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## NFA INSPECTIONS — PRACTICAL GUIDANCE FOR CPOS AND CTAS

*Newly required to register with the CFTC and NFA, many CPOs and CTAs are being audited by NFA with on-site visits for the first time. The authors offer a practical guide to such inspections, beginning with firm preparation, and then discussing key areas of regulatory focus, management of the visit, and possible outcomes of the audit.*

By Deborah A. Monson and Jeremy A. Liabo \*

Since 2012, the number of commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”) required to register with the Commodity Futures Trading Commission (“CFTC”) has substantially increased, largely as a result of the combination of the rescission of commonly used registration exemptions and the broadening of the definition of commodity interests subject to the jurisdiction of the CFTC. CPO and CTA registrants generally are also required to register with the National Futures Association (“NFA”) and are thus subject to NFA rules as well. While the CFTC typically performs audits for cause and general informational sweeps, the NFA conducts periodic on-site audits of CPO and CTA registrants to monitor compliance with CFTC and NFA rules and best practices. This article provides an overview of the NFA’s process and describes updates that the NFA has made recently in light of the many new and different types of asset managers now under its purview. This article also

provides guidance on how best to prepare for an NFA audit and handle an audit once it has begun.

Historically, new CPO and CTA registrants could expect the NFA to perform an initial on-site audit within the first year following registration, and subsequent audits usually about every three to five years thereafter. With the influx of registrants since 2012, the NFA generally is conducting initial audits within the first two years following registration, and is determining the frequency of subsequent audits by relying more heavily on an analysis of risk factors. The risk factors include, among other things, customer complaints, qualifications of principals (including whether prior firms had regulatory issues), concerns noted during reviews of the firm’s promotional materials, regulatory filings and financial statements, referrals received from other regulatory agencies, and the time elapsed since registration or the last exam. The NFA increasingly has been scrutinizing footnotes to financial statements and

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### IN THIS ISSUE

- **NFA INSPECTIONS — PRACTICAL GUIDANCE FOR CPOS AND CTAs**

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looking at websites and other sources of information, including industry publications and databases, for information about firms. In addition, the information disclosed on Forms PQR and PR is factored into the risk analysis. In particular, the NFA focuses on the information provided on these forms about the level of assets under management, the degree of leverage, the types of investments, and performance returns that seem unusually high or low.

### **How to Prepare for an NFA Audit**

NFA examinations are announced by a phone call from the staff about two weeks in advance. In light of this short notice period, advance preparation is critical. One of the best ways to start preparing for an audit is to review the NFA's Self-Examination Checklist, available on the NFA's website. Although the Checklist is only required to be completed annually, it is a good idea to review it upon registration and periodically thereafter so you can make sure your compliance policies and procedures as developed and implemented are in line with what the NFA expects. Another good way to prepare for an audit is to review the pre-audit questionnaires and the follow-up initial document request letters that are issued by the staff. Although current versions are not publicly available, counsel should have examples. By reviewing these materials, you can set up a system for making sure you are able to quickly supply the requested information and documents.

Of course, the key to preparation is establishing and implementing a robust compliance program that addresses the requirements under the Commodity Exchange Act, CFTC and NFA regulations, staff guidance, and best practices. Firms should test the effectiveness of their policies and procedures periodically to make sure that they are keeping up with business, personnel, regulatory, and technological developments. Firms also should make sure that they have satisfactorily addressed any findings raised on prior NFA exams. Ensuring that all required records are maintained properly is important. A useful tool is a comprehensive recordkeeping matrix that identifies the records to be kept, how and where they are kept, and the person responsible for each record. Mock examinations are also a useful exercise. Firms can do this internally

based on recent document request letters or engage an outside service provider to conduct the mock audit. A mock audit can help a firm identify and address any deficiencies in compliance, recordkeeping, or internal controls before an NFA audit occurs.

### **Areas of Focus**

Internal controls have emerged as a key area of focus. In particular, the NFA will review policies and procedures, the separation of duties within the firm, due diligence reviews of service providers, and risk management policies. Other areas of focus have continued to include registration, promotional materials, account opening, trading, performance reporting, supervision, ethics training, business continuity/disaster recovery plans, NFA By-law 1101, and financial records, including records of cash activity. Some of these areas, especially those where the NFA commonly finds deficiencies, are discussed further below.

