Who Does What: Broker Dealers | Registered Investment Advisers | Commodities/Futures Entities

Ernest E. Badway, Esq.
Partner
212.878.7986 | 973.994.7530
ebadway@foxrothschild.com

Joshua Horn, Esq.
Partner
215.299.2184
jhorn@foxrothschild.com

Benjamin H. McCoy, Esq.
Associate
610.397.7972
bmccoy@foxrothschild.com

Introduction

At Fox Rothschild LLP, we have a wealth of experience in creating and forming broker-dealers, registered investment advisers, commodity entities and various hedge funds. Over the years, our strategy has been to work with our clients to develop these entities while also assisting them in their ongoing business operations. As a result of the breadth of our experience, we have produced this handbook as a reference guide for both those who are contemplating an entrance into this exciting field as well as those already in the business seeking a handy resource when a question arises.

In anticipation of your interest, we wish to provide you with a summary of the most common compliance-related issues faced by the above-referenced entities. Of course, we have not covered every conceivable issue. Therefore, we suggest that you contact us with any questions or concerns if an issue should arise. Please keep in mind that any deviation from the current statutory and regulatory structure could subject you and your associates to significant liability.

This handbook has been prepared in four parts. The first part provides a summary of the regulatory issues affecting broker-dealers, while the second and third parts relate to registered investment advisers and commodity entity formation and operation. The fourth part contains a discussion of hedge fund issues associated with registration as a commodity pool operator.

SECTION I – STARTING A BROKER DEALER FORMATION

I. Starting a Broker-Dealer

Becoming an owner of a broker-dealer (BD) is a time consuming and expensive endeavor. The FINRA New Member Application (NMA) process requires prospective owners to participate in an agonizing 180-day waiting game. Before FINRA will approve the NMA, a prospective BD owner must provide, among other things: a detailed business plan; capital and first-year expense deposits; experienced principals; clearing agreements; systems contracts and other relevant third-party agreements; as well as actual office space, among other things, before FINRA will approve the NMA.

Purchasing an existing BD also has certain drawbacks. For example, buying a "used" BD requires extensive due diligence to explore the FINRA member firm being purchased. The acquirer has to investigate the selling member firm's regulatory history and inherits any future claims. FINRA will also investigate each new manager and supervisor; and any third party contracts as if you are creating a new BD. The main benefit to purchasing a used BD is that it may be processed after a 30-day notification to FINRA. However, FINRA may still subject a purchase application to the same 180-day review required for an NMA.

II. A New BD

FINRA publishes a new member guide to assist potential members. This guide provides a detailed checklist. Below, we highlight some critical elements prospective members should consider.

A. *Timing*

FINRA has 180 days to review every NMA. You should expect FINRA to use the entire 180 days to reach a decision. It also usually takes applicants at least three to four months to assemble the required information, so the entire process may take 8-12 months.

B. *Filing*

NMAs are submitted through FINRA's online database called Firm Gateway on the Form NMA. The submission of the Form NMA requires significant time to manage the application process.

You should consider hiring counsel to manage that process. Form NMA has over 70 screens of required data and 14 standards of membership; substantial amounts of data in prescribed formats are necessary in particular places.

During the process, FINRA may make information and documentation requests. These requests are also managed within Form NMA once the initial application is deemed complete and the 180-day review process commences.

C. *BD Cost*

The true cost to start a new BD consists of application filing expenses; a net capital requirement; funding for first year expenses net of revenue; direct startup expenses; and other expenses.

FINRA application fees begin at $7,500 for new member applications and increase based upon business lines and size. Minimum net capital requirements are also somewhat objective. These costs are available at the following link: www.finra.org/industry/crd/fees.

FINRA's requirement to fund the first year of business operations net of revenue is one of the largest startup costs to consider. FINRA requires applicants to fund their designated bank account to cover projected fixed expenses for the first year. New owners must calculate their projected expenses for fixed items such as leases; salaries; systems; employees; and equipment rental, among other things. This money must be placed in the bank. You must also project first-year expenses for the space being leased and the salaries of people the firm will retain in its first year. For example, the number of registered representatives (RR) requested will help define FINRA's financial review because the projections for salary expenses and square footage be properly funded.

D. *Third-Party Contracts and Agreements*

Not all contracts or agreements can be finalized until FINRA approval is in place. Clearing firms and clearing agreements fall within this category.

Most clearing firms require documented FINRA approval prior to finalizing due diligence on new brokers. In turn, new members must wait for their clearing broker to complete their review and execute the clearing agreement before effectively starting its operations.

There are other required contracts including, but not limited to: fidelity bonds; annual audit engagement letters; representative employment agreements; and customer agreements.

E. *Supervision*

Without exception, each manager and/or supervisor must have at least one year of direct experience or two years of related experience in their anticipated function.

Each NMA must also identify two Principals (who have the appropriate licenses); a Chief Compliance Officer (CCO); an Anti-Money Laundering Officer (AML); an Executive Representative; Principal(s) to supervise each business line; a Chief Financial Officer (CFO); and a Financial Operations Manager (FinOP). Again, there are no exceptions, and thus if the identified individuals are not properly licensed, FINRA will require each to pass the appropriate exam before the conclusion of the review. An application may be denied if an exam is not taken and the requisite license secured.

