

Commodity Pool Operators

CPO Compliance Series: Registration Obligations of Principals and Associated Persons (Part Three of Three)

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Commodity pool operators (CPOs) that are registered, or registering, with the U.S. Commodity Futures Trading Commission (CFTC) and that are, or are becoming, members of the National Futures Association (NFA), need to comply with numerous CFTC and NFA requirements. One of the key compliance obligations is the requirement for a CPO to (1) list its principals on its registration application with the NFA (Form 7-R) and (2) register its associated persons (APs) with the NFA (Form 8-R) and submit a Form 8-R for each natural person principal so that the NFA can perform a background check. This article details who or what is a principal and who is an AP; outlines the process for registration of APs and listing of natural person principals; and describes some basic supervisory obligations applicable to APs and principals as employees of the CPO and provides some general guidance on how to comply with those supervisory obligations.

This article is the third of a three-part series of articles that focuses in detail on various compliance obligations of CPOs under CFTC and NFA regulations and guidance. The first article covered NFA Bylaw 1101, which addresses conducting business with non-NFA members. See “CPO Compliance Series – Conducting Business with Non-NFA Members (NFA Bylaw 1101) (Part One of Three),” The Hedge Fund Law Report, Vol. 5, No. 34 (Sep. 6, 2012). The second article covered the various prohibitions and guidelines for marketing activities and promotional materials for both CPOs and commodity trading advisors under various

CFTC regulations and NFA compliance rules. See “CPO Compliance Series – Marketing and Promotional Materials (Part Two of Three),” The Hedge Fund Law Report, Vol. 5, No. 38 (Oct. 4, 2012). For additional coverage of each of these topics and other relevant topics, see “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).

Background: CFTC Regulations and NFA Registration Rules and Interpretive Notices

Principals

CFTC Regulation 3.1(a) defines the term “principal” with respect to any entity registering or required to be registered with the CFTC. A CPO’s principals must be listed on the CPO’s registration application on Form 7-R, and the CPO must submit a Form 8-R for each natural person principal. See “NFA Workshop Details the Registration and Regulatory Obligations of Hedge Fund Managers That Trade Commodity Interests,” The Hedge Fund Law Report, Vol. 5, No. 47 (Dec. 13, 2012).

For a corporation, the term principal is defined as the CPO’s directors, executive officers (i.e., president, CEO, COO, CFO or CCO) and any person in charge of a principal business unit, division or function subject to regulation by the CFTC. For a partnership, the term principal is defined as any general partner and the CCO. For a limited liability

company or limited liability partnership, the term principal is defined as any executive officers, managers or managing members, or those members vested with the management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the CFTC. Additionally, the term principal is defined to include any person having a similar status or performing similar functions as any of the foregoing who has the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the CPO's activities that are subject to regulation by the CFTC. CFTC Regulation 3.1(a)(1).

There are also certain tests with respect to 10% ownership, profit rights, control and capital contribution that will cause an individual or entity to be a principal of a CPO, which are as follows:

1. any natural person who, directly or indirectly, owns, is entitled to vote, or has the power to sell or direct the sale of, 10% or more of any class of the CPO's voting securities;
2. any natural person who, directly or indirectly, is entitled to receive 10% or more of the CPO's profits;
3. any natural person who, directly or indirectly, has the power to exercise a controlling influence over the CPO's activities that are subject to regulation by the CFTC;
4. any entity that is the direct owner of 10% or more of any class of the CPO's voting securities; and
5. any natural person or entity who has contributed 10% or more of the CPO's capital (except for banks or insurance companies that are not affiliated with the CPO that contribute capital through subordinated debt that is not guaranteed by another party not listed as a principal of the CPO). CFTC Regulation 3.1(a)(2) and (3).

Finally, the definition of principal includes any natural person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose or effect of divesting such person of direct or indirect ownership of a voting security of the CPO, or preventing the vesting of such ownership, or of avoiding making a contribution of 10% or more of the capital of the CPO, as part of a plan or scheme to evade being deemed a principal of the entity. CFTC Regulation 3.1(a)(4).

