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# Client Alert

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# NFA Adopts New Notice Filing Requirements for CPO Members to Report Financial Events Affecting Pool Participants

## I. Introduction and Executive Summary

Effective June 30, 2021 (the **Compliance Date**), new National Futures Association (**NFA**) Compliance Rule 2-50 will require NFA's commodity pool operator (**CPO**) Members to notify NFA promptly (within one business day) upon the occurrence of any of the following four events with respect to a commodity pool, including an exempt pool, operated by the CPO Member:

- The pool is unable to meet a margin call;
- The pool is unable to satisfy redemption requests in accordance with its subscription agreement;
- The pool halts redemptions and the halt is not associated with pre-existing gates, lock-ups or a pre-planned cessation; or
- The CPO Member receives notice from a swap counterparty that the pool is in default.[1]

The purpose of the Rule is to provide NFA with timely notice when critical market or other events raise potential financial issues that may impact a CPO Member's ability to fulfill its obligation to pool participants or that may result in a pool's unplanned liquidation. In order to align the Rule more closely with its purpose, NFA simultaneously issued an Interpretive Notice (the **Interpretive Notice**) identifying circumstances that technically fall within one of the four specified events but, because of their nature, are NOT required to be reported.[2] For example, a notice filing is not required where a CPO Member is temporarily unable to meet a routine margin call but will be able to do so within the time prescribed by the call, or where a CPO Member decides to liquidate a pool in the ordinary course of business and halts redemptions until a final accounting occurs.

This client alert describes the new requirements and suggests next steps for ensuring appropriate additions to compliance policies and procedures in time for the Compliance Date.

*(continued)*

[1] *See* NFA Compliance Rule 2-50: CPO Notice Filing Requirements (**Rule 2-50** or the **Rule**); NFA Notice to Members I-21-15, Effective date for NFA rules establishing CPO notice filing requirements (April 13, 2021), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5346; Proposed NFA Compliance Rule 2-50 and related Interpretive Notice entitled NFA Compliance Rule 2-50: CPO Notice Filing Requirement (March 8, 2021) (**Rule Submission Letter**), https://www.nfa.futures.org/news/PDF/CFTC/Proposed-CR-2-50-and-Interp-Notc-CPO-Notice-Filing-Requirements.pdf.

[2] See NFA Interpretive Notice 9080 - NFA Compliance Rule 2-50: CPO Notice Filing Requirements, https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9080; Rule Submission Letter, *supra* note 1.

## II. The New CPO Notice Filing Requirements

The new requirements are set forth in a new rule, NFA Compliance Rule 2-50, as modified by the Interpretive Notice, which effectively narrows the obligations set forth in the Rule to conform to the purpose of the Rule by identifying circumstances that need not be reported. Similar to Commodity Futures Trading Commission (**CFTC**) and NFA notification requirements regarding financial issues already in place for futures commission merchants (**FCMs**) and introducing brokers, Rule 2-50 and the related Interpretive Notice are intended to provide NFA with important information regarding CPO Members and their pools during a market or other event.[3]

### A. Rule 2-50

#### 1. Terms of the Rule

Rule 2-50 requires that each CPO Member must provide prompt notification to NFA upon the occurrence of one of the following events, in accordance with the Interpretive Notice:

(a) CPO Member operates a commodity pool that is unable to meet a margin call(s);

(b) CPO Member operates a commodity pool that is unable to satisfy redemption requests in accordance with its subscription agreements;

(c) CPO Member operates a commodity pool that has halted redemptions and the halt on redemptions is not associated with pre-existing gates or lock-ups, or a pre-planned cessation of operations; or

(d) CPO Member receives notice from a swap counterparty that a pool the CPO Member operates is in default.

#### 2. Scope – Inclusion of "Exempt Pools"

The term "commodity pool" as used in Rule 2-50 includes "exempt pools," and thus the reporting obligation under Rule 2-50 applies to a CPO Member with respect to circumstances identified in the Rule that occur in such exempt pools, as well as pools for which the Member serves as a registered CPO.[4]

#### 3. Timing and Method of Notification

The notification must be filed promptly, which the Rule defines as no later than 5:00 p.m. (CT) of the next business day following the event. The Rule also states that the notice must be provided in the form and manner prescribed by NFA. To date, NFA has not provided instructions regarding the form and manner of CPO notice filings under the Rule but has advised Members that it will do so prior to the Compliance Date and will cover these requirements during forthcoming educational programs.[5]

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[3] *See* Rule Submission Letter, *supra* note 1, at 4. NFA recognizes that CPO Members are currently required to report some of these events to NFA in a PQR filing or pool annual report, however those reports would not cover all the events and do not provide NFA with information on a current basis. See Interpretive Notice at n.1.

[4] While exempt pools are not mentioned in either in the Rule itself or the Interpretive Notice, the Rule Submission Letter makes clear that the scope of the Rule includes events occurring in exempt pools operated by CPO Members:

> Compliance Rule 2-50 applies to circumstances that occur in an exempt pool operated by an NFA Member CPO, which is consistent with the application of NFA Compliance Rule 2-45. NFA's Board determined this application was appropriate given that the regulatory policy of the rule is to assist NFA with its oversight of CPO Members and their pools during times of extreme market stress. In particular, the Board determined that this information would be useful especially in situations where an exempt pool was unable to meet a margin call issued by an NFA Member FCM or was defaulting on a swap with another NFA Member.

