope of registration relief historically available to CPOs. Since January 1<sup>st</sup> of this year, when much of that rulemaking was implemented, CPO registration has become all but mandatory for most U.S. managers of hedge funds, mutual funds, and various other types of pools that engage in more than *de minimis* levels of commodity interest trading.

Newly registered CPOs likely will need to weave into their compliance programs numerous policies and procedures dictated by the rules of the CFTC and the National Futures Association (“NFA”).<sup>1</sup> This article highlights several of the more significant areas in which the CFTC and NFA regulate CPOs, and a number of particular requirements that recent CPO registrants should ensure they have accounted for in preparing for life with their new regulators. This article also highlights certain significant regulatory relief that some CPOs may be able to claim, particularly with respect to their CFTC disclosure, reporting, and recordkeeping obligations.

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## 1. Duty to Update Registration Forms

CPOs generally must ensure that the identification information, disciplinary history, contact details, and other information contained in their CPO registration form—CFTC/NFA Form 7-R—remains current. Specifically, CFTC Rule 3.31 and NFA Registration Rule 210 require that all CPO applicants and registrants “promptly” correct any deficiency or inaccuracy in the information contained in their

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Form 7-R. Although it is unclear how quickly a correction generally must be made to have been made “promptly,” NFA Registration Rule 208 specifically requires an NFA member to update its Form 7-R to reflect the addition of any new president, chief financial officer, or other “principal” of the member within 20 days after the applicable addition.

In addition to requiring CPOs to maintain the accuracy of their Form 7-R, Registration Rule 210 requires that all CPO applicants and registrants promptly correct any deficiency or inaccuracy in the information contained in each CFTC/NFA Form 8-R used to list the CPO’s principals and to register the CPO’s “associated persons” (i.e., any marketer, or any person who directly or indirectly supervises any marketer, for a CPO). Consequently, a CPO should ensure that each of its principals and associated persons is familiar with this obligation, and with their corresponding obligation to update appropriate personnel at the firm, no later than the submission of the applicable individual’s Form 8-R.

## 2. Pool Disclosure Documents

CFTC Rules 4.21, 4.24, 4.25, and 4.26 generally impose extensive disclosure obligations on

registered CPOs, requiring them to prepare, electronically file with the NFA, and provide to prospective investors a prescribed form of pool disclosure document. Other CFTC Rules and positions of the CFTC staff offer potential relief from such requirements, including CFTC Rule 4.7 relief discussed below.

### Disclosure Document Content

CPOs required to prepare a pool disclosure document likely will find that several disclosure items required by Rule 4.24 are ones that they would have furnished to investors in any event. These include:

- discussions of the principal risks associated with investing in the pool;
- the business background of certain key principals of the CPO;
- information relating to the fees and expenses borne by the pool; and
- details of the pool’s policies concerning redemptions and transfers of pool interests.

However, Rule 4.24 also prescribes several disclosure items that many CPOs likely would not have thought to include in their offering memorandum for a pool, either at all or to the level of detail prescribed by Rule 4.24. These include:

- the amount of any interest in the pool owned by the CPO or any of its principals;
- the past performance information specified in Rule 4.25;
- material litigation (whether ongoing or concluded within the last five years) concerning the CPO and any of its principals; and
- the amount of trading profit that the pool must realize in the first year of an investor’s investment to equal all fees and expenses such that the investor will recoup its initial investment (referred to as the investor’s “break-even point”).

### Distribution and Filing Requirements

CFTC Rule 4.21 generally requires a CPO to provide a pool’s disclosure document to a prospective investor by no later than the time that the CPO first delivers to the investor a subscription agreement for the pool. Rule 4.21 also generally prohibits a CPO from accepting an investor’s investment in a pool unless the CPO has received from the investor an acknowledgment signed and dated by the

investor, stating that the investor has received the pool's disclosure document.

CFTC Rule 4.26 generally requires CPOs to electronically file their pool disclosure documents with the NFA at least 21 days prior to the date that they first intend to deliver them to a prospective investor. Similarly, if a CPO knows or should know that a disclosure document has become materially inaccurate or incomplete in any respect, Rule 4.26 requires a CPO to amend the document to cure the defect and to electronically file the amendment or revised document with the NFA and distribute it to all existing pool participants, in each case, within 21 days after the date that the CPO first knew or should have known of the defect requiring the amendment. Additionally, if a pool is continually offered, Rule 4.26 requires its CPO to update the pool's disclosure document at least every nine months and electronically file the updated document with the NFA at least 21 days prior to first use.

