# NATIONAL FUTURES ASSOCIATION PROPOSES AMENDMENTS TO COMPLIANCE RULES; RELEASES FAQS AND OTHER INFORMATION ON UPCOMING SWAPS PROFICIENCY REQUIREMENTS

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**U.S. Investment Management Alert**

By: Cary J. Meer

By letters to the Commodity Futures Trading Commission ("CFTC") dated August 29, 2019, the National Futures Association ("NFA"), the self-regulatory organization for the U.S. derivatives industry, submitted proposed amendments to:

- NFA Compliance Rule 2-29: Communications with the Public and Promotional Material;
- NFA Compliance Rule 2-36: Requirements for Forex Transactions;
- NFA Compliance Rule 2-13: Break-Even Analysis;
- NFA Compliance Rule 2-34: CTA Performance Reporting and Disclosures; and
- Related Interpretive Notices and other Technical Amendments to NFA Requirements.

As discussed below, the amendments are effective January 1, 2020. According to the NFA, these amendments were proposed to: (i) reflect current technology and business practices; (ii) create consistent requirements concerning hypothetical performance results in promotional materials; and (iii) update the required performance reporting disclosures.

Separately, on September 12, 2019, the NFA issued a Notice to Members releasing an updated Frequently Asked Questions ("FAQs") page in response to Member inquiries regarding the new Swaps Proficiency Requirements. In March 2019, the NFA indicated that individuals registered as associated persons ("APs") at futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs"), and commodity trading advisors ("CTAs") who engage in swaps activity subject to the CFTC's jurisdiction, as well as individuals acting as APs at swap dealers ("SD"), are subject to the new NFA's Swaps Proficiency Requirements. Individuals can begin satisfying the Swaps Proficiency Requirements on the January 31, 2020 effective date and have an entire year to complete these requirements. Any individual who does not satisfy the requirements within that timeframe will no longer be an approved swap AP at an FCM, IB, CPO, or CTA or be permitted to act as an AP at an SD. More recently, NFA issued Notices to Members regarding webinars for Swaps Proficiency Requirements Administrators (October 11, 2019) and the dues surcharge for swap firms (October 16, 2019). [1]

## PRACTICAL IMPLICATIONS

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- Market participants should review their existing compliance programs in light of the new NFA Rule Amendments.
- Registrants should note that any statement of opinion in promotional materials must have a reasonable basis in fact and that NFA members may also be subject to discipline for promotional material developed or maintained by third parties.
- Written confirmations for accounts that are partially funded or that are funded in excess of nominal account size must be provided to or received from all clients, including qualified eligible participants ("QEPs"), [2] as well as an explanation of how cash additions, cash withdrawals, and net performance will affect the nominal account size. The rule amendments further require that CTAs document any changes in a written confirmation if any of this information changes.
- Performance information may be presented gross of fees so long as it is accompanied by a presentation of performance net of fees made with equal prominence.
- Firms should review whether they wish to maintain their status as swap firms in light of the additional proficiency requirements and dues surcharge. This, of course, would mean that such a firm would have to cease swaps activity.

## NFA COMPLIANCE RULE 2-29: COMMUNICATIONS WITH THE PUBLIC AND PROMOTIONAL MATERIAL [3]

NFA Compliance Rule 2-29 addresses the communications of NFA Members and Associates with the public. According to NFA, the amendments are intended to better reflect current technology and business practices and to implement consistent requirements for the use of hypothetical performance in promotional materials directed exclusively to QEPs. The amended rule generally requires that any performance-related claims be presented net of all commissions, fees, and expenses. However, based upon discussions by the authors with NFA senior staff, NFA will continue its current practice of permitting presentation of gross performance in a manner similar to that allowed by Securities and Exchange Commission ("SEC") staff in certain circumstances. These circumstances include: (1) presentation of gross and net performance with equal prominence in a format designed to facilitate the ease of comparison between the gross and net performance and that contains sufficient disclosure that gross-of-fee performance does not reflect the payment of advisory fees and other expenses, and (2) exclusion of custodial and fund administrative expenses from the calculation of CTA net returns as long as those fees are not a requirement of the CTA to trade the program.

NFA Compliance Rule 2-29 was expanded to include all commodity interest activities (i.e. swaps) and not just futures-related activities. In addition, the NFA Board amended the definition of promotional material to incorporate technological advancements such as internet broadcasts and electronic communications and to clarify that promotional material includes any standardized materials concerning a commodity interest account, agreement, or transaction. Likewise, NFA Compliance Rule 2-29(h), which currently applies to radio and television advertisements, was expanded to be applicable for all forms of audio and video promotional materials used by FCMs, IBs, CPOs, and CTAs.