A firm's registration procedures will be reviewed to confirm that the firm has the appropriate persons listed as Principals and registered as Associated Persons ("APs"), and the appropriate locations identified as branch offices. The definition of a Principal is set forth in CFTC Rule 3.1(a) and includes persons who own 10% or more of the registrant, senior officers and directors, and those with control of a business unit regulated by the CFTC. A registrant should cross-check the list of Principals with those individuals listed in Form ADV to be sure that they are consistent. The definition of an AP, set forth in CFTC Rule 1.3(aa), is broad and includes persons who solicit clients and anyone above them in the supervisory chain of command. If an AP is based out of a location other than the main business office, that location is a branch office. The NFA staff may also examine whether fund general partners, managers, directors, and trustees are properly registered, have claimed (and annually renewed, if required) an exemption from registration, have delegated their CPO responsibilities in accordance with CFTC Letter 14-126, or separately obtained no-action relief. Common deficiencies include failure to update registration records, unlisted Principals and branch offices, and unregistered APs, as well as APs whose registrations were not terminated but should have been.

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A key component of the NFA's examination is a review of the firm's NFA Bylaw 1101 due diligence. NFA Bylaw 1101 prohibits NFA members from doing business with anyone who is required to be, but is not, an NFA member. The NFA considers Bylaw 1101 to be a critical piece of its self-regulatory regime and a firm can be strictly liable for a violation of Bylaw 1101 unless it has done adequate due diligence. The NFA will review representations as to compliance with NFA Bylaw 1101 that the firm obtains from investors, clients, fund sponsors, investment advisers, and brokers with whom it does business, as well as any follow-up documentation needed to obtain a satisfactory explanation. (Registered CPOs of registered investment companies do not have to conduct Bylaw 1101 due diligence on investors in those funds.) The NFA also will review diligence files documenting that the firm checked the registration or exemption status of those with whom it does business on the NFA website. In addition, to the extent that a firm does business with persons relying on an exemption that must be renewed annually, the NFA will check that the firm annually confirmed that such persons reaffirmed their registration exemptions. Common deficiencies include inadequate due diligence and documentation.

The NFA will request certain of the firm's promotional materials for review. Promotional materials include offering documents, and certain print and electronic materials (including pitch books, accompanying scripts, websites, e-mails, and social networking). The NFA will review these materials for compliance with CFTC and NFA rules, as well as for consistency with actual operations and practices of the firm. The NFA also will request the log showing that a supervisory person other than the person who prepared the materials reviewed and approved the materials prior to their use. Common deficiencies include not documenting the prior approval of promotional materials, operations inconsistent with disclosures, and not having adequate records substantiating performance reports.

The NFA also will review a firm's trading activities. Part of this review will focus on order entry, and allocation policies and procedures, in part to determine whether aggregated orders have been allocated among eligible accounts in a manner that is fair, equitable, and consistent, and that does not favor one client or group of clients. The NFA will examine the firm's periodic reviews of such policies and procedures, as well as the documentation of such reviews. Common deficiencies include inadequate procedures for allocating split or partial fills, and not reviewing bunched orders to ensure that they are allocated properly.

The NFA will review periodic and annual reports to investors to be sure that such reports are in the required form and contain the required substance, that the reports were distributed within the required timeframe, and that the required investor consents were obtained if reports were sent electronically. A report is not complete if it does not contain the required signed oath or affirmation of a person authorized to bind the firm stating that, to the best of the knowledge and belief of that individual, the information contained in the document is accurate and complete. It is relatively common for the NFA to find that reports do not include all required pool and investor information, and also that the oath is missing or does not contain the required information.

NFA Compliance Rule 2-45 prohibits a CPO from allowing a commodity pool to make a direct or indirect loan or advance of pool assets to the CPO, or any affiliated person or entity. As a result, a firm should adopt a policy that funds are prohibited from entering into a loan agreement (or similar agreement) with the firm (or an affiliate of the firm). An NFA interpretive notice outlines permissible transactions, but NFA pays particular attention to receivables from a general partner to a fund and has broadly construed what is a loan under certain circumstances.

### **Tips for Surviving an Audit**

After a preliminary planning call, the staff will send questionnaires to be completed to help them determine the scope of their exam. The planning call is a good opportunity for the firm to explain to the staff any limits on the nature of its CPO/CTA activities, such as operating under Rule 4.7 or other relief that would narrow the scope of the exam. Once the staff receives and reviews the information in the questionnaires, it will provide an initial document request list that includes materials to be provided to them in advance of their arrival on-site. It is not uncommon for a firm to need to request clarification of some of the requests. Since all of these steps usually take place within about a two-week period, quick turnaround is important. Appropriate persons should be designated as responsible for providing particular information within the required time period, and should be available throughout the process to answer questions and provide any further information. A common mistake is for personnel to provide materials that they may have used in an SEC or Financial Industry Regulatory Authority audit to the NFA, without realizing that these materials needed to be tailored to address CFTC and NFA issues before being given to the staff.