Associated Persons

Definition and General Background

CFTC Regulation 1.3(aa)(3) defines a CPO's APs as any natural person associated with a CPO as a partner, officer, employee, consultant or agent (or any person occupying a similar status or performing similar functions) involved in soliciting funds, securities or property for participation in a commodity pool or any person who supervises such person. CFTC Regulation 3.12(a) requires a CPO's APs to be registered under the Commodity Exchange Act (CEA), unless eligible for one of the exemptions from registration under CFTC Regulation 3.12(h). To the extent a CPO's pool trades swaps, directly or indirectly, the CPO must also register as a "swaps firm" and designate one of its principals who is also registered as an AP as a "swaps AP." (A detailed discussion of registration as a swaps firm and swaps AP is beyond the scope of this article. Details on these designations and the process for obtaining them are available in NFA Notice I-12-24.) To be eligible for registration as an AP, NFA Registration Rule 401 requires that a CPO's APs must have taken one of the applicable proficiency exams or otherwise satisfied the proficiency exam requirements of Rule 401, unless an exam waiver is available under NFA Registration Rule 402.

In determining who are a CPO's APs, it is important to keep in mind that, even where a CPO may have a dedicated marketing team, its APs may not necessarily be limited to the individuals on that marketing team and the person or persons to whom that marketing team reports. It is important to consider, for example, if the CPO's portfolio managers or others, such as executive officers, are in fact actively involved in solicitation activities via pitches to potential investors.

Exemptions from Registration as an AP

Under CFTC Regulation 3.12(h)(1) and (3), an AP of a CPO is exempt from registration if he or she is:

1. individually registered as a futures commission merchant, retail forex dealer, swap dealer, major swap participant (which is unlikely in any of the foregoing categories), floor broker or introducing broker;
2. engaged in the solicitation of funds, securities, or property for a participation in a commodity pool, or the supervision of any person or persons so engaged, pursuant to registration with Financial Industry Regulatory Authority (FINRA) as a registered representative, registered principal, limited representative or limited principal, and that person does not engage in any other activity subject to regulation by the CFTC;
3. the chief operating officer, general partner or other person in the supervisory chain of command, provided that (a) the CPO derives no more than 10% of its total revenue on an annual basis from commodity interest transactions for customers; (b) the CPO is not subject to a pending proceeding brought by the CFTC or a self-regulatory organization alleging fraud or failure to supervise or has been found in such a proceeding to have committed fraud or failed to supervise; (c) the person seeking exemption is listed as a principal and has no derogatory information that may disqualify the person from being listed as a principal or an AP; and (d) the CPO files with the NFA a resolution stating that (i) such person is not authorized to solicit or accept customers', retail forex customers' or leverage customers' orders, solicit a client's or prospective client's discretionary account, solicit funds, securities or property for participation in a commodity pool, exercise any line supervisory authority over such persons, or hire or fire firm personnel engaged in activities subject to regulation under the CEA; (ii) another registered AP or AP-applicant of the CPO who is not subject to a pending proceeding brought by the CFTC or a self-regulatory organization alleging fraud or failure to supervise, and has not been found to have committed fraud or failure to supervise, holds and exercises full and final supervisory authority, including authority to hire and fire personnel, over the customer commodity interest related activities of the CPO; and (iii) if that AP so designated by the foregoing item (ii) ceases to have the authority referenced in the foregoing item (ii), the CPO will notify the NFA within 20 days by filing a subsequent resolution, which must also include the name of another AP who has been vested with the same full supervisory authority in the event that all of those APs previously designated have been relieved of such authority;
4. engaged in any AP activity from outside of the United States and limits his or her activities to soliciting customers outside of the United States;
5. registered as a CPO;
6. exempt from registration as a CPO under CFTC Regulation 4.13 (unless the CPO with whom the person is associated is registered as a CPO);
7. associated with a person who is exempt from registration as a CPO under CFTC Regulation 4.13 (unless that person is associated with a registered CPO); or
8. where a commodity pool is operated by two or more

CPOs, registered as an AP of one of the CPOs, provided that each such CPO shall be jointly and severally liable for the conduct of that AP in the solicitation of funds, securities or property for participation in the commodity pool, or the supervision of any persons so engaged, regardless of whether that AP is registered as an AP of each such CPO.