The proposed amendments also modify the existing relief with respect to promotional material directed exclusively to QEPs under CFTC Regulation 4.7. Under the amendments, NFA Members operating pursuant to the

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exemption provided in CFTC Regulation 4.7 will now be required generally to comply with the disclaimer requirements set forth in NFA Compliance Rule 2-29(c)(1) and (2), which mandate that specific language be used in a disclaimer to customers with respect to hypothetical results. However, if extracted performance (the use of one or more components of overall past trading results) or composite performance (showing what a multi-advisor account portfolio or pool could have achieved if assets had been allocated among particular advisors) is presented, the disclaimers in NFA Compliance Rule 2-29(c)(7) or (c)(8), respectively, may be used.

## NFA COMPLIANCE RULE 2-36: REQUIREMENTS FOR FOREX TRANSACTIONS [4]

NFA Compliance Rule 2-36 governs the conduct of Forex Dealer Members ("FDMs"). NFA Compliance Rule 2-36(g) was amended to note that FDMs must comply with Compliance Rules 2-29(a)(1), (b)(1), (c)–(h), and the Interpretive Notices related to these provisions. These provisions prohibit communications with the public that operate as a fraud or deceit, or are likely to deceive, and establish standards for: hypothetical results, statements of opinion, supervisory requirements, record keeping, filing promotional material with NFA, and radio and television advertisements.

## NFA COMPLIANCE RULE 2-13: BREAK-EVEN ANALYSIS [5]

NFA Compliance Rule 2-13 requires CPO members to prepare and disclose a break-even analysis, which includes a tabular presentation of fees and expenses. NFA amended a related Interpretive Notice to clarify that CPOs may not include interest income that cannot be reasonably anticipated to offset expenses. Only interest expected to be earned by a pool's buy-and-hold cash management strategy from investments in high-credit quality, short-duration instruments, or from deposits may be used to offset expenses in the break-even analysis. These instruments include Treasury bills, cash on deposit at a bank or in a money market account, funds on deposit with a brokerage firm, or interest in a money market mutual fund. The Interpretive Notice also clarifies that the break-even analysis must be based on both the minimum initial investment amount for a participant and the minimum total subscription amount required for a pool to commence trading to provide the participant with the most conservative break-even point.

## NFA COMPLIANCE RULE 2-34: CTA PERFORMANCE REPORTING AND DISCLOSURES [6]

NFA Compliance Rule 2-34 governs the performance reporting and disclosures of CTAs. NFA Compliance Rule 2-34(b) requires CTAs with clients who have partially funded accounts to either receive from or provide to a client a written confirmation that contains a description of the trading program and the nominal size of the client's account. NFA expanded the confirmation requirement to apply to accounts in which the client maintains an amount that exceeds the amount the client has directed the CTA to use as a basis for trading decisions.

NFA Compliance Rule 2-34 was also amended to require that a written confirmation be provided or received from all clients, including QEPs, that includes an explanation of how cash additions, cash withdrawals, and net performance will affect the nominal account size. CTAs will also be required to document any changes in a written confirmation if any of this information changes. Based upon discussion with NFA staff, firms registered as CTAs can present performance information in accordance with procedures permitted by the SEC that allow for

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presentation of data on a gross basis, so long as it is also accompanied with data that shows a calculation net of all fees, as discussed above.

## RELATED INTERPRETIVE NOTICES AND OTHER TECHNICAL AMENDMENTS TO NFA REQUIREMENTS [7]

NFA also amended more than a dozen related Interpretive Notices corresponding with the amendments to the NFA Compliance Rules.

## SWAPS PROFICIENCY REQUIREMENTS

### FAQs

NFA recently released a series of FAQs [8] to help NFA Members understand their regulatory obligations related to the new Swaps Proficiency Requirements. Members should review these FAQs and the related Notice to Members. As a reminder, the Compliance Date to satisfy NFA's Swaps Proficiency Requirements is January 31, 2021. Individuals who are currently approved as a swap AP at an FCM, IB, CPO, or CTA or act as an AP at an SD and intend to continue acting in this capacity have until January 31, 2021, to satisfy the NFA Swaps Proficiency Requirements. [9]

### Administrators

Each NFA Member with APs required to satisfy Swaps Proficiency Requirements must designate at least one Swaps Proficiency Requirements Administrator (“SPR Admin”), who must also be an Online Registration System Security Manager, to coordinate enrollment and track progress. An NFA Member may designate an SPR Admin(s) on or after November 1, 2019. In Notice to Members I-19-20, NFA announced a webinar that it will hold for SPR Admins on various dates. [10] Please refer to that Notice to Members and have your SPR Admin register for this free presentation.