F. *Technology and Systems*

Before going live, the BD will need to have tested and implemented its technology infrastructure. At a minimum, this includes testing of: the server, phone lines, personal computers and handheld devices. The new BD will also need an accounting system, accounting software, email supervision system, and electronic communication archiving system.

Depending upon its business lines, a new BD may also need tested and implemented trading systems or reporting technology as well as Order or Execution Management Systems.

Examples of order and execution management systems include FINRA trade reporting systems such as OATS and TRACE. Other systems may also be needed before trading begins, including a cybersecurity plan.

G. *FINRA Approval*

The firm will also need to register with the SEC and/or the relevant state authorities. To apply, a firm will need access to the Central Registry Depository (CRD) and other FINRA systems. Critically, access to these systems requires express approval from FINRA. The SEC and most states will not issue approval until FINRA approval appears on the CRD system.

Generally, these approvals must be in place before business can begin.

H. *Compliance*

New firms must also have their regulatory program in place before commencing business.

Counsel should assist in drafting written compliance procedures, which the firm must adopt. For example, the firm will need a: Written Supervisory Procedure; Anti-Money Laundering Program; Data Security Program; and Business Continuity Plan, among other things. Training sessions and distributions for each RR and their corresponding attestations to abide by the policies is required. These compliance policies will need to be implemented along with an appropriate supervisory system.

The firm must also obtain all required RR disclosures, such as: outside business activities, background checks and outside brokerage accounts. The firm must also investigate each disclosed activity and account, as well as obtain personal trading statements from outside brokerage accounts.

Fully licensed compliance officers are essential in this process.

III. Buying an Existing BD

To buy an existing FINRA member firm, one must submit a NASD Rule 1017 Continuing Membership Application (CMA). The FINRA application process for material changes of business operations and for ownership changes both require application to the FINRA Membership Division through the Form CMA. The submissions are governed by NASD Rule 1017.

A. *Filing Process*

Careful coordination is required between the buyer and seller, since the Rule 1017 application must be filed by the seller and managed by a member firm's authorized person through FINRA Firm Gateway. The buyer does not submit and drive the application. This lack of "control" may be frustrating.

The seller submits the change request application to its primary regulator, FINRA, and requests a change to its membership status; namely, a change in ownership. FINRA will require express written approval for any change of ownership or control above 25 percent.

A CMA is also required for material changes in business operations. Whether a change is material is a determined on a case-by-case basis. Members who are expanding or altering their existing business practices should consult with counsel on whether they are required to file a CMA for a material change in business.

B. *Timing*

It is here that one of the primary benefits of buying a used BD occurs.

Although CMAs are subject to the same 180-day review process as NMAs, ownership changes are permitted to proceed on the 31st day, unless FINRA takes issue with the proposed ownership change. If FINRA does not restrict the firm from proceeding after 30 days, the member firm may proceed with the ownership change. If that happens, FINRA has 180 days to complete its review of a proposed ownership change application.

Nonetheless, FINRA's review remains open, and it retains authority to deny the application or advise the firm to withdraw the application.

C. *New Business Operation vs. New Ownership*

As noted above, a CMA may propose both a change of ownership and new business line or lines, also known as a material change in business operations. New ownership may occur after the 30-day review, but new business line(s) require the full 180-day processing. The firm will not be permitted to conduct the new line(s) of business until FINRA completes its review and issues an updated membership agreement.

FINRA also reserves the right to place an interim restriction on a firm's existing business based upon its first look. Put another way, FINRA can limit certain transactions or approved business lines while it performs its full 180-day review if concerns arise regarding the firm's adherence to the 14 standards of membership. Among the factors reviewed by FINRA at this stage are: management and supervision, contracts and agreements, monetary sources and firm regulatory history.

D. *Management and Supervision*

FINRA will examine an ownership change CMA for changes to a firm's management or supervisory personnel. If existing officers such as the Chief Executive Officer (CEO), CCO, CFO or FinOP or key supervisory principals are leaving the organization, FINRA may restrict parts or all of a firm's business while the new proposed officers or supervisors are considered pursuant to FINRA Rule 1014(a)(10)(D).

We usually recommend keeping the firm's officers and supervisors in place for a transitional period of up to 12-18 months, or make sure the new officers and supervisors included in the initial CMA submission are highly experienced to avoid FINRA restricting business lines or ownership changes while it processes the application.

E. *Contracts and Agreements*

FINRA reviews each ownership change to determine if important contracts and agreements will remain in effect. While FINRA's authority extends to any contract, third-party agreements that FINRA considers integral to the firm's business operations will also need to be assigned or re-executed.

FINRA may restrict the firm's business or the firm's ability to consummate the ownership change if there are issues with certain third-party agreements, such as:

- a firm's clearing agreement;
- systems contracts (e.g., cybersecurity protocols, email, order management or execution management providers);
- audit agreement;
- fidelity bond;
- lease;
- insurance;
- vendor; and
- expense sharing or services agreements.

Assigning existing agreements or having new agreements is critical or FINRA will restrict certain business lines or the ownership change itself.

F. *The Money*

One of the more interesting aspects of the FINRA review is its consideration of three months of bank statements from the purchasing entity or individuals, including the source of those funds and other funding sources.

