

## Commodity Pool Operators

### **CPO Compliance Series: Conducting Business with Non-NFA Members (NFA Bylaw 1101) (Part One of Three)**

By Stephen A. McShea, Cary J. Meer and Lawrence B. Patent

Commodity pool operators (CPOs) that must soon register with the U.S. Commodity Futures Trading Commission (CFTC) and become members of the National Futures Association (NFA) because of the repeal of the CFTC Regulation 4.13(a)(4) registration exemption will need to undertake numerous CFTC and NFA compliance obligations. One of the key NFA compliance obligations facing new CFTC registrants and NFA members arises out of NFA Bylaw 1101, which prohibits an NFA member, such as a CPO, from conducting business with or on behalf of a non-NFA member that is otherwise required to register with the CFTC. NFA Bylaw 1101 compliance is also topical for existing NFA members given the repeal of the Regulation 4.13(a)(4) registration exemption, as existing NFA members will need to take steps to ensure that they comply with NFA Bylaw 1101 with respect to any CPOs with whom they are engaged in commodity interest business that currently claim the Regulation 4.13(a)(4) exemption.

This article is the first of a three-part series that will focus in detail on the compliance obligations of CPOs under CFTC and NFA regulations and guidance addressing a CFTC-registered CPO's: (i) conducting business with non-NFA members; (ii) preparation and use of marketing and promotional materials; and (iii) reporting of principals and registration of associated persons. Each of these topics is also briefly summarized in "Do You Need to Be a Registered Commodity Pool Operator Now and What Does it Mean If You Do? (Part One of Two)," The Hedge Fund Law Report,

Vol. 5, No. 8 (Feb. 23, 2012). This article discusses in greater detail the NFA's guidelines on conducting business with non-NFA members.

#### ***Background: NFA Bylaw 1101 and Interpretive Notice 9007***

NFA Bylaw 1101 generally prohibits an NFA member, such as a CPO, from conducting business with or on behalf of any non-member of the NFA, or suspended member of the NFA, that is otherwise required to be registered with the CFTC. Bylaw 1101 sets out a strict prohibition in this regard, which has a few limited exceptions.<sup>[1]</sup> NFA Interpretive Notice 9007 – Compliance with NFA Bylaw 1101, March 19, 1987, revised July 1, 2000 (the Interpretive Notice) discusses the background of Bylaw 1101 and how the NFA staff views and applies it, and provides guidance on how NFA members may comply with Bylaw 1101.

NFA Bylaw 1101 prohibits NFA members from carrying an account, accepting an order or handling a transaction in commodity futures<sup>[2]</sup> contracts for or on behalf of any non-member of the NFA, or suspended member, that is required to be registered with the CFTC as a futures commission merchant (FCM), introducing broker (IB), CPO, commodity trading advisor (CTA) or LTM, unless: (a) the non-member is a member of another futures association registered with the CFTC under Section 17 of the Commodity Exchange Act (CEA)<sup>[3]</sup> or is otherwise exempted

from the Bylaw 1101 prohibition by NFA Board resolution; (b) the non-member is registered with the CFTC as a FCM or IB under Section 4f(a)(2) of the CEA and the account, order or transaction involves only security futures products; or (c) the suspended member has been exempted from the Bylaw 1101 prohibition by the NFA Appeals Committee.

The complete text of Bylaw 1101 is available in the NFA's online Manual/Rules on this [webpage](#).

In the Interpretive Notice, the NFA highlights the importance of Bylaw 1101 within the NFA's regulatory structure, noting that its prohibitions on conducting business with non-NFA members is of such critical importance to the NFA that those prohibitions are included as one of the NFA's fundamental purposes in its Articles of Incorporation. The Interpretive Notice makes clear that, although Bylaw 1101 by its terms imposes a strict liability standard on NFA members, the NFA staff has not enforced Bylaw 1101 unreasonably and has "consistently not relied on the strict liability standard set by the rule itself." Instead, the Interpretive Notice indicates that complaints in Bylaw 1101 cases have been issued by the NFA staff in instances where in the staff's view "evidence indicates that the Member knew or should have known of the violation." The Interpretive Notice then makes clear that the determination of whether a member should have known will largely depend on the adequacy of the procedures that it has in place to prevent Bylaw 1101 violations and the diligence with which it carries out those procedures. To that end, the Interpretive Notice sets out steps that the NFA suggests its members can take to help ensure compliance with Bylaw 1101, which are included in the discussion below under "How to Comply." When conducting routine exams of its members, the NFA will ask for copies or examples of a member's procedures for Bylaw 1101 compliance.

