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Pardon My Interpretive Notices: The NFA Releases Two Interpretive Notices for Members

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Earlier this year, the National Futures Association (NFA) released two Interpretive Notices, each impacting separate aspects of NFA members' businesses and operations. On March 24, 2021, the NFA released an interpretive notice entitled *NFA Compliance Rules 2-9 and 2-36: Members' Use of Third-Party Service Providers* (the Service Provider Notice).¹ The Service Provider Notice will become effective on September 30, 2021. The notice primarily addresses the regulatory responsibilities of NFA members, which include registered commodity pool operators and registered commodity trading advisors (collectively, Members), to diligently supervise service provider relationships. Specifically, Members are responsible for:

1. mitigating the risks associated with outsourcing regulatory functions by implementing policies and procedures to oversee service providers;² and
2. complying with all Commodity Futures Trading Commission (CFTC) and NFA regulations.

Furthermore, the Service Provider Notice warns that hiring a third-party service provider does not absolve Members from their regulatory obligations.

In addition, on April 13, 2021, the NFA released an Interpretive Notice entitled *Compliance Rule*

2-50: CPO Notice Filing Requirements (the Rule 2-50 Interpretive Notice).³ The Rule 2-50 Interpretive Notice details how a commodity pool operator (CPO Member) can comply with Compliance Rule 2-50 (Rule 2-50),⁴ and applies to both registered and exempt commodity pools.

Rule 2-50 and the Rule 2-50 Interpretive Notice detail the circumstances under which a CPO Member must file a notice with the NFA because a commodity pool (or exempt commodity pool) may not be able to fulfill its participant obligations. Prompt notification must be given to the NFA no later than 5:00 pm CT of the next business day if the CPO Member operates a commodity pool that:

1. is unable to meet a margin call;
2. is unable to satisfy redemption requests in accordance with its subscription agreements;
3. halts redemptions based on factors not associated with pre-existing gates or lockups; or
4. receives notice from a swap counterparty that its pool is in default.

Rule 2-50 and the Rule 2-50 Interpretive Notice went into effect on June 30, 2021.⁵

Summary of the Service Provider Notice

NFA Compliance Rule 2-9(a) places a continuing responsibility on Members diligently to supervise employees and agents.⁶ Specifically, the rule requires that Members must adopt a written supervisory framework. To assist in properly carrying out this responsibility, the Service Provider Notice highlights five areas Members should consider when outsourcing responsibilities to a service provider, which include:

1. initial risk assessment;
2. onboarding due diligence;
3. ongoing monitoring;
4. termination; and
5. recordkeeping.

Initial Risk Assessment

As an initial matter, the Service Provider Notice states that Members should determine whether a particular service provider, and the particular service(s), are appropriate and, at a minimum, should consider: (1) whether there is adequate protection of confidential, personally identifying information; (2) the regulatory impact if the service provider fails to carry out its functions properly; and (3) the service provider's location and whether it has adequate resources to meet its contractual obligations and provide the Member with access to required records. The Service Provider Notice also states that, in addition to the above primary areas of risk, Members should also consider other potential areas of risk applicable to its business and the regulatory function that is being outsourced.

Onboarding Due Diligence

The Service Provider Notice also notes that prior to entering into a contractual relationship, Members should ensure the service provider can perform the outsourced function in compliance with applicable regulations. Specifically, the Service

Provider Notice states that a Member's level of onboarding due diligence should be proportionate to the risks associated with outsourcing a particular regulatory function. The Service Provider Notice further directs Members to consider whether heightened risk would occur as a result of the service provider having access to confidential information or performing critical regulatory-related functions, such as handling customer segregated funds, keeping required records, or filing financial reports. Members should also assess whether the service provider's services are tailored to a Member's business needs and provides such Member with an appropriate level of confidence in the service provider's ability to properly carry out the outsourced function.