G. *Regulatory History*

Buyers inherit the selling firm's regulatory history and potential FINRA restrictions. If the new ownership has disclosure reporting items on the Form BD, Form U4 or CRD, one can expect enhanced or heightened scrutiny from FINRA.

Among the items that may result in FINRA restrictions on a firm's business or ability to complete the proposed ownership change(s) are: a "bad" history of state denials; FINRA, SRO or state examinations for cause; personal judgments; liens; bankruptcies; and outstanding regulatory or criminal matters involving owners, control persons, officers or supervisors.

IV. Conclusion

Proceeding with either the NMA or the CMA is fraught with peril and incredibly time consuming. Thus, having experienced and knowledgeable counsel is paramount to help you manage either process.

PART II – INVESTMENT ADVISER FORMATION

There are two paths to becoming a registered investment adviser (RIA); either registering with the United States Securities and Exchange Commission (SEC) or with the state where the RIA will have it principal place of business. Registering with the SEC is only required if the RIA will have over $150 million in assets under management (AUM).

I. Registration Process

Registering with either the SEC or the state where you intend to do business is required, except: (i) where the investment services or advice will be incidental to your business as an accountant, attorney, engineer, teacher, bank, broker-dealer, publisher, U.S. government securities adviser, or Commodity Futures Trading Commission (CFTC) registrant; (2) where the providing of investment advice is not a primary line of business; or (3) for charitable advisers. From the SEC's perspective, incidental must be just that.

Firms or individuals who manage more than $150 million in AUM are required to file with the SEC, while those with fewer AUM must register with the state of its principal place of business. However, any firm or individual acting as an investment adviser for an investment company is also required to file with the SEC, regardless of its AUM.

Firms that register with the SEC (i.e., more than $150 million of AUM) are never required to file with states, except to provide notice of their SEC registration with each state where they do business.

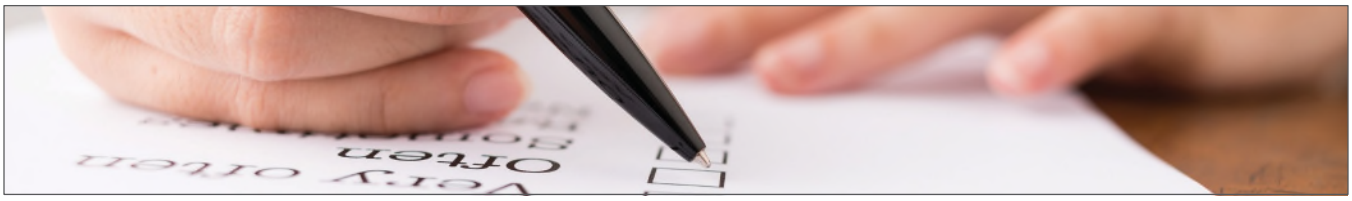
The majority of states do not require registration or filing of notice if the advisor has less than five clients in the state and does not have a place of business in that state. Most RIAs register as a corporation or limited liability company (LLC), and each employee then acts as a representative of the investment advisor (IARs). Although corporate registration may limit a RIA's financial liability, it does not shield legal or regulatory action where the RIA violates rules.

II. Licensing and Qualifications

To become an RIA, one must pass the Series 65 (Uniform Investment Advisor Law) exam. Although this up to three-hour exam is administered by FINRA, a person is not required to be sponsored by another RIA. The test encompasses legal and other topics, has 140 multiple choice questions (only 130 of which count towards the final grade); and one must obtain a 72 percent to pass.

The Series 65 is all that is required to become an RIA, but some advisers have additional professional designations, such as the CFP® or CFA designation. Many states will actually allow advisors who carry the following designations in good standing to waive the Series 65 exam:

- Certified Financial Planner® (CFP®)
- Chartered Financial Analyst (CFA)
- Chartered Investment Counselor (CIC)
- Chartered Financial Consultant (ChFC)
- Personal Financial Specialist (PFS)



III. The Registration Process

The first step in the registration process is to create an account with Investment Adviser Registration Depository (IARD). This system is managed by FINRA on behalf of the SEC and each state. A few states do not require an account; therefore, RIAs who only do business in those states do not have to use this system.

Once the account is open, FINRA will supply the adviser or firm with a CRD number and account ID information. The RIA may then file its Form ADV and the U4 forms with either the SEC or each state in which it does business.

The Form ADV is the government's official application document for RIA applications.

It has multiple sections that all must be completed, although only the first section is electronically submitted to the SEC or applicable state agency for approval. Part II of the Form ADV serves as a disclosure document that is distributed to all clients. Regulators still review this section during the examination process to ensure the adequacy of the disclosures. Part II must list, among other things: all services that are provided to clients; a breakdown of compensation and fees; possible conflicts of interest; the firm's code of ethics; the RIA's financial condition; educational background and credentials of the individual advisers; and any affiliated parties.

The Form ADV must be uploaded electronically into the IARD, and provided to all new and prospective clients. The preparation and submission of these forms typically requires weeks of work. The SEC must respond to the application within 45 days and some states may respond as soon as 30 days. Nonetheless, the process, in either case, is often delayed by SEC requests for additional information and questions that need clarification. All firms that register with the SEC (and some states) must also create a comprehensive written compliance program that covers all aspects of their practice, from trading and account administration to sales, marketing, internal disciplinary procedures, and even cybersecurity protocols.