If interests in a pool are offered or sold exclusively to "accredited investors" (as defined in Regulation D under the Securities Act of 1933 ("Securities Act")), CFTC Rule 4.8 permits a CPO to bypass the above-noted 21-day waiting periods, and to use a disclosure document immediately upon filing it with the NFA.

### Rule 4.7 Regulatory Relief

CPOs wishing to avoid the CFTC's disclosure document regime may seek various forms of relief from it. Perhaps the most popular form of relief is that available under CFTC Rule 4.7. Rule 4.7 generally permits a CPO to bypass the disclosure document regime for a pool if the pool will (i) offer its interests solely pursuant to the Section 4(a)(2) private offering exemption from registration under the Securities Act, and/or pursuant to Regulation S under that Act, and (ii) limit the offer or sale of its interests solely to persons who meet the standards of a "qualified eligible person" ("QEP") under Rule 4.7. There are numerous ways in which an investor can meet the QEP standard, including if it both (i) is an accredited investor and (ii) owns securities with an aggregate market value of at least \$2,000,000. A CPO seeking to rely on Rule 4.7 must claim the relief on a pool-by-pool basis, and must provide prospective pool investors with a prescribed form of notice.

Other forms of relief from the CFTC's disclosure document regime (as well as certain CPO reporting and recordkeeping requirements discussed below) are also potentially available to CPOs. These include (i) broad relief with respect to certain pools that have limited U.S. jurisdictional contacts (relief available pursuant to CFTC Advisory 18-96), and (ii) narrower relief with respect to certain pools that limit the extent to which they trade in commodity interests (relief available pursuant to CFTC Rule 4.12).

### Anti-Fraud Considerations

It is important to note that all CPOs (even those that may rely on Rule 4.7 or are exempt from registration altogether) remain subject to certain general anti-fraud provisions of the Commodity Exchange Act, including Section 4o of that Act, which effectively prohibits CPOs from making fraudulent or deceitful statements or omissions in connection with their offerings of pool interests. Accordingly, while applicable commodity laws and rules may impose no affirmative duty on a CPO to furnish a disclosure document to investors in a Rule 4.7 pool, a CPO electing to rely on Rule 4.7 should strongly consider furnishing prospective investors with a comprehensive offering memorandum for the benefits it may hold in preempting offering-related fraud claims.

## 3. Periodic Reporting to Investors

CFTC rules generally require registered CPOs to provide to their pool investors two forms of periodic reporting: monthly or quarterly account statements, and annual reports.

### Periodic Account Statements

#### *Statement Content*

CFTC Rule 4.22 generally requires CPOs to distribute periodically to each investor in their pools a prescribed account statement containing both a statement of operations and a statement of changes in net assets for the applicable reporting period. The statement of operations must separately itemize, among other things, the total amounts of all advisory fees, brokerage commissions, and other fees paid by the pool during the applicable period, as well as details of

the pool's realized and unrealized gains and losses from commodity interest and other transactions effected during the period. The statement of changes in net assets must separately itemize:

- the net asset value of the pool as of the beginning and end of the applicable period;
- the value of all subscriptions to, and all withdrawals from, the pool during the period;
- the total net income or loss of the pool during the period; and
- the net asset value per outstanding unit of interest in the pool (or the total value of the investor's interest in the pool) as of the end of the period.

For pools that have multiple classes of interests outstanding, these statements generally must specify the relevant items for the class of interests held by the investor and, separately, for the pool as a whole. Statements generally also must be presented and computed in accordance with GAAP, consistently applied (or, under certain conditions, in accordance with International Financial Reporting Standards), and must include a manually signed oath or affirmation that, to the best of the knowledge and belief of the individual making the oath or affirmation, the information contained in the statement is accurate and complete.

### ***Distribution Requirements***

CPOs generally must distribute periodic account statements to investors at least monthly or, if a pool's net asset value did not exceed \$500,000 at the beginning of its most recent fiscal year, quarterly and, in either case, within 30 days after the end of the applicable reporting period. CPOs wishing to deliver account statements electronically may do so, but only after having obtained investors' consent to such delivery. CFTC Rule 4.22(i) conveniently permits a CPO to obtain such consent from an investor negatively if the CPO discloses to the investor its intention to electronically deliver such statements and the investor does not object to the notice within ten business days after receiving it.