Ongoing Monitoring

The Service Provider Notice further indicates that Members should, on an ongoing basis, monitor a service provider's ability to properly carry out its functions. In particular, a Member's ongoing monitoring should include both a continuous review of particular outsourced functions to ensure that they are being performed appropriately, and periodic holistic reviews of the service provider's performance, regulatory compliance and, if appropriate, information technology security, financial stability, business continuity and contingency plans, audit or examination results, websites, public filings, insurance coverage, and references. Accordingly, Members should have a process for escalation to senior management and should consider the procedures associated with any contract renewal.

Termination

Relating to the termination of a third-party service provider relationship, the Service Provider Notice specifies that Members should confirm: (1) if there will be sufficient notice prior to a service provider's termination; and (2) that following termination, the service provider no longer has access to confidential information.

Recordkeeping

Finally, the Service Provider Notice highlights that Members that enter into a third-party service provider relationship must maintain records pursuant to NFA Compliance Rules 2-10 and 2-49.

Compliance with Rule 2-50

Rule 2-50 and the Rule 2-50 Interpretive Notice detail the circumstances under which a CPO Member must file a notice with the NFA because a commodity pool (or exempt commodity pool) may not be able to fulfill its participant obligations.

Prompt notification must be given to the NFA no later than 5:00 pm CT of the next business day (the Notification Cut-Off), if the CPO Member operates a commodity pool that:

1. is unable to meet a margin call;
2. is unable to satisfy redemption requests in accordance with its subscription agreements;
3. halts redemptions based on factors not associated with pre-existing gates or lockups; or
4. receives notice from a swap counterparty that its pool is in default.

Rule 2-50 and the Rule 2-50 Interpretive Notice went into effect on 30 June 2021.⁷

Guidance and Takeaways

- Rule 2-50 applies to both registered commodity pools and exempt commodity pools managed by CPO Members.⁸ CPOs operating exempt commodity pools will still need to make the notice filing with the NFA.
- Even if the CPO Member is disputing the amount or appropriateness of the margin call from their trading partners, it must make a filing if the dispute will not be resolved by the Notification Cut-Off.
- If a CPO Member cannot satisfy a participant's redemption request, a CPO Member may need

to make the filing prior to the expiration of any grace periods.

- Astute CPOs should review their current policies and procedures to ensure compliance with Rule 2-50's requirements. At a minimum, many CPOs will need to amend their existing policies and procedures to ensure a filing is made by the Notification Cut-Off.
- CPOs must ensure they are operationally capable of complying with these requirements, especially during periods of potentially high market stress.

Summary of CPO Notice Filings Required by Rule 2-50

A Commodity Pool is Unable to Meet a Margin Call. If the CPO Member reasonably expects to meet the margin call within the time period imposed by its designated contract market or futures commission merchant, a CPO Member is not required to make a filing. Alternatively, if the CPO Member determines that a commodity pool will be unable to meet its margin call, the CPO Member must promptly notify the NFA prior to the Notification Cut-Off. Importantly, even if the CPO Member disputes the amount or appropriateness of the margin call, the CPO must still make the notice filing.

A Commodity Pool is Unable to Satisfy Redemption Requests. The CPO Member should consider the terms of the commodity pool's subscription agreement when determining whether a filing with the NFA is required. Specifically, the CPO Member must determine whether any grace periods or provisions relate to the timing of redemption payments. If a CPO Member is able to meet a redemption request in accordance with the subscription agreement, no filing is required. However, if the CPO Member determines that a pool will not meet a redemption request within the terms of the subscription agreement, the CPO Member must make the filing prior to the Notification Cut-Off. This means

that under some circumstances, the filing may need to be made prior to the end of the grace period.

A Commodity Pool Halts Redemptions. A filing is required when a pool unexpectedly halts redemptions, either temporarily or permanently, as a result of a market or other event that impacts the pool's ability to meet redemptions. A CPO Member is not required to file a notice for its pool(s) in situations where the CPO Member decides to liquidate a pool in the ordinary course of business.