### Dues Surcharge

Beginning in 2020, NFA will add a dues surcharge of $1,750 for swap firms, thus raising annual dues for CPOs and CTAs to $2,500. More information on this surcharge, which was announced in June, can be found in a Notice to Members issued on October 16, 2019. [11]

## EFFECTIVE DATE

The NFA invoked the “ten-day” provision of Section 17(j) of the Commodity Exchange Act when it submitted these proposed amendments, which would have allowed NFA to make them effective as early as 10 days after August 29, 2019, unless the CFTC notified NFA that it plans to review the proposed amendments for approval. The NFA issued a Notice to Members on November 13, 2019 indicating that these amendments will become effective on January 1, 2020. [12]

## CONCLUSION

Market participants should assess their compliance programs in light of the NFA Rule Amendments, which may impact their business activities, as well as whether they should remain as swaps firms given the additional

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requirements and dues applicable to such firms. The NFA Rule Amendments and new Swaps Proficiency Requirements reflect an expanding regulatory program at the NFA.

The global futures and derivatives team at K&L Gates continues to follow these and other upcoming developments at the NFA and the CFTC, and we stand ready to assist market participants in the navigation of these developments.

*The authors wish to thank Lawrence B. Patent, retired of counsel, for his contributions to this client alert.*

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## NOTES

[1] NFA Notice I-19-20, NFA announces webinars for Swaps Proficiency Requirements Administrators (Oct. 11, 2019), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5165.

*See also* NFA Notice I-19-21, Reminder: Dues surcharge for certain Member firms engaged in swaps activities effective January 1, 2020 (Oct. 16, 2019), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5166.

[2] QEPs are persons defined in CFTC Regulation 4.7 that are considered sophisticated investors because (1) of their involvement in or relationship to the financial industry, or (2) they are regulated or governmental entities, or they meet certain income and/or asset standards, and they satisfy the portfolio requirements with respect to investment experience. The latter category is akin to the "accredited investor" standard in the securities industry.

[3] NFA, Proposed Amendments to NFA Compliance Rule 2-29: Communications with the Public and Promotional Material, NFA Compliance Rule 2-36: Requirements for Forex Transactions, Related Interpretive Notices and other Technical Amendments to NFA Requirements (Aug. 29, 2019), https://www.nfa.futures.org/news/PDF/CFTC/08292019-CR-2-29-CR-2-36-Interp-Notices-Use-of-Promotional-Material.pdf.

[4] *Id.*

[5] NFA, National Futures Association: Proposed Amendments to NFA Interpretive Notice Entitled: Compliance Rule 2-13: Break-Even Analysis, NFA Compliance Rule 2-34 and the Interpretive Notice Entitled: Compliance Rule 2-34: Performance Reporting and Disclosures (Aug. 29, 2019), https://www.nfa.futures.org/news/PDF/CFTC/08292019-Amendments-CPO-CTA-Disclosure-Performance-Reporting-Requirements.pdf.

[6] *Id.*

[7] NFA, Proposed Amendments to NFA Compliance Rule 2-29: Communications with the Public and Promotional Material, NFA Compliance Rule 2-36: Requirements for Forex Transactions, Related Interpretive Notices and other Technical Amendments to NFA Requirements (Aug. 29, 2019), https://www.nfa.futures.org/news/PDF/CFTC/08292019-CR-2-29-CR-2-36-Interp-Notices-Use-of-Promotional-Material.pdf.

*See also* National Futures Association: Proposed Amendments to NFA Interpretive Notice Entitled: Compliance Rule 2-13: Break-Even Analysis, NFA Compliance Rule 2-34 and the Interpretive Notice Entitled: Compliance Rule 2-34: Performance Reporting and Disclosures (Aug. 29, 2019),

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https://www.nfa.futures.org/news/PDF/CFTC/08292019-Amendments-CPO-CTA-Disclosure-Performance-Reporting-Requirements.pdf.

[8] NFA Notice I-19-17, NFA updates FAQs related to Swaps Proficiency Requirements (Sept. 12, 2019), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5156.

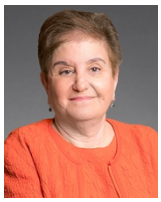
[9] We previously published an Investment Management Alert regarding the new Swaps Proficiency Requirements. *See* Cary J. Meer, Lawrence B. Patent, & Edgar Mkrtchian, *Swaps Proficiency Requirements for Associated Persons; Revised Form 7-R*, K&L GATES LLP (Apr. 8, 2019), http://www.klgates.com/swaps-proficiency-requirements-for-associated-persons-revised-form-7-r-04-05-2019/.

[10] NFA Notice I-19-20, NFA announces webinars for Swaps Proficiency Requirements Administrators (Oct. 11, 2019), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5165.

[11] NFA, Notice I-19-21, Reminder: Dues surcharge for certain Member firms engaged in swaps activities effective January 1, 2020 (Oct. 16, 2019), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5166.

[12] NFA, Notice I-19-25, Effective Date for Amendments to NFA's Promotional Material Rules and Interpretive Notices (Nov. 13, 2019), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5176.

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