Employees should be alerted that the examiners will be in the office so that they know not to have

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conversations that could be overheard and not to leave documents around that could be seen. Adequate facilities should be arranged for the examiners while they are on-site, but the space should be set up so that the examiners do not roam freely throughout the office.

The on-site fieldwork portion of the examination can last from a few days to a few weeks. NFA fieldwork teams generally consist of three to five people. It is a good idea for a firm to prepare an opening presentation by its senior officers to the staff explaining the background and history of the firm, its business activities, its use of commodity interests, its structure and affiliated firms, and its personnel. During the on-site visit examiners will conduct initial interviews with selected persons, and review and test documents. Examiners usually request additional materials and interviews as their review progresses. The staff generally will note any concerns or potential findings as they arise during the audit process.

It is important for the firm to designate a contact person to control the process. All requests for information from NFA staff should be directed to this person. The contact person should be responsible for gathering and submitting the requested information. All documents should be reviewed by the contact person prior to being produced to ensure that irrelevant or privileged documents are not inadvertently produced. In addition, the contact person should keep a record of all requests and of the documents that are produced in response to those requests so that it will be possible to reconstruct the information that was made available to the staff. When the NFA requests to interview any firm personnel, the contact person should arrange these interviews, seek to determine the scope of the proposed interviews, prepare the interviewee, and attend the interviews to take notes and help keep the interview on course. The contact person should keep in close and regular contact with the examiners.

Once the on-site examination has begun, the goal of the firm should be to minimize the amount of time the NFA spends on-site. As noted above, to accomplish this goal it is important to provide the examiners with adequate facilities. It is also important for the firm to quickly review and provide requested records and interviews. The longer the staff waits for requested information, the more opportunity they have to observe irregularities in the information they have already received or to think of new areas of possible inquiry, and the longer they will remain on-site. However, the firm should be mindful that interviews and materials produced will be part of the record of the exam and could become evidence in an enforcement or other later

proceeding. This means that the firm should take care about what is produced or said to the staff. If a request from the staff is not clear, the contact person should discuss it with the staff. If the contact person or interviewee does not know the answer to a question with certainty, the person should tell the staff that they don't know and (assuming the question is within the scope of their expertise) that they will find out and get back to the staff quickly. This approach not only prevents mistakes and inconsistencies from becoming part of a permanent record, but it also provides an opportunity to consult with legal counsel for guidance as to the response. A firm should not refuse to produce records that are subject to the NFA's inspection powers. Doing so will prolong the examination process, annoy the examiners, and may lead to an enforcement action.

When interacting with examiners, it is critical to always be honest. A regulatory problem will become more serious if personnel lie to the NFA. In addition, the lying itself may lead to an enforcement or other action in addition to the regulatory problem. It is also essential to keep all promises made to the NFA and to avoid any confrontations with the examiners. Of course, it is important that personnel advocate the firm's case to the examiners. If an examiner indicates during the inspection that violations have been detected, the firm should promptly explain either why the questioned practices are not violations, or why they are inadvertent and isolated, and that steps have been taken so they do not recur. It is crucial to respond to the examiners as they raise concerns during the exam, since it is possible that if such concerns are adequately addressed right away they may not be noted as deficiencies in the final report.

### **Possible Outcomes of an Audit**

The examiners generally conclude the on-site portion of the audit with an exit interview during which they will note issues and findings that should be discussed, and if possible resolved, prior to the issuance of the examiners' report. The NFA may raise additional issues after the on-site portion has concluded. The NFA has five months to issue its final report on the examination. The possible outcomes of an NFA audit include the issuance of a letter closing the examination, the issuance of a deficiency letter, and a referral for enforcement. A letter closing the examination is issued when the staff has concluded an examination without findings. A deficiency letter is a summary of examination findings and can include violations of the law and rules, as well as supervisory and control weaknesses. Deficiency letters are provided to the firm at the conclusion of the examination and can require the firm to respond within

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10 business days, documenting the steps it has taken to correct the noted deficiencies. (This potentially tight timing is another reason for firms to address concerns raised by the examiners as they arise). An enforcement referral can occur when examiners find a violation and determine that it should be referred to the enforcement staff for further investigation and possible enforcement

action. Prospective and current clients of CPOs and CTAs often ask about deficiency letters and enforcement investigations in their due diligence reviews. Moreover, enforcement investigations and actions may need to be disclosed in regulatory filings, which are publicly available. ■