NFA Interpretive Notice 9007 – Compliance with NFA Bylaw 1101 is available in the NFA's online Manual/Rules on this [webpage](#).

### *How to Comply*

Two key determinations are necessary for compliance with Bylaw 1101: (i) whether you are doing business with an entity that is required to be registered with the CFTC; and (ii) if such registration is required, is that entity an NFA member. The Interpretive Notice sets out "certain minimal steps" that NFA members should take to comply with Bylaw 1101. The relevant steps for CPOs set out in the Interpretive Notice are as follows:

- Review the list of CFTC registrants with which you do business to determine if they are NFA Members. You can determine whether a particular entity is a CFTC registrant by checking the BASIC system on NFA's website, sending a request to NFA through the "contact" feature on the website, or calling NFA's Information Center toll-free at (800) 621-3570;
- Review your list of customers (i.e., investors). If a customer's name indicates that it may be engaged in the futures business, you should inquire as to its registration and membership status;
- If any customer is operating a commodity pool but claims to be exempt from registration as a CPO, you should verify that the customer has made any required filings with the CFTC and NFA;<sup>[4]</sup> and
- Either ensure that your branch offices are not separately incorporated entities, or, if they are, that they are registered in the appropriate capacity with the CFTC.

As the NFA points out in the Interpretive Notice, it is important for CPOs to keep in mind that these steps are not necessarily a complete list of all the procedures that may be necessary to avoid a violation of Bylaw 1101 and following them may not as a matter of course prevent a violation of Bylaw 1101. Following these steps from the Interpretive Notice, however, should go a long way in helping a CPO to satisfy its Bylaw 1101 compliance obligations and to avoid liability for a violation of Bylaw 1101.

Beyond following the steps set out in the Interpretive Notice, CPOs can take other affirmative steps by seeking information and representations in materials such as their funds' subscription agreements and contracts with third-parties such as distributors.

CPOs managing private funds should include in their subscription agreements a representation concerning an investor's CFTC registration and/or exemption status. The NFA has looked to this in examinations as a valid procedure for complying with Bylaw 1101. The following is an example of what such an item might look like:

In order to be in compliance with applicable rules of the National Futures Association ("NFA") and the regulations of the Commodity Futures Trading Commission ("CFTC"), \_\_\_\_\_ (the "Investment Manager") must ensure that each investor in the Fund ("Investor") that is required to register under the U.S. Commodity Exchange Act ("CEA") and to become a member of NFA has done so. The Investor must check the statement(s) below that apply to the Investor (or, if the Investor is a commodity pool, to the operator thereof):

The Investor hereby certifies that **(Please check all of the appropriate boxes):**

The Investor (or, if the Investor is a commodity pool, the operator thereof) is a member of NFA and is registered under the CEA as a: \_\_\_\_\_  
\_\_\_\_\_. **(Please indicate the category or categories in which the Investor, or the operator thereof, is so registered, and its NFA ID number. Registration categories include commodity pool operator, commodity trading advisor, futures commission merchant, introducing broker, and retail foreign exchange dealer.)**

**(If the Investor is a commodity pool operator or commodity trading advisor but is exempt from registration as such)** The Investor (and the pool operator of the Investor in the case of a commodity pool) represents that it is exempt from registration under the CEA pursuant to \_\_\_\_\_ and has made any necessary filings with the NFA in order to avail itself of such exemption. **(Please cite the section of the CEA or CFTC Regulation under which exemption from registration is claimed.)**

The Investor represents that it is not required to be a member of NFA or to be registered under the CEA because it does not engage in activity that comes within the definition of any of the registration categories stated in bold above.

The Investor covenants to advise the Investment Manager immediately in writing if any warranty or any information contained herein becomes untrue.

With respect to third-party arrangements such as distribution agreements, CPOs may wish to include representations from the counterparty as to its CFTC registration and NFA membership status. An example of such a representation is as follows:

NFA Bylaw 1101 Representation. The Distributor represents and warrants to the Funds and the Investment Manager and agrees with the Funds and the Investment Manager as follows:

(a) The Distributor acknowledges that the manager is registered as a commodity pool operator (“CPO”) with the Commodity Futures Trading Commission (“CFTC”) and a member of the National Futures Association (“NFA”).

