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## REGULATORY MONITOR

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### **NFA Examinations—Overview, Hot Issues and Preparation**

In 2012, the Commodity Futures Trading Commission (CFTC) modified the CFTC registration exclusion and exemption applicable to operation of registered investment companies (registered funds) and related controlled foreign corporations (CFCs) that trade in commodity interests in order to avoid registration with the CFTC as a commodity pool operator (CPO).<sup>1</sup> Beginning in 2013, many investment advisers to such registered funds and CFCs are required to register as CPOs and are required to become members of the National Futures Association (NFA), the self-regulatory organization that administers the CFTC's registration regime. Pursuant to CFTC-delegated authority, the NFA oversees the activities and conducts examinations of all registered CPOs.

This column describes the NFA's examination process for CPOs, points out current "hot button issues" and suggests actions to help newly registered CPOs prepare to handle NFA examinations efficiently and effectively.

### **Purposes and Selection of CPOs for Examination**

NFA examinations of CPOs are designed to ensure that (1) registered CPOs are operating in compliance with the Commodity Exchange Act (CEA), CFTC regulations, NFA rules and best practices, and (2) customers are protected from fraudulent activities.<sup>2</sup> The NFA views the examination as a collaborative process in which the NFA supports the CPO's commitment to meet its regulatory obligations.<sup>3</sup>

Generally, all registered CPOs are subject to examination every three to five years and on a more frequent basis if identified as necessary by the NFA's Compliance Department under its risk-based audit selection process.<sup>4</sup> The NFA identifies CPOs for risk-based examination based on their review of CPO promotional materials and financial statements, assets under management and degree of leverage, customer complaints, and referrals the NFA receives from other agencies.<sup>5</sup> The NFA generally will examine a newly registered CPO within the first year of the CPO's initial registration. We understand that the NFA has been treating CPOs that maintained active registrations with the NFA, but operated solely in an excluded or exempt capacity in recent years as being newly registered CPOs for purposes of examination.

### **Examination Process**

*Initial Contact and Document Request List.* Once the NFA has identified a CPO

for examination, the NFA examination staff (NFA staff) typically will contact the CPO via telephone to notify the CPO of the upcoming examination and conduct a planning interview.<sup>6</sup> The NFA generally makes the initial contact approximately two weeks before the NFA staff plans to conduct an on-site examination of the CPO.<sup>7</sup> Based on the planning interview, the NFA staff will prepare and send the CPO an initial document request list that is tailored to the CPO's business. The CPO must then provide the NFA with responsive documents prior to the scheduled on-site portion of the examination. Of course, the NFA staff also may make a surprise on-site examination of a CPO and conduct the planning interview and present the initial document request list when the NFA staff first arrives at the CPO's offices.

The initial document request list may include information regarding all aspects of a CPO's business, including the CPO's affiliates and other funds and clients under the CPO's management that do not implicate the CPO registration obligations. Nearly all initial document request lists include: (1) general information on the CPO such as lists of the adviser's principals, associated persons, affiliates, and branch offices; (2) organizational documents and records relating to investors; (3) the CPO's CFTC compliance policies and procedures; (4) lists of the CPO's investors, sub-advisers and other fund service providers, futures commission merchants (FCMs), swap dealers and other trading counterparties, and certain other relevant persons and entities; (5) information to facilitate testing with respect to fund trading activities such as the CPO's trade blotter, a list of securities held by each fund, and a description of brokerage arrangements; and (6) information to perform testing for compliance in various other areas such as performance advertising and financial records.<sup>8</sup>

*Response to the NFA's Initial Document Request List.* Providing complete and responsive documentation with respect to the initial document request list is one of the first steps a CPO can take to assure the NFA staff that the CPO has a solid compliance culture, is conducting business properly, and has nothing to hide. The NFA staff has publicly stated that

appropriate information allows the NFA staff to gain a comfort level with the CPO's compliance, reduces follow-up document requests, and makes the on-site examination as efficient as possible.<sup>9</sup>

*On-Site NFA Examination.* Based on its review of the initial documents provided by the CPO, the NFA staff will conduct its on-site examination of the CPO's operations and normally will request additional documents. Typically, the NFA staff will begin the on-site portion of the examination by conducting an initial interview with the CPO's management during which the NFA staff will (1) describe the expected examination process, (2) review the CPO's responses to the initial document request list, and (3) inquire about the adviser's business and organizational structure. Generally, at least one NFA staff supervisor and two or more NFA staff members will conduct the on-site examination.