Proficiency Exam Requirements for APs

An AP would generally satisfy the NFA Registration Rule 401 proficiency exam requirements by taking (and passing) the National Commodity Futures Examination, known as the Series 3. NFA Registration Rule 401 also provides three other exams that APs may take to satisfy the exam requirement in certain circumstances – Series 31, Series 32 and Series 33. The Series 31 exam may be used by individuals with a Series 7 held by their CPO (i.e., their CPO must also be a registered broker-dealer – it is not sufficient for the CPO simply to be an affiliate of a broker-dealer) that limit their futures activities on behalf of the CPO to soliciting customers for participation in a commodity pool or for discretionary accounts to be managed by commodity trading advisors. The Series 32 exam may be used by individuals who, within two years of the filing of their AP application, have been registered or licensed to solicit customer business in futures in the United Kingdom or Canada, provided such registration meets certain conditions established by the NFA. The Series 33 exam may be used by individuals with a Series 7 and who are going to limit their futures activities on behalf of their sponsor to soliciting or accepting customer orders for futures or options involving stock index, currency or interest rate products or security futures products, or supervising persons who perform these same limited activities. A person may rely upon passing these examinations for two years following termination of his or her registration.

NFA Registration Rule 401 also provides that the proficiency exam requirement will be deemed satisfied if:

1. the AP is registered with FINRA as a general securities representative (GSR) of his or her sponsor and the AP is going to limit future activities on behalf of the sponsor to (a) referring clients to APs of the sponsor who have satisfied the requirements of Rule 401 (which referrals are solely incidental to his or her business as a GSR); or (b) supervising persons who perform these same limited activities; or
2. the AP limits his or her activities to (a) soliciting persons for participation in a commodity pool that either (i) exclusively trades swaps subject to the jurisdiction of the CFTC or (ii) would have met the de minimis trading limitations in CFTC Regulations 4.5 or 4.13(a)(3) but for the inclusion of swaps; or (b) supervising on behalf of the sponsor persons who perform such limited activities.

Where a CPO's APs do not satisfy any of Registration Rule 401's examination requirements or any of its express exemptions, a CPO may be able to obtain an exemption from the examination requirements under NFA Registration Rule 402, which provides the NFA's Vice-President of Registration and Membership with the authority to waive the requirements of Registration Rule 401 under circumstances approved by the NFA's Board of Directors. The NFA's Board of Directors has set forth the circumstances under which such an examination waiver may be obtained in NFA Interpretive Notice 9018. Interpretive Notice 9018 grants the NFA's Director of Compliance the authority to waive the Series 3 examination for individuals who are APs of CPOs that are required to register solely because they operate commodity pools that are principally engaged in securities transactions where:

1. the AP's CPO (a) is regulated by a federal or state regulator (such as the Securities and Exchange Commission) or (b) operates a pool that is privately offered under Regulation D, and the CPO limits its activities for which registration is required to operating a commodity pool that (i) engages principally in securities transactions; (ii) commits only a small percentage of assets as initial margin deposits and premiums for futures and options on futures; and (iii) uses futures transactions and options on futures only for hedging or risk management purposes; or
2. (a) the individual requesting the waiver is a general partner of a CPO or of a commodity pool that is primarily involved with securities investments; (b) there is at least one registered general partner of the CPO or pool who has taken and passed the Series 3 examination; and (c) the individual requesting the waiver is not involved in soliciting or accepting pool participations, trading futures or options on futures, handling customer funds, supervising any of the above activities or engaging in any other activity that is integral to the operation of the fund as a pool.

NFA staff has also granted examination waivers for persons who were previously registered; then de-registered because the firm for which they worked was able to claim exemption from registration, and are now required to re-register because certain exemptions/exclusions at the firm level are no longer available.

The individual or firm requesting the examination waiver, or their counsel, must provide a written description of the facts that qualify the individual for the waiver to the Director of Compliance of the NFA.

It is important to note that any such waiver so obtained covers all APs of the firm – that is, it is firm-specific, not AP-specific. It is also possible to obtain a waiver under item (1) above for a specific division or group within the firm, if the division or group satisfies the condition of item (1), but the firm as a whole does not. Any firm that has been granted a waiver with respect to its APs that later becomes ineligible for the waiver must promptly notify the Vice-President of Registration and Membership in writing of such ineligibility.