### ***Rule 4.7 Regulatory Relief***

As with the prescribed content of pool disclosure documents noted above, CPOs required to distribute a Rule 4.22 account statement likely will find that several items of information required by the Rule are ones that they would have furnished to

investors with the requisite frequency in any event. Other content, however, including the separate itemization of certain pool expenses, is less likely to be provided to investors as a matter of course, and likely will require related enhancements to a fund manager's reporting procedures. CPOs that wish to minimize or avoid such additional reporting obligations may do so by claiming certain regulatory relief referenced above, including the relief available pursuant to CFTC Rule 4.7.

A CPO claiming Rule 4.7 relief with respect to a pool may distribute to each investor in that pool, in lieu of the monthly statement of operations and statement of changes in net assets noted above, a quarterly account statement indicating:

- the net asset value of the pool as of the end of the reporting period;
- the change in net asset value from the end of the previous reporting period; and
- the net asset value per outstanding unit of participation in the pool (or the total value of the investor's interest in the pool) as of the end of the reporting period.

In the case of a multi-class pool, such Rule 4.7 account statements must specify the relevant items for the class of interests held by the investor and, separately, for the pool as a whole. Rule 4.7 statements also must include the above-referenced oath or affirmation required of non-4.7 pool statements, and must be presented and computed in accordance with GAAP (or, under certain conditions, in accordance with International Financial Reporting Standards).

## **Annual Reports**

### ***Report Content***

CFTC Rule 4.22 also generally requires CPOs to distribute to each investor in a pool an annual report for the pool. The annual report must include a statement of financial condition, a statement of changes in net assets, and a statement of operations for the fiscal year, and must include similar information relating to one or, in certain cases, more of the pool's immediately preceding fiscal years. For pools that have multiple classes of interests outstanding, the report generally must include the relevant items for the class of interests held by the investor and, separately, for the pool as a whole. Rule 4.22 further requires that, if the pool

is structured as a fund of funds, the annual report generally must state the income and investment advisory fees associated with each of its sub-funds separately or, for all sub-funds representing less than five percent of the fund of fund's net assets, on a consolidated basis. The annual report also must include appropriate footnote disclosure and other material information.

Like account statements, annual reports must be presented and computed in accordance with GAAP, consistently applied (or, under certain conditions, in accordance with International Financial Reporting Standards), and must include a manually signed oath or affirmation as to their accuracy and completeness. Unlike account statements, annual reports must be audited and certified by an independent public accountant.

### ***Distribution and Filing Requirements***

A CPO generally must distribute a pool's annual report to investors within 90 days after the end of the pool's fiscal year or the pool's permanent cessation of trading (whichever is earlier). For many CPOs, particularly CPOs of funds of funds, this 90-day delivery window may prove impracticable. The 90-day delivery window also represents a significant reduction of the 120-day period during which investment advisers registered with the Securities and Exchange Commission ("SEC") are generally permitted to deliver a fund's annual report under the SEC's investment adviser "custody rule."

Rule 4.22(f) offers CPOs two potential means of extending the 90-day delivery window:

- Rule 4.22(f)(1) provides that if a CPO is unable to distribute the annual report for a pool within the 90-day timeframe without substantial undue hardship, it may file with the NFA an application for an extension that is not more than 90 days after the date as of which the annual report was to be distributed. The application must state, among other things, the reason for the requested extension and, if applicable, that the circumstances requiring the extension are beyond the control of the CPO and a brief description of such circumstances. The application also must include a letter from the pool's independent public accountant explaining the reasons for the request and whether the accountant has any reason to believe that the CPO is not in compliance with

its recordkeeping obligations under applicable CFTC Rules or with its obligation under CFTC Rule 4.20 to not commingle the property of the pool with the property of any other person.

- Rule 4.22(f)(2) provides that if a CPO is unable to obtain the necessary information to comply with the 90-day timeframe as a result of its pool investing in another collective investment vehicle, the CPO may claim an extension by filing with the NFA a notice within 90 days after the end of the pool's fiscal year. The notice must state the date that the annual report will be distributed to investors and filed with the NFA, and must contain several representations by the CPO, including a representation that certain information specified by the pool's auditor cannot be obtained in sufficient time for the annual report to be prepared, audited, and distributed before the specified extension date. The specified extension date can be no more than 180 days after the end of the pool's fiscal year.