The NFA staff will then conduct an in-depth on-site review of the CPO's business and investment activities and its corresponding records, compliance policies and procedures, and other information. The NFA staff likely will ask follow-up questions of management and request additional documents and meetings with certain of the adviser's employees, and also may request relevant information from service providers to the CPO and other third parties. The on-site portion of the examination generally will last for a week, but can take longer depending on the NFA staff's prior experience with the CPO, the CPO's business, the size and complexity of the CPO's organization, the CPO's assets managed, the speed at which the CPO provides requested information, and whether the NFA staff is satisfied that it has developed a good understanding of the CPO's operations and compliance procedures.<sup>10</sup> During the on-site portion of the examination, the NFA staff will discuss with management of the CPO any potential testing discrepancies or compliance deficiencies it has identified and will give the CPO an opportunity to correct the identified problems.<sup>11</sup>

The NFA staff generally closes the on-site portion of the examination with an exit interview with the CPO's management to discuss (1) specific issues discovered during

the visit, (2) the status of the examination, (3) any potential concerns the NFA staff may have, (4) any corrective actions the NFA staff believes that the CPO should take, and (5) any additional necessary information the CPO's management would like to provide the NFA staff. After the on-site portion of the examination, the NFA staff will conduct further review and analysis and may discuss with the CPO's management further actions the CPO should take or request additional information.

*Closing the NFA Examination.* If the NFA staff is satisfied that there are no violations and the CPO has satisfied any potential deficiencies through corrective action, the NFA staff generally will request that the CPO provide the NFA with a letter containing representations that, among other things: (1) the CPO has responded fully to all inquiries by the NFA staff during the examination and made available to the NFA staff all information and documentation requested; (2) the CPO has not received any communications from other regulatory agencies concerning non-compliance or deficiencies regarding the CPO's compliance program; and, if applicable, (3) the CPO has taken necessary corrective actions (as discussed with the NFA staff) to resolve any deficiencies identified during the examination. It is important for the CPO to work with the NFA staff to ensure that all such representations accurately reflect the CPO's operations and are true. The NFA staff then, generally, will issue a written report to the CPO restating the findings of the NFA staff and closing the examination.

If the NFA determines that the CPO is potentially violating NFA rules (based on the finding of the NFA staff), the NFA Compliance Department will close the examination by submitting a written report to the NFA's Business Conduct Committee (BCC)<sup>12</sup> regarding the examination results and potential violations of NFA rules. The BCC then will (1) issue a closure letter because the BCC concludes that no violation has occurred, (2) determine that, notwithstanding potential violations, prosecution is unwarranted and issue a closure letter that includes a warning to the CPO, or (3) initiate an NFA enforcement action by issuing a complaint to the CPO.<sup>13</sup>

## Current Hot Button Issues

The scope of an NFA examination may be extremely broad. Among other matters, the NFA staff likely will focus on:

- The CPO's annual self-examination process and related certifications. The NFA requires CPOs, on an annual basis, to review their operations and compliance procedures using the NFA's "Self-Examination Questionnaire" and to maintain a written attestation stating that they have done so.<sup>14</sup>
- The CPO's process for compliance with NFA Bylaw 1101 (1101). 1101 imposes a strict liability prohibition on NFA members against doing business with a non-member of the NFA that is required to be registered with the CFTC and to be an NFA member. Under CFTC guidance, CPOs to registered funds must review and keep records of the status of brokers, counterparties and sub-advisers to the registered funds they advise to comply with 1101.<sup>15</sup> In addition, as a matter of good practice, CPOs to registered funds should review and keep records of the status of commodity pool and institutional investors in the registered funds they advise and monitor developments in this area.
- Registration of all of the CPO's principals, associated persons, branch offices, and relevant affiliates.
- CPO promotional materials (including any sales materials distributed to the public, advertising, phone solicitations, and newsletters).<sup>16</sup>
- Compliance policies and procedures required under applicable CFTC and NFA rules (for example, disaster recovery plan, privacy policy, ethics training policy) and internal distribution of these documents.
- Compliance with the conditions to the CFTC's Harmonization Rules.
- Compliance with the CFTC and NFA requirements other than disclosure, reporting and recordkeeping applicable to registered CPOs.

## Preparing for NFA Examinations

CPOs should try to be prepared for a possible NFA examination at any time.

Maintaining compliance policies and procedures that accurately reflect the CPO's operations and are responsive to applicable CFTC and NFA requirements is the most significant part of this process. Conducting the annual self-examination is vital to being prepared for an NFA examination. In addition, it is helpful to internally test and monitor compliance with the CPO's compliance procedures on a regular basis and/or engage compliance service providers to conduct a mock NFA examination.

CPOs should try to anticipate the types of questions that the NFA staff may raise during an examination. If the CPO has been subject to examination in the past, the CPO should annually review its records regarding prior examinations to address recidivism concerns.

As soon as the CPO receives the initial contact from the NFA staff or becomes aware of the NFA staff's on-site examination, the CPO should consult with counsel who is familiar with the NFA's examination process and is able to provide detailed guidance on how to deal with the legal aspects of the examination. Counsel should be permitted to review any information before it is provided to the NFA staff and should review e-mails and other communications for privilege before those materials are provided to the NFA staff. The CPO should also consider contacting its external auditor and that of any registered funds it advises, as accounting issues may arise in examinations. Finally, the CPO should advise its employees about the NFA staff's visit.