Once the SEC (or state) approves an application, the firm may engage in business as an RIA and is required to file an annual amendment to Schedule 1 of the ADV, updating all of the firm's relevant information (such as the AUM). Although the SEC has no specific financial or bonding requirements for RIAs, such as a minimum net worth or cash flow, it does closely examine the RIA's financial condition during the application process. Most states require RIAs to have a net worth of at least $35,000 if they have actual custody of client funds, and $10,000 if they do not. RIAs who fail to meet this requirement must post a surety bond. The rules for this requirement, as well as several other aspects of registration, vary from state to state.

IV. Fees

RIAs charge usually charge their customers either (i) a percentage of AUM, or (ii) a flat or hourly fee. To simplify their recordkeeping and administration, many RIAs also use another firm, such as a discount broker, to hold their clients' assets instead of internally holding the accounts. Many brokers with securities licenses also carry the Series 65 license to offer professional money management services such as wrap programs similar to the percentage of AUM programs at RIAs.

V. Regulatory Oversight

The SEC and the relevant state authorities oversee RIAs. RIAs are legally required to act as a fiduciary for their clients at all times. The fiduciary standard requires that advisers unconditionally put their clients' best interests ahead of their own at all times and in all situations and circumstances.

Recently, the SEC proposed new Rule 206(4)-(4) under the Investment Advisers Act of 1940. The proposed rule would require RIA's to adopt and implement business continuity and transition plans that address material risks that could lead to a disruption in an RIA's operations. Notably, in a prior release, the SEC indicated that the an RIA actually owes a fiduciary duty to its clients to implement business continuity and transition plans in order to ensure that client's interests are protected in the event of, *inter alia*, a natural disaster or the death of key personnel.

VI. Conclusion

RIAs may enjoy greater freedom than their counterparts in the BD industry who work on commission, but they have a higher standard of conduct (i.e., fiduciary duty versus suitability). Accordingly, prospective RIAs should consult with experienced counsel before undertaking this endeavor.

PART III – STARTING A COMMODITIES OR FUTURES BUSINESS

I. Commodity Act

The Commodity Exchange Act requires a fund that trades futures contracts or commodity options or invests in another commodity pool, to register with the National Futures Association (NFA) and CFTC as a Commodity Pool Operator (CPO) or Commodity Trading Advisor (CTA).

Experienced counsel and prudent planning is essential in any endeavor.

II. Commodities Pool Operators and Commodities Trading Advisers

A commodity pool is an enterprise where funds contributed by a number of persons are combined for the purpose of trading future contracts or commodity options or to invest in another commodity pool. A CPO is an individual or organization that operates or solicits funds for a commodity pool. A CTA is an individual or organization that, for compensation or profit, advises others as to the value of or the advisability of buying or selling futures contracts or commodity options.

A. *Registration and Exemptions*

1. CPOs

CPOs must be registered unless the CPO qualifies for an exemption outlined in Part 4 of the CFTC Regulations §§ 4.5, 4.7, 4.12, or 4.13(a)(1)-(4). In general, the following qualify for this registration exemption:

- otherwise regulated entities, such as a bank, trust company or other financial depository institution, an insurance company, a registered investment company, a trustee of, a named fiduciary of or an employer maintaining a pension plan that is subject to Title I of ERISA;
- CPOs that are only open to "qualified eligible persons," that is, persons who meet a certain level of sophistication;
- pools that are offered pursuant to the Securities Act of 1933 and whose futures trading is incidental (i.e., limited to 10% of pool's assets) to securities trading activities;
- a pool operator who operates only one pool at a time, does not receive any compensation or does not advertise in connection with the pool and the operator is not otherwise required to register with the CFTC;
- total gross capital contributions in all pools operated do not in the aggregate exceed $400,000 and none of the pools operated has more than 15 participants; or
- pools where less than 10 percent of the firm's assets are invested in futures.

If a CPO qualifies for an exemption, the pool operator must electronically file a notice of exemption from CPO registration through the NFA Electronic Exemption Filing System.

2. CTAs

CTAs must be registered unless the CTA qualifies for an exemption outlined in Part 4 of the CFTC Regulations §§ 4.6 and 4.14. In general, the following qualify for this registration exemption:

- an insurance company whose activities are solely incidental to the conduct of the insurance business;
- otherwise regulated entities, such as a bank, trust company or other financial depository institution, an insurance company, a registered investment company, a trustee of, a named fiduciary of or an employer maintaining a pension plan that is subject to Title I of ERISA, provided, however, that the commodity interest advisory activities are solely incidental to its operations;
- the adviser has provided advice to 15 or fewer persons during the past 12 months and does not generally hold himself out to the public as a CTA; or
- the adviser is one of a number of businesses or professions listed in the Commodity Act, such as a dealer, processor, broker or seller in cash market transactions, a nonprofit, voluntary membership, trade organization, a registered associated person and the trading advice is solely incidental to the business.