*Newly registered CPOs likely will need to weave into their compliance programs numerous policies and procedures dictated by the rules of the CFTC and the National Futures Association ("NFA").*

Like account statements, CPOs may deliver annual reports to investors electronically, subject to the consent requirement of Rule 4.22(i). Unlike account statements, however, a CPO generally must also file with the NFA (electronically) a copy of each of its pool's annual reports.

### ***Rule 4.7 Regulatory Relief***

A CPO claiming Rule 4.7 relief with respect to a pool may distribute to each investor in the pool, and electronically file with the NFA, in lieu of an annual report described in Rule 4.22, a certified annual report that includes:

- a statement of financial condition as of the close of the fiscal year;
- a statement of operations for that year;
- appropriate footnote disclosure and any other material information; and

- a statement that the pool is an exempt pool under CFTC Rule 4.7.

Rule 4.7 pool annual reports are subject to the same GAAP, certification, timing, oath, class-specific information, sub-fund information, and NFA filing requirements noted above with respect to non-4.7 pool annual reports.

#### 4. Periodic Reporting to the NFA

Apart from the requirement to file with the NFA annual reports for its pools, a registered CPO generally must file two periodic reports with the NFA: CFTC Form CPO-PQR and NFA Form PQR.

##### CFTC Form CPO-PQR

###### *Filing Framework*

CFTC Rule 4.27 requires that CPOs periodically file electronically with the NFA certain systemic-risk-related reports on CFTC Form CPO-PQR. Form CPO-PQR consists of three Schedules—A, B, and C. A CPO must file one or more of these Schedules with the frequency, and within the timeframes, specified in the chart below, based primarily on whether the amount of the CPO’s

“aggregated gross pool assets under management” (“AUM”) renders the CPO a “small,” “mid-sized,” or “large” CPO.

A CPO that is also registered with the SEC as an investment adviser generally can satisfy its obligation to file Schedules B and/or C for the reporting period in question by, in the case of Schedule B, including in Sections 1.b and 1.c of Form PF the applicable information for each of its pools, and, in the case of Schedule C, including in Section 2 of Form PF the applicable information for each of its pools and Large Pools (as defined in the table above), as applicable. However, because Form PF reporting periods are tied to an investment adviser’s fiscal year and Form CPO-PQR reporting periods are tied to the calendar year, the extent to which an investment adviser/CPO can benefit from such reporting reciprocity may be limited if it has elected a fiscal year other than the calendar year.

###### *Filing Content*

Schedule A requests relatively basic identification and operational information about a CPO and each pool it operates, including, among other things:

- the identity of certain service providers to the pool;

**Table 1**

CPO Size*	Schedule A	Schedule B	Schedule C
<b>Large CPO</b> (AUM $\geq$ \$1.5B as of the close of business of any day during the most recent calendar quarter)	Quarterly within 60 days of the close of the most recent calendar quarter.	Quarterly within 60 days of the close of the most recent calendar quarter. Must file a separate Schedule B for each pool operated during the quarter.	Quarterly within 60 days of the close of the most recent calendar quarter. Must file a separate Part 2 of Schedule C for each pool operated during the quarter that had a net asset value (“NAV”) $\geq$ \$500M* as of the close of business of any day during the quarter (“Large Pool”).
<b>Mid-sized CPO</b> (\$1.5B > AUM $\geq$ \$150M as of the close of business of any day during the most recent calendar year)	Annually within 90 days of the close of the most recent calendar year.	Annually within 90 days of the close of the most recent calendar year. Must file a separate Schedule B for each pool that it operated during the most recent calendar year.	Not required.
<b>Small CPO</b> (AUM < \$150M as of the close of business of any day during the most recent calendar year)	Annually within 90 days of the close of the most recent calendar year.	Not required.	Not required.

\* The instructions to Form CPO-PQR include several rules for determining a CPO’s AUM, and a pool’s NAV, that are not included in this chart. CPOs should consult the Form’s instructions for guidance.

- the pool's monthly rates of return; and
- the value of subscriptions to, and redemptions from, the pool during the reporting period.