Rule Submission Letter, supra note 1, at 5. The Rule Submission Letter does not define the term "exempt pool." This may be clarified in the upcoming NFA educational programs noted below, and will be important to know in order to appropriate design compliance policies and procedures. However, Rule 2-50 applies only to CPOs that are NFA Members, so that fully exempt Non-NFA Member CPOs and their exempt pools are not subject to the Rule.

[5] NFA Notice to Members I-21-15.

 

## B. The Interpretive Notice – Guidance on Events That Do NOT Require Reporting

### 1. Purpose of the Guidance

The Interpretive Notice reflects NFA's recognition that there may be circumstances that technically fall within one of the four events enumerated in the Rule itself (**triggering events**), but would not be the type of event that should require a CPO Member to notify NFA (**reporting events**). To that end, the Interpretive Notice provides guidance that more fully clarifies the circumstances that may be triggering events under the literal terms of the Rule but are NOT reporting events that require notice under the Rule. The guidance is intended to ensure that the Rule is "narrowly tailored" to its purpose – to provide timely notification to NFA of potential financial issues that may impact a CPO Member's ability to fulfill its obligations to pool participants or that may result in a pool's unplanned liquidation and assist NFA in readily identifying CPO Members with pools that have been adversely impacted by a market or other event – "without being unduly burdensome."[6]

The Interpretive Notice provides guidance on each category of triggering event separately.

### 2. Guidance for Each Triggering Event

#### (a) A Commodity Pool is Unable to Meet a Margin Call

##### (i) Routine Margin Calls

A commodity pool may experience a routine margin call that it may not be able to meet on the day of the call, but that is able to meet within the time period imposed by its FCM or broker (the **prescribed time period**) by altering its portfolio or accessing other means to meet the call.[7]

A CPO Member is not required to file a notice if, on the day the pool receives a margin call, the CPO Member reasonably expects to meet the margin call within the prescribed time period.

However, once a CPO Member determines that one of its commodity pools will NOT be able to meet a margin call, including in situations where the CPO Member disputes the amount or appropriateness of the margin call (other than as described below), the CPO Member must file the Rule 2-50 notice by 5:00 p.m. (CT) the following business day.

##### (ii) Disputed Margin Calls

Where the CPO Member disputes the amount and appropriateness of a margin call, the CPO Member is not required to file a notice if the commodity pool has sufficient assets to meet the greatest of the disputed amount.[8]

#### (b) A Commodity Pool is Unable to Satisfy Redemption Requests

**Redemption Terms of Subscription Agreement**

In determining whether it is obligated to file a notice under this provision, a CPO Member should consider the terms of the pool's subscription agreement, including any grace period or other provisions that impact the timing of a redemption payment.

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[6] *See* Rule Submission Letter, *supra* note 1, at 5. While the Interpretive Notice gives a number of specific examples of triggering events in each category that will not require a notice filing, the Notice also describes the principles underlying these examples, indicating that there may be additional circumstances not specifically identified that would not require reporting based on appropriate application of these principles.

[7] Note that the Interpretive Notice does not define the term "routine" margin call, other than to refer to margin calls that the CPO is able to meet on a timely basis, within the prescribed time period.

[8] *See* Interpretive Notice at n.2.

 

Provided a CPO Member is able to meet a redemption request in accordance with the subscription agreement, no notice is required. The mere fact that a pool is unable to meet the request on the day received is not controlling. For example:

**Grace Period**. A pool may have securities that will mature within the grace period and can be used to satisfy the redemption.

**Redemption in Kind/Side pockets**. In some instances, a CPO Member may also be able to offer a participant a payment-in-kind or provide for the creation of a side pocket when dealing with illiquid investments.

However, once a CPO Member determines that a pool will not be able to meet a redemption request within the terms of the subscription agreement, the CPO Member must file a notice within the required time period, even if the grace period has not expired.

**(c) A Commodity Pool Halts Redemptions**

**Expected vs. Unexpected Redemption Halts**

This category requires notice of the type of trading halt that is not expected or contemplated based on pool documents or in the ordinary course of business. For example, a CPO Member is not required to file a notice in the following instances:

**Pre-determined gates or lock-ups**. Trading halts in accordance with pool subscription agreements that identify pre-determined gates or lock-ups dependent on a base level of funding.

**Ordinary course liquidation**. A halt on redemptions until a final accounting can occur when the CPO Member decides to liquidate a pool in the ordinary course of business (i.e., not due to a market or other unexpected event).

However, a CPO Member is required to file a notice within the required time period when one of its pools unexpectedly halts redemptions, either temporarily or permanently, as a result of a market or other event that impacts the pool's ability to meet redemptions.

