Customer Protection Rules for CPOs and CTAs

A New Way Forward?

Background

In light of the wave of fraud committed by pools in recent years, the National Futures Association ("NFA") is considering moving towards a more stringent regime for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). On January 23, 2014, the NFA issued a Member Notice in which it sought comments on new proposed CPO and CTA capital requirements and customer protection measures.[1]

The NFA may do well to consider the European Union and Securities and Exchange Commission ("SEC") models in refining its new proposed regulatory regime. Either the Alternative Investment Fund Managers Directive ("AIFMD") or the Investment Company Act of 1940 and the Investment Advisers Act of 1940 could serve as relevant examples.

[1] Notice I-14-03, "Request for Comments-CPO/CTA Capital Requirement and Customer Protection Measures-Comments Due by April 15, 2014," NFA Notices to Members, https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4377.

Alan Lash

Elizabeth R. Lash

Below we break down some of the new proposed rules and measures, analyze how they could impact CPOs and CTAs, and propose some alternative solutions to the perceived problems of fraud and misstatements by both.

Minimum capital requirements for both CTAs and CPOs

CTAs

CTAs by definition do not hold customer funds, so requiring CTAs to maintain minimum capital levels appears unnecessary, except to ensure that these entities and/or individuals have a bare minimum of resources to support an ongoing business, similar to the requirements governing Introducing Brokers ("IBs"). Is it a good idea? Maybe, if the intent is to drive out small operators.

The NFA points to the IB's minimum capital level requirements as a supporting rationale for this same requirement for CTAs, but comparing these two member types is like comparing apples and oranges. While neither IBs nor CTAs hold customer funds, CTAs are more likely to be individuals—principals or salesmen in entity member firms themselves, whether of CPOs, IBs, Futures Commission Merchants ("FCMs"), *et al.*, thus making it duplicative for CTAs to maintain certain minimum capital levels. Moreover, unlike IBs, CTAs have fewer requirements, and thus, fewer resources and necessary experience in complying with these requirements.

CPOs

Unlike CTAs, CPOs solicit and maintain customer funds, decide how much capital to keep on hand over and above margin requirements, and decide when and how to dispense funds directly to customers. Thus, requiring CPOs to have a certain amount of funds on hand does have a sound basis. But rather than requiring maintenance of a certain threshold minimum capital level, CPOs should be required to keep a certain percentage of funds in the pool itself, i.e., a certain percentage of the Net Asset Value. Historically, it was common for CPOs to keep at least 1% of their own interest in the pool, forcing them to be more careful with their trading (the notion of having one's "skin in the game"). If their customers lost, so did they. Today, pools may not care—they simply close the pool and start fresh (unless barred from doing so by a prior NFA or CFTC action, at least). Investors would be better protected by rules aligning the incentives of the CPOs with their own, more so than by requirements of minimum capital levels.

The EU has settled upon a capital requirements model which could provide a balance for U.S. pools as well; in that model, requirements depend in part on the amount of assets under management. Managers of smaller funds may in some cases be subject to individual member state regulations, while managers of larger funds are subject to a combination of a minimum threshold plus a requirement to contribute their own monies to the fund as a certain percentage of the total portfolio (subject to a maximum cap on contribution). These contributions can be

significantly reduced if the manager has obtained a guarantee from a bank or insurer. [2] Such an approach would appear to balance the needs of managed funds (i.e., providing flexibility in regulation based on the CPO's portfolio of pools) while providing stronger customer protections.

Additionally, the AIFMD requires the fund to post additional 'own funds', or obtain professional indemnity insurance to cover risks arising from professional negligence. In fact, this is also the approach taken with FCMs, who are required to post collateral with depository banks. Requiring CPOs and CTAs to post bonds with the NFA or some other third-party administrator, or to set up an insurance fund prior to doing business, could also assist in protecting unsuspecting investors. Thus, even were a CPO to abscond with most of the monies in the pool, the posting of collateral, a bond, or some insurance fund with a third-party could virtually guarantee that investors would be able to obtain the return of at least some monies. Moreover, the amount of the bond/collateral/insurance fund could vary along with the amount of the CPO's assets under management.