Schedule B requests significantly more detailed information about each pool operated by the CPO, including, among other things:

- the extent to which the pool pursues various investment strategies (as a percentage of the pool's NAV);
- information about the pool's borrowing activities, types of creditors, counterparty credit exposure, and clearing mechanisms; and
- the dollar value of the pool's positions in various categories and sub-categories of investments, including a schedule of any individual investments having a value greater than or equal to five percent of the pool's NAV.

Schedule C requests aggregated information for all pools operated by the CPO (including classification of the pools' investments by geographic sector and the turnover rate for the pools' portfolios), and additional information about each Large Pool operated by the CPO, including, among other things:

- the liquidity and various risk metrics of the Large Pool's portfolio;
- additional details of the Large Pool's borrowing activities and counterparty credit exposure; and
- the dollar value of the Large Pool's derivatives positions and collateral posted in relation to those positions.

### NFA Form PQR

NFA Compliance Rule 2-46 generally requires that CPOs electronically file with the NFA, within 45 days after the end of each calendar quarter, NFA Form PQR. Form PQR requires a CPO to report for each pool for which it has a reporting obligation under CFTC Rule 4.22 the following information:

- the identity of the pool's administrator, carrying broker(s), trading manager(s) and custodian(s);
- a statement of changes in NAV for the quarterly reporting period;
- monthly rates of return for the three months comprising the quarterly reporting period; and
- a schedule of investments identifying each investment that exceeds 10% of the pool's NAV at the end of the quarterly reporting period.

The NFA has proposed extensive amendments to Compliance Rule 2-46 that are intended to harmonize and reduce duplication of Form PQR's

requirements with the requirements of CFTC Form CPO-PQR. These amendments would, among other things:

- revise Form PQR to consist of (i) Schedule A of Form CPO-PQR and (ii) the schedule of investments required by Schedule B of Form CPO-PQR;
- allow small and mid-sized CPOs to file Form PQR within 60 days after the end of each of the first three calendar quarters of each year, and within 90 days after the end of the fourth calendar quarter of each year; and
- allow large CPOs to satisfy their Form PQR filing obligations simply by filing their required Form CPO-PQR schedules within 60 days after the end of each calendar quarter.

## 5. Recordkeeping

CFTC Rule 4.23 generally requires a registered CPO to make and keep numerous categories of books and records in an accurate, current, and orderly manner at its main business office.

### Required Books and Records

A CPO's recordkeeping obligations extend both to books and records regarding a CPO's pools and books and records regarding the business of the CPO itself. Required books and records regarding each pool include, among other things:

- itemized daily records of each commodity interest transaction of the pool, showing various prescribed details of each transaction;
- a journal of original entry or other equivalent record showing all receipts and disbursements of money, securities, and other property;
- a subsidiary ledger or other equivalent record for each investor in the pool showing the investor's name and address and all funds, securities, and other property that the pool received from or distributed to the investor;
- a general ledger or other equivalent record containing details of all asset, liability, capital, income, and expense accounts;
- copies of each confirmation or acknowledgment of a commodity interest transaction of the pool, and each purchase and sale statement and each monthly statement for the pool received from a futures commission merchant, retail foreign exchange dealer, or swap dealer;

- cancelled checks, bank statements, journals, ledgers, invoices, computer generated records, and all other records, data, and memoranda prepared or received in connection with the operation of the pool;
- the original or a copy of each report, letter, circular, memorandum, publication, writing, advertisement or other literature or advice (including the texts of standardized oral presentations and of radio, television, seminar or similar mass media presentations) distributed or caused to be distributed by the CPO to any existing or prospective pool investor or received by the CPO from any commodity trading advisor of the pool, showing the first date of distribution or receipt if not otherwise shown on the document; and
- copies of the financial reporting information required by Rule 4.22, including manually signed copies of each required account statement and annual report.

Required books and records regarding the business of the CPO itself include, among other things:

- itemized daily records of each commodity interest transaction of the CPO and each of its principals, showing various prescribed details of each transaction;
- each confirmation of a commodity interest transaction, each purchase and sale statement, and each monthly statement furnished by a futures commission merchant or retail foreign exchange dealer to (i) the CPO relating to a personal account of the CPO, and (ii) each principal of the CPO relating to a personal account of such principal; and
- books and records of all other transactions in all other activities in which the CPO engages. Those books and records must include cancelled checks, bank statements, journals, ledgers, invoices, computer generated records, and all other records, data, and memoranda that have been prepared in the course of engaging in those activities.