When an NFA examination starts, the CPO should make all reasonable attempts to cooperate with the NFA staff. The CPO should designate a senior officer within its legal or compliance department to serve as an "exam coordinator" with the NFA staff and should advise its employees that the exam coordinator will coordinate all information provided to the NFA staff and should be present during any discussions and interviews with the NFA staff. The CPO should request that the NFA staff direct all questions and document requests through the exam coordinator and should request that the exam coordinator be present for all interviews with the CPO's employees. Also, it is important that the CPO make an appropriate workspace in

its offices available to the NFA staff for the on-site examination.

The CPO should provide the NFA staff only with information that is responsive to its request. Attempts to avoid providing the NFA staff with responsive information will undermine the examination and cause the NFA staff to become concerned about the integrity of the CPO. Certain requested information and documents may be protected by attorney-client privilege and disclosure of privileged information to the NFA staff likely will result in the loss of the attorney-client privilege. However, resisting the NFA staff's requests for information may raise concerns. As a result, a decision as to whether to disclose privileged information and documents to the NFA should be made on a case-by-case basis in consultation with the CPO's counsel. The CPO should maintain a log of documents provided to or reviewed by the NFA staff.

## Conclusion

NFA examinations are significant, can be burdensome and can lead to NFA disciplinary action if the CPO (1) is not adequately prepared for the examination or (2) does not have a sufficient CFTC-related compliance program in place. Consequently, all CPOs should take necessary steps, as discussed above, to adequately prepare for NFA examinations.

## Notes

1. *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 FR 11252 (Feb. 24, 2012) (amending CFTC Reg. 4.5 (registered funds) and rescinding CFTC Reg. 4.13(a)(4) (CFCs)). This column focuses on CPOs of registered funds (*i.e.*, investment companies registered under the Investment Company Act of 1940) and related CFCs, many of which no longer are eligible for an exclusion or exemption.

2. *See, e.g.*, Matt Pendell and Lauren Golm, NFA Compliance Department, "Preparing for an NFA Audit," audio podcast (June 29, 2009), (NFA Podcast), available at <http://www.nfa.futures.org/NFA-compliance/NFA-general-compliance-issues/nfa-examinations.HTML> (last visited Sept. 14, 2013).

3. *See id.*

4. *See, e.g.*, NFA Compliance Department, Session 6: NFA Audits, slide deck prepared for September 27, 2012 New York NFA CPO Workshop, available at <http://www.nfa.futures.org/nfa-compliance/NFA-education-training/>

*NFA-member-workshops/CPO-exempt/materials.HTML* (last visited Sept. 14, 2013); and NFA Compliance Rule 3-1.

5. *See id.* The CFTC recently adopted harmonization rules that allow CPOs to registered funds to comply with CFTC disclosure, reporting to shareholders, and record-keeping requirements through substituted compliance with the existing Securities and Exchange Commission (SEC) regime. *See Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators*, 78 FR 52308 (Aug. 22, 2013) (Harmonization Rules). The NFA may also conduct a risk-based review of fund disclosure statements filed only with the SEC under the Harmonization Rules, but as of the date of this column the NFA has not indicated whether it intends to do so.

6. *See* NFA Compliance FAQs: Examinations (NFA FAQs), available at <https://www.nfa.futures.org/NFA-faqs/compliance-faqs/examinations/index.HTML> (last visited Sept. 14, 2013).

7. *Id.*

8. NFA Compliance Department, CPO/CTA Regulatory Seminar Materials (Mar. 2, 2010), available at [http://www.nfa.futures.org/nfa-compliance/NFA-education-training/NFA-member-workshops/doc\\_req\\_list.pdf](http://www.nfa.futures.org/nfa-compliance/NFA-education-training/NFA-member-workshops/doc_req_list.pdf) (last visited

Sept. 14, 2013) (providing a sample document request list (not tailored to CPOs of registered funds)).

9. *See* NFA Podcast.

10. *See* NFA FAQs.

11. *See* NFA Examinations, <http://www.nfa.futures.org/NFA-compliance/NFA-general-compliance-issues/nfa-examinations.HTML> (last visited Sept. 14, 2013).

12. *See* NFA Compliance Rules 3-2 and 3-3 and NFA Bylaw 704.

13. *Id.*

14. *See* NFA Self-Examination Questionnaire, available at <http://www.nfa.futures.org/NFA-compliance/publication-library/self-exam-questionnaire.HTML> (last visited Sept. 14, 2013).

15. *See* Guidance on Obligations Under NFA Bylaw 1101 for Commodity Pool Operator Members Advising Pools that are Registered Investment Companies, NFA Notice to Members I-12-34 (Dec. 19, 2012).

16. *See* NFA Compliance Rule 2-29 and related NFA interpretive notices (subjecting promotional materials to general anti-fraud and specified disclaimer requirements and, in certain cases, NFA pre-review prior to use).

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