**(d) A Commodity Pool is Declared in Default by Swap Counterparty**

**(i) Reasonable Belief in Ability to Cure**

This category requires a CPO Member to file a notice of a default notification where the CPO Member does not reasonably believe that the default can be cured within the contractual cure period. For example, a CPO Member may receive notification if one of its pools is in default to a swap counterparty on a margin call, resulting in a deficit that the pool will not be able to cover or address by adding additional funds.

The Interpretive Notice specifies that a CPO Member must file notice within the required time period once the CPO Member is notified that a pool is in default to a swap counterparty and the CPO Member does not reasonably believe the pool can cure the default within the previously agreed to cure period.

**(ii) Disregard of Negotiations or Dispute**

In determining whether the CPO Member reasonably believes that it can cure the default within the cure period, and thus whether the reporting obligation applies, the CPO Member must disregard negotiations with the swap counterparty to liquidate positions or any dispute of the default notice. That is, the reporting obligation would arise regardless of the existence of such negotiations or dispute.

## III. Next Steps – Developing Rule 2-50 Compliance Policies and Procedures

**A. Components of Rule 2-50 Compliance Policies and Procedures**

For many (if not most) CPO Members, the occurrence of a triggering event will be rare, and that of a triggering event that constitutes a reporting event rarer still. Nevertheless, CPO Members should have in place policies and procedures sufficient to ensure compliance with the notice filing requirement, should a triggering event that requires a notice filing occur. Such policies and procedures should be tailored to the particular circumstances of the pool and may take into consideration the likelihood of occurrence of any of the triggering events. They should address the following steps for each pool (including exempt pools) that the CPO Member operates:

**Step 1** – **Identifying triggering events**. Design and implement a mechanism for identifying the occurrence of a triggering event.

**Step 2** – **Determination of whether a triggering event is a reporting event**. Assign personnel and establish a process for conducting an immediate analysis of the circumstances surrounding the triggering event under the Interpretive Notice to determine whether it is a reporting event, including appropriate escalation procedures.

**Step 3** – **Documentation of Step 2 determinations**. Establish parameters and a process for documentation of the analysis performed under Step 2, which provides a reasonable basis for each determination that a triggering event was not a reporting event. Step 3 would be particularly important where the analysis under Step 2 involves subjective factors (for example whether there was a "reasonable belief" that the CPO could meet a margin call or cure a default in a timely manner), that may be viewed differently in hindsight and could subject the CPO Member to second-guessing.

**Step 4** – **NFA Notification**. Assign personnel and develop connectivity necessary to ensure that timely filings are made when required.

**Step 5** – **Responding to NFA inquiries**. Assign a contact person for receiving and appropriately escalating NFA inquiries relating to notices filed.

**B. General Considerations**

The components of a Rule 2-50 compliance program that are likely to be the most important, time-sensitive, and labor-intensive are Steps 2 and 3, described above. Once a triggering event has been identified, the CPO Member must garner and analyze the relevant facts, make the determination, and, if necessary, be prepared to file the notice (with whatever information NFA requires) within a short period of time (one business day). Note that triggering events, if they occur at all, may be most likely to occur in times of general market stress when resources may be needed across a range of functions. In order to be most effective, documentation of this analysis should be completed as contemporaneously as possible, especially for any determination that a notice filing is not required.

To ensure that these components are both efficient and effective, firms may wish to consider the following suggestions.

**1. Establishing Triage Parameters and Escalation Procedures**

As indicated in the Interpretive Notice, some events that qualify as triggering events are clearly not reporting events, based on objective criteria set forth in the Notice, while others require further analysis and subjective determinations. One approach to streamlining the process could involve creating a list of circumstances that, based on the Interpretive Notice, meet the objective criteria for not qualifying as reporting events, with an escalation process for those that require additional analysis.

In addition, different types of triggering events may require analysis by personnel from different functional groups. For example, for a triggering event that relates to a redemption halt where the issue is whether the halt is contemplated by subscription documents, personnel from legal may be appropriate. By contrast, where the triggering event relates to a margin call or default notice, and the determination rests on the CPO Member's financial ability to meet the call or cure the default, business and finance personnel are likely to have the relevant information. In order to ensure the appropriate determination and filing within the one business day timeframe, it may be helpful for compliance policies to identify the specific personnel or functional group responsible for each category of triggering events.

**2. General Principles**

As indicated above, the Interpretive Notice is intended to help identify triggering events that are not reporting events, based on the purpose of the Rule. While the Interpretive Notice identifies some of these circumstances specifically, there may be others that fall within the purpose of the Interpretive Notice. In all cases, it may be helpful to include a section that sets out the purposes of the Rule as guidance for making and documenting the Step 2 determinations.

**3. Further NFA Guidance**

NFA has announced that it intends to conduct educational programs on the new Rule, and these are likely to provide additional guidance on both the mechanics of the notice filing and the type of events that must be reported. These programs are likely to provide helpful information on how compliance programs can be efficiently and effectively developed.

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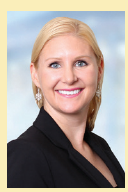

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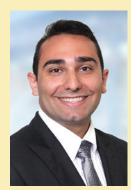

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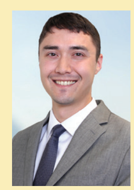

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