### Recordkeeping Procedures

CFTC Rule 1.31 generally requires CPOs to keep required books and records for a period of five years from the date such records were made, and to keep them readily accessible during the first two years of the five-year period (standards that SEC-registered investment advisers will recognize well). However,

CPOs that trade, or that permit their pools to trade, in any swap or related cash or forward transaction should note that records relating to such transactions must be preserved for potentially longer periods—until the termination, maturity, expiration, transfer, assignment, or novation date of any such transaction and for a period of five years after such date.

All such books and records must be open to inspection by any representative of the CFTC or the Department of Justice, and, with the exception of books and records relating to particular investors or to the business of the CPO itself, must be made available to pool investors for inspection and copying during normal business hours at the main business office of the CPO. Upon the request of a pool investor, a CPO also must send copies of records to the investor by mail, within five business days, if reasonable reproduction and distribution costs are paid by the investor.

### Rule 4.7 Regulatory Relief

CPOs that have claimed Rule 4.7 regulatory relief are not required to make and keep the specific books and records prescribed by Rule 4.23. Such CPOs are, however, required to maintain at their main business address copies of the account statements and annual reports that they are required to distribute to investors under Rule 4.7, and all other books and records prepared in connection with their activities as the CPO of a Rule 4.7 pool (including, among other things, records relating to the qualifications of QEPs and substantiating any performance representations). CPOs of Rule 4.7 pools must preserve such books and records for the same time periods, and must make them available to any representative of the CFTC, the NFA, and the Department of Justice, as noted above with respect to non-4.7 pools.

## 6. Advertising and Promotional Material

When reviewing the adequacy of its compliance program, a registered CPO also must be mindful of the CFTC's and NFA's rules relating to advertising and promotional material. Below is a summary of certain standards and requirements included in the CFTC's and NFA's two principal rules governing

CPO advertising and promotional material—CFTC Rule 4.41 and NFA Compliance Rule 2-29.

### **CFTC Rule 4.41**

#### ***General Standards***

CFTC Rule 4.41 broadly prohibits CPOs from advertising in any manner that (i) employs any device, scheme, or artifice to defraud any pool investor or prospective pool investor, or (ii) involves any transaction, practice, or course of business that operates as a fraud or deceit upon any pool investor or prospective pool investor. For these purposes an advertisement generally includes any publication, distribution or broadcast of any report, letter, circular, memorandum, publication, writing, advertisement, or other literature or advice, whether by electronic media or otherwise. CPOs that are also subject to the Investment Advisers Act of 1940 (“Advisers Act”) will recognize these general prohibitions as substantively identical to the standards of conduct to which they are subject with respect to their clients and prospective clients under Section 206(1) and (2) of that Act.

#### ***Specific Prohibitions***

Beyond its general prohibition against fraudulent and deceptive advertising practices, Rule 4.41 specifically prohibits the use of any “testimonial” (in general, any third-party statement that could be viewed as endorsing a CPO) unless certain conditions are met. Specifically, Rule 4.41 prohibits a CPO from referring to any testimonial unless the advertisement or material providing the testimonial prominently discloses:

- that the testimonial may not be representative of the experience of other investors;
- that the testimonial is no guarantee of future performance or success; and
- if more than a nominal sum is paid for the testimonial, the fact that it is a paid testimonial.

CPOs that are also subject to the Advisers Act are unlikely to be able to use testimonials in any event given the SEC’s general prohibition against the use of testimonials.

Rule 4.41 also specifically prohibits a CPO from using any presentation of hypothetical performance for a commodity pool unless the presentation includes a prescribed cautionary statement included in Rule 4.41 or in NFA

Compliance Rule 2-29 (discussed below). This statement must be prominently disclosed and in “immediate proximity to” (generally on the same page as) the presentation of performance. For these purposes, performance generally will be regarded as “hypothetical” if any trading activity factored into the performance figure has not in fact occurred. Importantly, in the view of the NFA, performance also should be regarded as hypothetical—even if it relates solely to actual trading activity—if the performance results portray the composite performance that could have been achieved if assets of the pool had been (but in fact were not) allocated to multiple different trading programs during the performance period.

### **NFA Compliance Rule 2-29**

Like CFTC Rule 4.41, NFA Compliance Rule 2-29 includes both general standards of conduct to which NFA members are subject and certain more-specific requirements concerning the use of “promotional material” (in general, any advertisement concerning or soliciting a commodity interest account, agreement, or transaction).