Use of an Independent Third Party Disbursement of Pool Funds

The NFA has proposed that an independent third party review and authorize a CPO's disbursement of any pool funds. This is a stringent requirement; even FCMs are not required to follow this step (Section 16 of the NFA Financial Requirements).

The rationale for such a requirement is, clearly, customer protection. The NFA has proposed independent third-party disbursement of pool funds as a solution to reduce and prevent fraud and misstatement. Based on a review of the last three years of enforcement actions against CPOs and CTAs, it does not appear that existing disclosure and/or reporting requirements have helped reduce or prevent fraud—many of the emergency actions ("MRAs") were based on the discovery by the NFA that CPOs and CTAs had fraudulently reported numbers in their disclosure documents and other financial statements already required under current rules. But perhaps requiring outside approval to disburse funds might in fact prevent fraud and misstatement.

How does one guarantee that a third party is actually independent? The third party would not be a director of the company, so it would have no fiduciary responsibility to the pool itself. As with independent boards, individuals must be compensated for their time—by the entity that retains them. [3] One might ask just how independent a board member can really be if paid by the company which he or she is supposed to oversee. [4] In addition, an external

[2] Linklaters, "AIFM Directive: Capital Requirements," January 28, 2013, http://www.linklaters.com/Publications/20100218/Pages/10_CapitalRequirements.aspx.

[3] Ann Bares, Managing Partner of Altura Consulting Group, "New Study Covers Outside Director Compensation," (from Hewitt 2010 Analysis of Outside Board of Director Compensation), Compensation Force blog post, June 14, 2010, *at* http://www.compensationforce.com/board_of_director_compensation.

[4] Max. H. Bazerman, Kimberly P. Morgan, and George F. Loewenstein, "Opinion: The Impossibility of Auditor

third party may not understand what is best for the business, as he, she or it is not (and probably should not be) involved in the day-to-day management of the fund.

While not a perfect solution, the use of an independent third party licensed by the CFTC or the NFA (similar to an auditor) to review and approve the disbursement of funds, at least for smaller operations, could help reduce fraud. In fact, the SEC offers a good model: Financial and Operations Principals ("FinOps"). FinOps, used primarily by broker-dealers, are financial accountants licensed by the SEC (internal, i.e., a CFO, or external), who are responsible to the SEC for their actions.[5] External FinOps can be fined just like a member firm if there is negligence or fraud. Thus, the potential loss of a license from wrongdoing could help offset the payment bias discussed above.

To further ensure protection of less-sophisticated customers (i.e. non-accredited investors), the NFA could consider requiring such pools to maintain funds at CFTC-regulated entities, and/or solely use custodial bank accounts, with the third party required to be a signatory on the accounts. While this could restrict the freedom of hedge funds to operate as they currently do, it could also help ensure a reduction in theft of funds.

The issue for smaller CPOs, of course, is the cost—adding another layer of oversight and payment for another outside party to review its operations may drive out smaller operators.

NAV Valuation, Reporting and Performance Results

The question is, again, whether to permit in-house preparation of reports and performance results, or to require the use of a third party. As above, perhaps the best solution for smaller firms is to require a type of external FinOp, while permitting larger firms to use internal FinOps--and hope that those firms' internal controls remain robust, unlike in the recent PFG and MF Global cases.

Verification of Assets on a Daily Basis

The next proposed rule is to require the pool to verify assets on a daily basis. The essential issues are that: (a) CPOs are not required to have segregated funds if they have the right to trade non-segregated products; (b) each fund is different as to trading philosophy and frequency of trading; and (c) verification of funds on a daily basis would be difficult for even the NFA or CFTC since unlike FCMs, there are hundreds and maybe thousands of them.[6] Thus, the potential burden on firms, as well as on the NFA

Independence," Sloan Management Review, Vol. 38, No. 4, Summer 1997, http://www.cmu.edu/dietrich/sds/docs/loewenstein/ImpossAuditorIndep.pdf; James D. Cox and Harry L. Munsinger, "Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion," Law and Contemporary Problems: Corporate Cohesion, Vol. 48, No. 3, Summer 1985, http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=3806&context=lcp; Antony Page, *Unconscious Bias and the Limits of Director Independence*, U. OF ILL. L. REV., Feb. 21, 2009, http://illinoislawreview.org/wp-content/ilr-content/articles/2009/1/Page.pdf;

[5] Regulatory Compliance, LLC, "What Are a FinOp's Real Duties?", The Regulatory Compliance Blog, December 6, 2012, http://blog.regulatorycompliance.com/what-are-a-finop-real-duties-financial-securities-reports.