In contrast to CPOs, those that qualify for CTA exemptions need not file any type of notice with the authorities to effectuate the exemptions.

B. *Requirements*

CTAs and CPOs that do not qualify for an exemption are required to file:

- completed online Form 7-R;
- completed online Form 8-R and an $85.00 fee for each principal, except that the fee is $65.00 for each Form 8-R filed in accordance with NFA Rule 209;
- fingerprint card, unless such person is already registered with the CFTC; and
- nonrefundable $200.00 fee.
- CTA or CPO membership dues, if applicable, of $750.00

Form 7-R is the firm registration application. A firm must have at least one principal affiliated with it to obtain registration. The application requests the applicant to fill in the following information: business name, address, form of organization, location of all business records, names and addresses of principals, holding company's name, branch office information, including names of branch managers and addresses, criminal disclosures, disciplinary disclosures, financial disclosures (including disclosures of bankruptcy and/or adversary actions), registration contact, membership contact, accounting contact, assessment fee contact, arbitration contact, compliance contact and enforcement/compliance contact.

Form 8-R is the individual registration application. Form 8-R requires the individual to include his name, address, criminal disclosures, exchange affiliations, regulatory disclosures, financial disclosures (including bankruptcy and/or adversary actions), employment disclosures, education history, residential history, proficiency requirement disclosures and fingerprint card.

Individuals applying for registration as a principal or associated person (AP) must satisfy proficiency requirements. To satisfy such requirements, the individual principal or AP must pass the Series 3 exam within the two years preceding the application. Individuals may avoid taking the Series 3 exam if they are qualified for, and successfully take, the Series 32 exam or another alternative exam:

- within two years of the date of application; or
- more than two years prior to the date of application and since that date there has not been a period of two consecutive years during which the individual was not registered as an AP or floor broker.

An AP is a person who solicits orders, customers or customer funds (or who supervises persons so engaged) on behalf of a CPO or CTA. Essentially, an AP is a salesperson or person who supervises salespersons for a CTA or CPO. Only registered associated persons may handle customer accounts. Registration is required for any person in the supervisory chain of command and includes a completed online Form 8-R, completed fingerprint card and $85 fee, unless the person is already registered with the CFTC.

To satisfy the proficiency requirements for individuals applying as a branch manager, the branch manager must pass the Series 30 exam or an alternative. A branch manager will have already satisfied the requirements if the NFA has evidence that the individual has taken and passed the Series 30 and since the date the individual last ceased acting as a branch office manager, there has not been a period of two consecutive years where he or she has not been registered as an AP.

C. *Potential Issues for CPOs and CTAs*

1. **Registration**

CPOs and CTAs must ensure all individuals responsible for supervising associated persons are registered as an AP. Similarly, they must review commission payouts and other

disbursements to ensure that only NFA members are being paid for customer business. For unregistered individuals, CPOS and CTAs must implement procedures that ensure that such individuals can only accept customer orders if they are acting in a purely clerical manner.

2. **Supervision**

   These entities must maintain a compliance procedures manual that includes the entities' established policies and procedures for handling, recording, investigating and responding to customer complaints.

   They must also designate a compliance officer – who is responsible for handling customer complaints – and provide associated persons with training on futures and options markets and sales solicitation. Further, if a pre-dispute agreement is included in the customer account documentation, the firm must provide customers with a list of three fora, one being the NFA, in the event the customer gives notice of intent to file a claim.

3. **Ethics Training**

   These firms must also establish policies and procedures relating to ethics training requirements for associated persons. The ethics training policies and procedures should cover areas such as content, frequency and format of training. They must also require associated persons to attend ethics training in accordance with the CFTC's Statement of Acceptable Practices and NFA's Interpretative Notice on Ethics Training Requirements.

4. **Disaster Recovery Plan**

   These firms must establish, maintain and test a disaster recovery plan, as well as maintain a complete inventory of all information technology and essential documents.

5. **Cybersecurity Plan**

   The NFA has promulgated an interpretive notice on NFA Compliance Rules 2-9, 2-36 and 2-49 regarding cybersecurity programs. The notice focuses on several important areas:

   - **risk assessments and analysis**: where there are data sensitivities, locations and risks are reviewed, as well as inventories, funds transfers and the risks around physical theft, system and compromised accounts or machines;
   - **written information systems security policies (ISSPs)**: granting flexibility to organizations in relied upon frameworks and the structure of these policies. The guidance specifically details the value of a written Incident Response Plan;
   - **staff training:** to help raise awareness around the policies, common threats and risks to the business upon hiring, to be done annually for all staff;
   - **institution of protective measures**: including intrusion detection and data loss prevention software and hardware;
   - **review:** periodic (at least yearly) ISSP and program review;

- **vendor inquiry and diligence:** as to risks, protections and security posture; and
- **recordkeeping**: around the program implementation and compliance.

The NFA has also added a cybersecurity section to its Self-Examination Questionnaire.

6. **Account Opening**

CPOs and CTAs also must require: (i) all necessary information be on file before new accounts are allowed to commence trading; (ii) approval from a partner, officer, director, branch office manager or supervisory employee for customer accounts; and (iii) the following information must be obtained from customers: name, address, occupation or business description, estimated annual income, estimated new worth, age and prior investment and futures trading experience.