(b) As a registered CPO and NFA member, the Manager is subject to NFA Bylaw 1101, which prohibits NFA members from engaging in transactions in commodity futures contracts (directly or through the Funds) for or on behalf of any non-Member of the NFA, or suspended Member, that is required to be registered with the CFTC as a futures commission merchant (“FCM”), introducing broker (“IB”), CPO, commodity trading advisor or leverage transaction merchant (collectively, the “Required CFTC Registrations”), *unless* (i) such non-Member of the NFA is a member of another futures association registered with the CFTC under Section 17 of the Commodity Exchange Act (the “CEA”), or is otherwise exempted from this prohibition, (ii) such non-Member of the NFA is registered with the CFTC as an FCM or IB under Section 4f(a)(2) of the CEA and the account, order, or transaction involves only security futures products, or (iii) such suspended Member is exempted from the NFA Bylaw 1101 prohibition by the

Appeals Committee (each of (i), (ii) and (iii) collectively, the “Bylaw 1101 Exemptions”).

(c) Distributor (i) is not subject to the Required CFTC Registrations, (ii) is properly registered pursuant to one of the Required CFTC Registrations and is an NFA member, or (iii) satisfies one of the Bylaw 1101 Exemptions. *(Modify as appropriate to indicate the basis pursuant to which this clause (c) is satisfied.)*

Finally, in connection with the repeal of the exemption from CPO registration in CFTC Regulation 4.13(a)(4), NFA Members currently engaging in commodity interest business with an exempt Regulation 4.13(a)(4) pool must ensure that, after December 31, 2012, the operator is either registered as a CPO and an NFA member, the operator has filed an exemption for the pool under CFTC Regulation 4.13(a)(3) or the operator is exempt on another basis. In order to assist its members in identifying such entities, the NFA has made available through the Annual Questionnaire that its members must complete once a year a listing of all Regulation 4.13(a)(4) and 4.13 No Action exemptions filed to date with NFA (which will be updated periodically to reflect any new filings received). The NFA distributed a notice to its members on August 15, 2012 indicating that this list has been included on the Questionnaire Index screen as a link at the bottom of the screen.

*Stephen A. McShea is the General Counsel and Chief Compliance Officer of Larch Lane Advisors LLC, a CFTC-registered CPO and SEC-registered investment adviser, that specializes in early-stage investing through its funds of hedge fund platform and its hedge fund seeding platform. In his role at Larch Lane, Mr. McShea manages and supervises all legal and regulatory operations of Larch Lane, including: structuring domestic and offshore private funds of funds offerings and*

*managing the funds' ongoing compliance obligations; negotiating and structuring founder class and seed investments in start-up and early-stage hedge funds; structuring credit facilities for domestic and offshore funds; implementing compliance policies and procedures; and preparing SEC and NFA filings. Mr. McShea is also an Adjunct Professor of Law at Fordham University School of Law, where he teaches a class on investment adviser and hedge fund regulation.*

*Cary J. Meer is a partner in K&L Gates' Washington, D.C. office and a member of the Investment Management practice group. She provides compliance advice to registered investment advisers and assists firms in registering as investment advisers, commodity pool operators and commodity trading advisors. She also structures and organizes private investment companies, including hedge and private equity funds and funds of funds.*

*Lawrence B. Patent is of counsel in K&L Gates' Washington, D.C. office. Prior to joining K&L Gates, Mr. Patent was Deputy Director of the CFTC's Division of Clearing and Intermediary Oversight. His principal areas of concentration are investment management,*

*commodity futures, financial services and derivatives matters. Mr. Patent's experience includes substantial involvement with all of the Commodity Futures Trading Commission regulations related to intermediaries, including registration and fitness, sales practices, disclosure, reporting, recordkeeping, minimum financial requirements, customer funds protection, international trading, foreign currency, anti-money laundering, bankruptcy, risk assessment and managed funds.*

<sup>[1]</sup> NFA Bylaw 1101 also has a section that deals with leverage transaction merchants (LTMs), but as there are no firms currently registered as such, this section is no longer relevant.

<sup>[2]</sup> As defined in NFA Bylaw 1507, the term "futures" includes commodity options, foreign futures and options, leverage transactions and security futures products.

<sup>[3]</sup> NFA is currently the only registered futures association, so there is no need to check if the entity is a member of another futures association.

<sup>[4]</sup> Note certain employee benefit plans are considered not to be commodity pools, so the operators thereof do not need to make filings with the NFA to maintain their CPO exemption. See CFTC Regulation 4.5(a)(4)(i) – (v).