[6] Chair Mary Jo White, "Hedge Funds – A New Era of Transparency and Openness," Managed Funds Association Outlook 2013 Conference, New York, New York, Oct. 18, 2013, http://www.sec.gov/News/Speech/Detail/Speech/1370539892574#.UxzL2uddU0o.

and/or the CFTC, may far outweigh any benefit of this proposed requirement.

Inactive CPOs and CTAs

The NFA has asked whether it should allow member firms and individuals to retain their membership even when in inactive status, or whether such members must be required to withdraw. The NFA notes that permitting inactive status requires it to expend resources (although it does not explain in detail what is required). However, the burden on the NFA should be balanced by sensitivity to the resources of the members themselves. To become an NFA member requires time, effort, and financial resources, and a business may wish to remain a member while it decides its future plans. Further tipping the scale on the side of maintaining this option is the ease with which customers and other members may check the status of the particular firm or individual on BASIC—it is easy enough to confirm that the member is not currently doing business.

One solution to the NFA's concern would be to permit members to remain in inactive status for some number of consecutive years, after which withdrawal is required. Alternatively, the NFA could require the completion of an annual or biannual member questionnaire or form in which the member could notify the NFA as to its future plans and discuss whether and why the member wishes to remain in inactive status for the time being. A third solution would be to implement both.

Conclusion

In brief, the NFA has come up with some interesting proposals to reduce fraud and theft of funds, which, in light of recent Member Responsibility Actions, may be needed to restore confidence in the managed funds industry. However, the NFA as well as the managed funds community may do well to consider some alternatives or modifications to these proposals from other sources, whether here in the United States or overseas.

About The Bates Group LLC

The Bates Group is a leading provider of securities litigation support, regulatory and compliance consulting, and forensic accounting services. Its growing list of 50 financial industry experts and damages consultants situated in Lake Oswego, Oregon and throughout the United States has provided expert consulting services on a multitude of topics within these practice areas. With more than three decades of experience working with Fortune 500 companies, leading law firms, financial services companies and regulatory bodies worldwide, The Bates Group continues to set industry standards. More information about The Bates Group is available at www.batesgroupllc.com.

Additional information is available upon request. Copyright © 2013, Bates Group LLC. All rights reserved.

No part of this report may be reproduced in any manner without written permission of Bates Group LLC. The information contained in this report is the opinion of the individual author only; Bates Group LLC does not endorse such views and is not liable for them. You should always seek the assistance of your own financial, legal, tax, and other professional advisors who know your particular situation for advice on investments, your taxes, the law, and any other business and professional matters that affect you. This report provides general information that may not be applicable to your situation. At any time or from time to time Bates Group LLC or its principals or affiliates may have been employed by or provided management, consulting, or other services to one or more companies mentioned in this report. Nothing in this report shall be construed as an offer to purchase or sell any securities. THIS REPORT IS PROVIDED ON AN "AS IS" BASIS AND AS OF THE DATE OF PUBLICATION ONLY, WITHOUT ANY OBLIGATION TO UPDATE. BATES GROUP LLC DISCLAIMS ANY AND ALL REPRESENTATIONS AND WARRANTIES, EXPRESS OR IMPLIED, INCLUDING WITHOUT LIMITATION, THOSE RELATING TO COMPLETENESS, ACCURACY, TIMELINESS, NON-INFRINGEMENT, OR FITNESS FOR A PARTICULAR PURPOSE.

Bates Group, LLC | 5005 SW Meadows Road, Suite 300 | Lake Oswego OR 97035 | Tel: 503.670.7772

http://BatesResearchGroup.com | research@BatesGroupLLC.com