7. **Promotional Material**

Firms must:

a. Maintain all promotional material for a period of five years from the date last used.
b. Maintain supporting documentation for all statements, claims and performance results.
c. Include a statement of risk of loss if the material mentions the possibility of profit, including the presentation of past performance results.
d. Calculate hypothetical results in the same way as actual results.
e. Explain all material assumptions made in preparing hypothetical results that includes at least the minimum investment amount, distribution or reinvestment of profits, commission charges, management and incentive fees and the method used to determine the purchase and sale price for each trade.
f. Submit all radio or television advertisements that make any specific recommendations or refer to or describe the extent of any profit obtained in the past or that can be achieved in the future to NFA's promotional material review team for its review and approval at least 10 days prior to first use.

g. Prohibit the use of promotional material that contains the following:
   i. claims regarding seasonal trade;
   ii. claims regarding historical price moves;
   iii. claims regarding price movements that are characterized as conservative estimates when in fact such price movements would be dramatic;
   iv. claims using certain pricing data for a product different from the one being marketed in the promotional material;
   v. claims containing profit projections;
   vi. claims containing "cherry picked' trades; and
   vii. claims regarding mathematical examples of leverage as a means of suggesting that prospective customers are likely to earn large profits from trading.

h. Ensure that all promotional material meet the following requirements:
   i. proximately identifies the firm;
   ii. includes the date the material was first used;
   iii. provides contact information for obtaining a copy of the disclosure statement for security futures products;
   iv. states that security futures products are not suitable for all customers;
   v. does not include any statement suggesting that security futures positions can be liquidated at any time;
   vi. does not include any cautionary statement, caveat or disclaimer that is not legible, that attempts to disclaim responsibility for the content of the promotional material or the opinions expressed in the material, that is misleading or that is otherwise inconsistent with the content of the material;
   vii. discloses the source of any statistical tables, charts, graphs or other illustrations from a source other than the firm, unless the source of the information is otherwise obvious;
   viii. states that supporting documentation will be furnished upon request if it includes any claims, comparison, recommendations, statistics or other technical data;
   ix. includes current recommendations regarding security futures products only if: (i) the firm has reasonable basis for the recommendation; (ii) the material discloses all material conflicts of interest created by the firm's or AP's activities in the underlying security; and (iii) the material contains contact information for obtaining a list of prior recommendations; and
   x. includes only a general description of the security futures products for which accounts, orders, trading authorization or pool participants are being solicited; the firm name and contact information for obtaining a copy of the current disclosure statement for security futures products.

8. **Securities Futures Products**

Additionally, firms must:

a. Designate a security futures principal at each main or branch office.

b. Provide the required risk disclosure statement prior to opening an account.

c. Obtain the following additional information for customers:

i. identification that the customer account is speculative or hedge;

ii. employment status;

iii. estimated liquid net worth;

iv. marital status; and

v. number of dependents.

d. Submit a quarterly report to NFA regarding written customer complaints.

D. *Special Issues for CPOs and CTAs*

Like everything else, experienced counsel is essential for CPOs and CTAs. This holds especially true when addressing the issues below:

1. Structure

These firms must establish pools as separate legal entities from the CPO and ensure that checks received from pool participants are payable to the pool.

2. Account Statements

In addition to submitting account statements to the NFA, account statements must also be distributed to pool participants. These statements should include:

a. Statement of income and loss itemizing; realized commodity trading gain or loss, change in unrealized gain or loss, other gains and losses, management fees, advisory fees, brokerage commissions, other fees and expenses.

b. Statement of changes in net asset value itemizing, including beginning value, additions, withdrawals, net income/loss, ending value, value per unit or individual's interest in the pool and oath or affirmation manually signed by the proper individual. In addition, the statement should include the name of the signor, the capacity in which the individual is signing and the name of the commodity pool operator.

3. Financials

These firms must also engage an independent certified public accountant for each pool operated during their fiscal year and distribute copies of the annual certified reports to the NFA and to each participant within 90 days of the fiscal year end or within 90 days of when the pool funds were returned to participants. These reports must include the following for the preceding two years in the certified audit for each pool: net asset value of the pool, net asset value per outstanding participation unit in the pool, total value of the participant's interest or share in the pool, statement of financial conditions, statement of income and loss, changes in financial position, changes in ownership equity and any other information required to ensure the statements are not misleading.

4. Disclosure Document

CPOs should also file a disclosure document and any amendments with NFA either by mail or electronically at least 21 calendar days prior to the date you first intend to solicit clients with the document. CPOs should also maintain signed and dated acknowledgments of receipt of disclosure documents from each participant.

CTAs should provide prospective pool participants with disclosure documents, including any existing amendments, which are less than nine months old prior to accepting funds from the participants. CTAs should also provide current pool participants with all amendments to the disclosure documents.