#### ***General Standards***

Rule 2-29’s general standards of conduct prohibit an NFA member from engaging in any communication that:

- operates as a fraud or deceit;
- employs or is part of a high-pressure approach; or
- makes any statement that commodity interest trading is appropriate for all persons.

These standards apply both to a member’s use of promotional material *and* any of its other communications with the public.

#### ***Specific Requirements***

Rule 2-29’s requirements with respect to promotional material also prohibit a member from using any promotional material that:

- is likely to deceive the public;
- contains any material misstatement of fact or contains any statement that the member knows omits a fact, the omission of which renders the promotional material misleading;
- mentions the possibility of profit unless accompanied by an equally prominent statement of the risk of loss;

- includes any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results;
- includes any statement of opinion, unless the opinion is clearly identifiable as such and has a reasonable basis in fact; or
- includes any specific numerical or statistical information about the past performance of any actual accounts (including rate of return) unless:
  - such information is, and can be demonstrated to NFA to be, representative of the actual performance for the same time period of all reasonably comparable accounts; and
  - in the case of rate of return figures, such figures are calculated in a manner consistent with CFTC Rule 4.25(a)(7).

Regarding the use of hypothetical performance information, Rule 2-29 generally also:

- requires members to include one or more prescribed disclaimers in addition to, or in lieu of, the cautionary statement required by CFTC Rule 4.41; and
- prohibits members from using promotional material that makes any reference to hypothetical performance results that could have been achieved had a particular trading system of the member been employed in the past if the member has three months of actual trading results for that system.

Importantly, however, these additional requirements relating to hypothetical performance do not apply if the member directs the relevant promotional material solely to persons that are QEPs (although, in such cases, a member must still observe its related cautionary statement obligations under Rule 4.41, described above).

Rule 2-29 further requires members to adopt and enforce written procedures for supervising their employees and associated persons for compliance with the Rule. These procedures must require, among other things, that a designated supervisor review and approve each piece of promotional material prior to first use of the material. This person cannot be the same person who prepared the material, unless that person is the only person qualified to review and approve the material.

Rule 2-29 also effectively supplements members' CFTC recordkeeping obligations by requiring members to maintain copies of all promotional

material (along with a record of the required review and approval of such material, and any materials necessary to support past performance, hypothetical performance, or testimonials included in such materials) for the periods specified in CFTC Rule 1.31 as measured from the date of the material's last use.

## 7. Prohibition Against Dealing with Non-NFA Members

NFA Bylaw 1101 generally prohibits NFA members from transacting CFTC-regulated business with any person that is required to be registered with the CFTC but is not an NFA member in good standing. Bylaw 1101 thus effectively obligates NFA members to police the CFTC's and NFA's registration and membership requirements in their day-to-day business dealings. Importantly for CPOs, the NFA views the acceptance of an investment in a pool as a Bylaw-1101-subject transaction between the pool's CPO and the pool investor (including any potential CPO of the investor).

Given the strict-liability nature of Bylaw 1101, and the fact that the NFA has referred to it as a "cornerstone" of its regulatory structure, a registered CPO should consider taking several steps to ensure its compliance with the Bylaw, including one or more of the following:

- obtain from each of its pools' existing and prospective commodity trading advisors, commodity interest brokers and counterparties, and investors' CPOs, as applicable, a representation that such persons are either (i) not required to be registered with the CFTC and a member of the NFA in good standing, or (ii) are in full compliance with all such requirements;
- when given a representation that the CPO of an existing or prospective pool investor is not required to be registered as a CPO, perform some level of follow-on diligence to confirm the particular exemption or other basis for the absence of such a registration requirement (often accomplished by including a related questionnaire in the subscription documents for a pool);
- perform additional diligence if Bylaw 1101 compliance questions arise in response to such initial requests, or if the CPO otherwise has reason to believe that a person may be in breach

of a CFTC registration or NFA membership obligation, including a review of such person's status (if any) in the NFA's online registration/exemption database, Background Affiliation Status Information Center (BASIC) (available at <https://www.nfa.futures.org/basicnet/>);

- if the CPO of a pool investor relies on a registration exemption that must be reaffirmed annually (such as the CPO registration exemption in CFTC Rule 4.13(a)(3)), confirm annually (via BASIC) whether such exemption has been reaffirmed; and
- maintain a written record of its diligence steps taken to comply with Bylaw 1101.