Supervisory Obligations

NFA Compliance Rule 2-9 requires each NFA member to diligently supervise its employees and agents in the conduct of their commodity futures activities on behalf of the member. While applicable to all employees, including principals and APs, compliance with Rule 2-9 is particularly important with respect to APs given their role in marketing activities. NFA Interpretive Notices 9019 and 9021 provide some guidance on the steps that a CPO can take to seek to ensure compliance with Rule 2-9, which are discussed below under '*How to Comply – Supervision.*'

In addition, pursuant to NFA Interpretive Notice 9042, CPOs who are also registered broker-dealers whose APs are engaged in security futures activities need to ensure that such APs participate, no less than once a year, in an individual interview or group meeting, conducted by persons designated by the CPO, at which compliance matters relevant to the AP's security futures activities are discussed. That interview or meeting may include other matters.

How to Comply

Registration of APs and Listing of Natural Person Principals

The basic steps for registration of a CPO's APs and listing of its natural person principals are as follows:

1. Completion of Form 8-R via the NFA's online registration system (ORS), including a verification of the information by the individual applicant;
2. The CPO sponsor must attempt to verify an AP's previous employers and educational institutions for the past three years;
3. Submission of fingerprint cards for individuals (two copies are recommended); and
4. Payment of a non-refundable application fee of \$85 to the NFA.

It is very important to complete all of the disciplinary history questions on Form 8-R carefully. If an AP applicant fails to disclose a disciplinary event and the NFA discovers the event through a background check, the failure to disclose the event could cause an applicant to be rejected, even if the disciplinary event itself would not have caused the applicant to be rejected.

As discussed above, in addition to these steps, APs will also need to satisfy the exam proficiency requirements, unless eligible for an exemption.

The Form 8-R is located on the ORS page in the "Apply for Registration" tab under the "Individuals" heading. Before processing the Form 8-R for principals and APs, an NFA ID number must first be obtained if they do not already have

one, which can be done via a link under the "Individuals" heading in the "Apply for Registration" page.

The fingerprint cards must be mailed to the NFA directly. The standard form of FBI fingerprint card available at a local police station may be used for this purpose and individual principals and APs can get fingerprinted at their local police office.

In registering APs and listing principals, it is important to complete all the steps, beyond simply filing the Form 8-R on ORS, in a timely manner to ensure that the registration is completed successfully. Once the Form 8-R is completed online, APs will be granted temporary licenses if they have no "yes" answers to the Disciplinary History questions, or if the "yes" answer pertains to a matter previously cleared by NFA or that NFA knows it will clear. The temporary license will be withdrawn if the verification, fingerprint cards, evidence of test passage (if applicable) and fee are not received by the NFA within 20 days from the date of the filing. Otherwise, an AP or principal applicant will have 90 days to resolve any deficiencies in the application.

If an AP or principal leaves or is terminated, a Form 8-T must be filed within 30 days of such departure. Failure to do so will require payment of a late fee of \$100.

Supervision

To seek to ensure compliance with NFA Compliance Rule 2-9, CPOs should adopt supervisory procedures for their APs and principals (as well as other relevant employees). In general, these procedures should be tailored to the activities of the CPO firm and particular attention should be given to sales practices, as this is an area of focus by the NFA. Under NFA Interpretive Notices 9019 and 9021, the supervisory

procedures should address the topics listed below. In addressing each of these topics, CPOs may want to consider at a minimum including the items noted next to each topic in their policies and procedures for that topic:

1. Hiring – confirming prior employment and performing criminal background checks;
2. Registration – the personnel responsible determining who must be registered and who no longer needs to be registered (including the timing for withdrawals);
3. Customer Information – general guidelines on the safeguarding and use of the information;
4. Account Opening Activity and Monitoring of Discretionary Accounts – review of the account opening process and review of discretionary trading in each account;
5. Promotional Material – review processes in accordance with NFA Compliance Rule 2-29(e) (see “CPO Compliance Series – Marketing and Promotional Materials (Part Two of Three),” The Hedge Fund Law Report, Vol. 5, No. 38 (Oct. 4, 2012));
6. Customer Complaints – processes for the receipt and processing of complaints that include (a) name of individual responsible for handling complaint, (b) types of records to be maintained in customer complaint file (which should include a log with name of customer and personnel involved, time frame, description of complaint and resolution and copy of any settlement agreement), and (c) process to be followed by responsible individual for determining whether disciplinary action is required; and
7. Ongoing Training – ethics training in accordance with NFA Interpretive Notice 9051.

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