These disclosure documents must include:

a. a cover page, with a statutorily specified disclosure; a statutorily specified risk disclosure statement; introduction, with name and address of main business office; list of principals; trading manager, including business background of the CPO; business background of the CTA and any principal of the CTA who will participate in making trading or operational decisions; principal risk factors of the trading program; and description of the trading and investment program, including types of commodities traded and any restrictions or limitations on such trading established by the trading adviser;

b. fees and a complete description of fees charged by the CTA; break-even analysis; any potential or actual conflict of interests; any material administrative, civil or criminal action, whether pending or concluded, within five years preceding the date of the disclosure document; performance disclosures of all accounts directed by the CTA and by each of its trading principals; and a disclaimer for past performance disclosures;

c. total assets, rate of return, expected range of returns, number of accounts traded pursuant to the trading program, the worst peak-to-valley draw-down experienced by the trading program during the most recent five calendar years and accounting in accordance with generally accepted accounting principles; disclose percentage allocation of pool assets invested in any pool in which more than 10 percent of the offered pool's net asset value is invested; description of any restrictions upon transferability of a participant's interest in the pool; liability of the pool participants; and distributions of profits and taxation.

PART IV – HEDGE FUNDS: SHOULD THEY REGISTER AS COMMODITY POOL OPERATORS?

Critically, given our substantial practice in the private equity field, we commonly see issues with our clients as to whether private equity funds or hedge funds require securities or broker-dealer registration. We deal with those issues in our other publication: "Private Equity and Hedge Funds: Regulatory Analysis and Structural Overview," available at: http://www.foxrothschild.com/publications/private-equity-and-hedge-funds-regulatory-analysis-and-structural-overview/. However, there are special issues when considering if funds must be registered as either a CPO or CTA.

A common belief among many is that hedge funds are unregistered and unregulated investment vehicles. While it is true that many hedge funds are exempt from registration under the Investment Company Act of 1940, hedge fund managers who trade in commodity options and future contracts may be required to register as CPOs.

As noted earlier, a commodity pool is an enterprise where funds are contributed by a number of persons combined for the purpose of trading futures contracts or commodity options, or to invest in another commodity pool. A CPO is an individual or organization which operates or solicits funds for a commodity pool. While there are exemptions, hedge fund managers should be aware that depending on the size, in terms of investors and net value, sophistication of the investors, and the percentage of assets invested in commodities trading, a hedge fund may have to register with the NFA and CFTC as a CPO if the manager invests in futures contracts or commodity options.

In 2012, the CFTC eliminated an exemption to registration that significantly impacts hedge funds and other private funds. Up to that point, to qualify for the exemption, the interests in the pool must have been exempt from registration under the Securities Act of 1933 and each participant had to be a qualified eligible person or an accredited investor. Now that the exemption has been rescinded, any private fund operating under that exemption must register with the CFTC. However, funds may still qualify for other exemptions, such as the *de minimis* exception.

A. *Registration Exemptions*

If you are a hedge fund manager and are trading in commodity options or futures contracts, before you rush to register your fund with the NFA, there are a number of exemptions that your fund may qualify for under the regulations. Generally, the following are exempt from registering with the NFA as a CPO:

- pools that are only open to "qualified eligible persons;"
- pools that are offered pursuant to the Securities Act of 1933 and whose futures trading involves less than 10 percent of the pool's assets;
- where the pool operator operates only one pool at a time and the operator does not advertise or receive any compensation in connection with the pool; or
- where the total gross capital contributions in all pools operated by the operator do not in the aggregate exceed $400,000 and none of the pools operated has more than 15 participants.

The most likely exemption for a hedge fund is where all of the investors are "qualified eligible persons." A "qualified eligible person" is a person who meets a certain level of sophistication. Briefly stated, "qualified eligible persons" include certain investment professionals, knowledgeable employees, qualified purchasers, non-United States persons or entities, accredited investors who meet a portfolio requirement, governmental entities, registered CPOs or registered commodity trading advisers, persons with net worth more than $1 million or a person with net income of more than $200,000 in each of the last two years or more than $300,000 when combined with a spouse.

If a hedge fund manager is trading commodity options and future contracts and believes that the fund qualifies for an exemption, the manager must electronically file a notice of exemption from CPO registration through the NFA's website. If the hedge fund does not qualify for any of the exemptions, then the manager must either register as a CPO or assure the NFA that the fund does not trade in commodities or future contracts.

B. *Registration Requirements*

Managers who are required to register as CPOs can file the required registration documents electronically through the NFA website at www.nfa.futures.org. As we discussed *supra* § III.II.B, registration requires a CPO to designate a principal to be affiliated with the CPO. The registration process includes filing a Form 7-R for the pool, Form 8-R for each individual principal, and the payment of certain fees and other submissions (i.e. fingerprint cards).

It bears repeating that principals and APs are the only persons who may solicit orders, customers or customer funds or handle customer accounts on behalf of the CPO. Principals and APs must satisfy proficiency requirements to be properly registered, which were discussed in greater detail above on pages 15-18. The most notable proficiency requirement is the Series 3 exam or an applicable alternative.

The registration process is not particularly onerous, but the compliance requirements that accompany CPO registration can greatly increase the cost and burden of operating the fund.