## 8. Branch Office Obligations

A branch office is generally any location other than a CFTC registrant's main business address at which persons associated with the registrant engage in activities requiring registration as an associated person. All branch offices are required to have a branch office manager who is registered as an associated person and has taken and passed FINRA's futures branch office manager examination (Series 30). A CPO must report the existence of each of its branch offices in its Form 7-R, and must report a person's status as a branch office manager in that person's Form 8-R.

CFTC Rule 166.4 and related NFA interpretive positions historically have required that branch offices be an office of the registrant itself, rather than an office of a separately incorporated entity. In the case of certain multinational CPOs, this requirement may raise potentially sensitive tax and non-CFTC regulatory questions, and such CPOs may need to work with their accounting, legal, and other advisors to ensure that all related concerns are properly addressed.

## 9. Supervisory Obligations

### *Generally*

NFA Compliance Rule 2-9 requires all NFA members to diligently supervise their employees and agents in all aspects of their commodity-interest-related business. As part of that duty, a CPO must establish and implement written supervisory policies and procedures (copies of which must be maintained at its main office and each of its branch offices) with respect to various aspects of its operations, including with respect to:

- screening and hiring of employees (including, for example, potentially heightened diligence of prospective employees whose employer has been disciplined by the CFTC, NFA, or other applicable regulators for fraud or similar wrongdoing);
- monitoring employee e-mail and the member's website (if any);
- handling of investor complaints (including, for example, the designation of a particular employee with primary responsibility for investigating all such complaints);
- training personnel with respect to their duties on behalf of the member and compliance with applicable CFTC and NFA rules (including appropriate qualification of the personnel charged with administering such training); and
- monitoring each branch office's compliance with the CPO's policies and procedures, and with applicable CFTC and NFA rules (including annual on-site visits to assess those offices' compliance).

### *Ethics Training Program*

CPOs' supervisory policies and procedures also must include written procedures outlining an ongoing ethics training program for each of their associated persons. CPOs generally have flexibility to tailor to their particular circumstances the form and content of their ethics training program, but, per NFA interpretive guidance, all ethics training programs should address at least the following topics:

- an explanation of applicable laws and rules of self-regulatory organizations (including exchanges and execution facilities) to which the CPO may be subject;
- the CPO's obligation to the public to observe just and equitable principles of trade;
- how to act honestly, fairly, and with due skill, care, and diligence in the best interest of investors and the integrity of the markets;
- how to establish effective supervisory systems and internal controls;
- how to assess the financial circumstances and investment experience of investors;
- procedures for ensuring disclosure of material information to investors; and
- how to avoid, properly disclose, and manage conflicts of interest.

CPOs should ensure that their written ethics training procedures also specify the frequency and format of the training, and who will provide the training. CPOs may furnish ethics training either in-house or through classes sponsored by third-party firms. However, whether the training is furnished in-house or through a third-party provider, the CPO must ensure that the person providing the training is adequately qualified to do so (including, at a minimum, FINRA Series 3 qualification, three years of industry experience, and an absence of any disciplinary history that could call into question the person's suitability to provide the training).

### *Annual Self-Audit*

The NFA further requires that each of its members substantiate the adequacy of their supervisory policies and procedures by annually completing a questionnaire-based self-audit process. This process requires a CPO to evaluate its procedures

for complying with numerous NFA membership obligations, including separate evaluations for the CPO's main office and branch offices (as applicable). Upon completing the self-audit, the applicable supervisory person must sign an attestation, affirming his or her belief that the CPO's procedures adequately address the CPO's NFA supervisory obligations.

### **Conclusion**

This article has highlighted several CFTC and NFA compliance obligations that newly registered CPOs should ensure they have accounted for in building-out their compliance policies and procedures. Given the substantial nature of these obligations, and the fact that they are by no means exhaustive of a registered CPO's CFTC and NFA compliance obligations, newly registered CPOs and their compliance personnel should consider allotting a generous amount of time and attention to that task.

#### **ENDNOTES**

\* This publication is intended to serve only as a general discussion of the highlighted issues. It should not be regarded as legal advice.

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<sup>1</sup> The NFA is the self-regulatory organization to which the CFTC has delegated numerous CPO oversight functions. NFA membership is mandatory for all CFTC registrants, including CPOs.

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