A Commodity Pool is Declared in Default by a Swap Counterparty. The NFA requires a CPO Member to file a notice with the NFA prior to the Notification Cut-Off if a swap counterparty declares the commodity pool to be in default and the CPO Member does not reasonably believe the pool can cure the default within the previously agreed *cure period*. Even if the CPO Member is in negotiations with the swap counterparty to liquidate positions or disputes the default notice, the CPO Member must make the notice filing with the NFA.

The Interpretive Notice highlights that Rule 2-50 is designed to ensure that the CPO Member timely notifies the NFA of potential financial issues that may impact a CPO Member's ability to fulfill its obligations to pool participants or result in a pool's unplanned liquidation. Accordingly, Rule 2-50 is intended to streamline the process of the NFA's identification of CPO Members with pools that have been negatively impacted by adverse market conditions or other events.

Conclusion

While the Service Provider Notice and Rule 2-50 Interpretive Notice focus on specific aspects of the NFA's requirements, Members would be well served to holistically review their current policies and procedures. In order to comply with the requirements provided in the Service Provider Notice, Members have the option of simply amending their existing policies and procedures to ensure all requirements in the Service Provider Notice are satisfied. Members should carefully review the Service Provider Notice

and their current supervisory framework and conduct a gap analysis to ensure all of their current service provider relationships satisfy the Service Provider Notice's requirements.

With respect to the Rule 2-50 Interpretive Notice, CPO Members must ensure they are capable of timely notification to the NFA of potential financial issues potentially impacting the CPO Member's ability to fulfill its obligations. CPO Members are currently required to report some of these events in a quarterly Form CPO-PQR filing or in a pool annual report. The required notifications are intended to assist the NFA in readily identifying CPO Members with pools that have been adversely impacted by market conditions or other events and may result in a pool's unplanned liquidation.

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NOTES

- ¹ NFA Interpretive Notice 9079: NFA Compliance Rules 2-9 and 2-36: Members' Use Of Third-Party Service Providers (March 24, 2021), available at <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9079>.
- ² The NFA has previously issued guidance relating to Members' supervisory obligations relating to third-party service providers. The requirements provided in the Service Provider Notice supplement prior guidance.
- ³ NFA Notice 9080—NFA Compliance Rule 2-50: CPO Notice Filing Requirements. The Rule 2-50 Interpretive Notice is available at <https://www.nfa.futures.org/rulebook/rules.aspx?Section=4&RuleID=RULE%202-50>.
- ⁴ Rule 2-50. CPO Notice Filing Requirements, available at <https://www.nfa.futures.org/rulebook/rules.aspx?Section=4&RuleID=RULE%202-50>.

- ⁵ The NFA will provide additional instructions regarding the form and manner of CPO notice filings prior to the effective date.
- ⁶ NFA Compliance Rule 2-9: Supervision of Branch Offices and Guaranteed IBS (Board of Directors, October 6, 1992; revised July 24, 2000 and January 1, 2020), available at [https://www.nfa.futures.org/rulebook/rules.aspx?RuleID=9019&Section=9#:~:text=NFA%20Compliance%20Rule%202%2D9\(a\)%20places%20a%20continuing,of%20their%20commodity%20interest%20activities](https://www.nfa.futures.org/rulebook/rules.aspx?RuleID=9019&Section=9#:~:text=NFA%20Compliance%20Rule%202%2D9(a)%20places%20a%20continuing,of%20their%20commodity%20interest%20activities).
- ⁷ On June 29, 2021, the NFA provided additional instructions regarding the form and manner of CPO Member notice filings prior to the effective

date. To file notice with the NFA, CPO Members will use EasyFile Extensions and Notice Filings. When filing notice pursuant to Rule 2-50, firms must upload a summary of the event, as well as specify all relevant subsection(s) of Rule 2-50 and the impacted pool(s). Further, step-by-step instructions for filing any type of notice are available in the NFA's EasyFile Extension and Notice Filing Help guide.

- ⁸ See National Futures Association: Proposed NFA Compliance Rule 2-50 and related Rule 2-50 Interpretive Notice entitled NFA Compliance Rule 2-50: CPO Notice Filing Requirements.

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