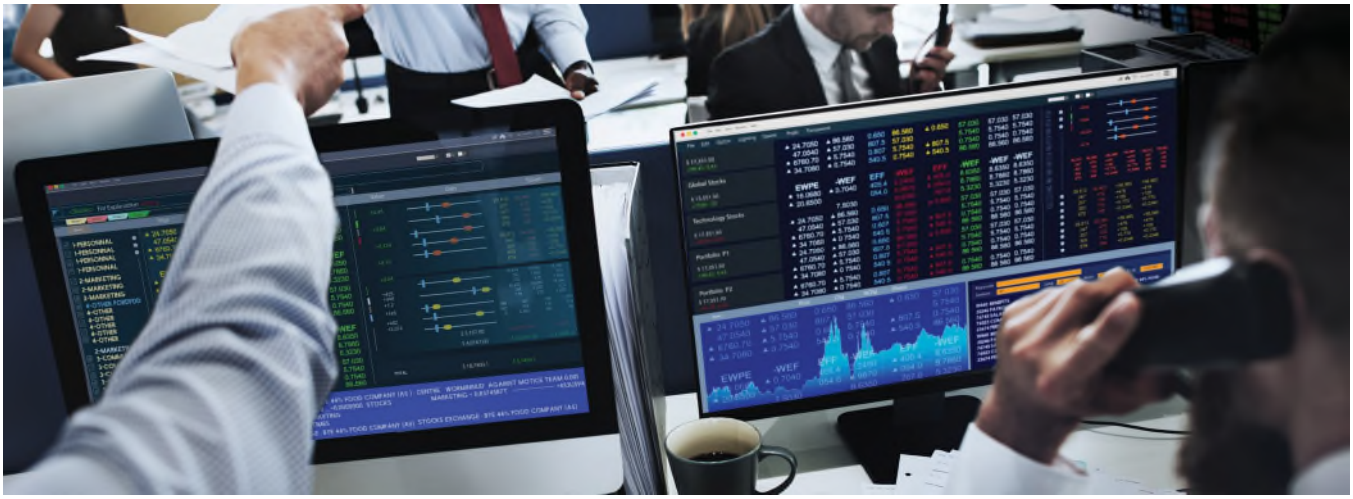
C. *Compliance Requirements*

As we discussed at length *supra* § III.II.C, registration as a CPO brings with it a host of compliance-related issues that fund managers must be cognizant of. To recap, these issues include, but are not limited to:

- Ensuring that the pool is set up as a separate legal entity and all checks from pool participates are made payable to the pool itself;
- All supervising AP's are registered and attend ethics training in accordance with the CFTC's Statement of Acceptable Practices;
- Policies and procedures are formulated for, *inter alia*, handling customer complaints and submitting quarterly reports to the NFA in relation thereto;
- Confirming that any and all promotional materials comply with CFTC regulations;

- Ensuring that all rules are followed in relation to account openings, maintenance, projections, recordkeeping and reporting.

Failure to have a comprehensive grasp on the gamut of issues facing CPOs can subject a hedge fund to unwanted scrutiny and, even worse, crippling sanctions. Combined with the issues already facing hedge funds, it is imperative that fund managers consult with knowledgeable legal counsel to ensure that their fund remains in compliance with all applicable rules and regulations.



D. *Conclusion*

Some hedge funds will easily fit within one of the exceptions listed above. Others, however, will have to take a close look at the CFTC regulations and determine whether it is worth investing in commodities and futures contracts. For some managers, this may be a tough decision. The cost of producing and complying with the CFTC regulations for CPOs could become onerous and extremely expensive. Fund managers that do not qualify for an exemption should keep in mind all the registration requirements and compliance issues discussed above when making their investment strategy decisions.

Therefore, it is essential for these funds to consult with experienced counsel before engaging in any commodities or futures business.

ABOUT THE AUTHORS

Ernest E. Badway | Partner | 212.878.7986 | 973.994.7530 | ebadway@foxrothschild.com

Ernest is co-chair of the firm's Securities Industry Practice and advises clients on a broad range of business matters, including securities, intellectual property, employment, corporate governance, partnership disputes, contracts and litigation. He also counsels clients on the creation of broker-dealers, hedge funds and investment advisers as well as compliance and regulatory matters relating to their operations.

Ernest is also the former co-chair of the firm's White Collar Compliance & Defense Practice and has extensive experience in representing individual and corporate clients in internal investigations.

Joshua Horn | Partner | 215.299.2184 | jhorn@foxrothschild.com

Joshua is co-chair of the Securities Industry Practice. He represents major financial services companies in matters throughout the country. He also represents financial advisory companies, individual advisors, and counselors in FINRA examinations, enforcement and arbitrations. Joshua has also represented individual brokers on disciplinary matters before FINRA and state securities commissions, and has represented companies and individuals in SEC investigations.

Joshua's practice also includes the representation of the premier merchant card processing company in various matters, including class actions, throughout the country.

Benjamin H. McCoy | Associate | 610.397.7972 | bmccoy@foxrothschild.com

Ben is an experienced trial and appellate litigator. He has a broad commercial practice with an emphasis on international, employment, entertainment and intellectual property litigation.

A substantial part of Ben's practice involves the representation of clients in international business litigation. Many of these cross-border disputes involve complex issues and often turn on the application of foreign law. Ben has particular experience litigating civil RICO claims, shareholder derivative suits, and breach of contract actions. In addition, Ben frequently works with foreign counsel in order to coordinate the prosecution of actions abroad.

Fox Rothschild LLP
ATTORNEYS AT LAW