CLIENT ALERT

NFA to Require CPOs to Adopt Internal Controls

January 18, 2019

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Commodity pool operators will be required to implement a written system of internal controls, pursuant to a new Interpretive Notice[1] adopted by the National Futures Association. NFA members should review their internal control policies and procedures now as this new requirement will take effect in the coming months.

NFA expects members to have a robust control environment. A CPO's internal controls system should be reasonably designed to deter and detect errors and fraudulent activity by both insiders and third parties. A strong system of controls enhances the CPO's ability to safeguard customer funds and provides reasonable assurance that the books and records of the CPO's commodity pools are reliable. NFA indicated that the key components of a strong and reliable system of internal controls include separation of duties and periodic analyses to identify critical risks. While a CPO must assess all risks attendant to its business, NFA identified three key areas of risk that all CPOs should consider: (i) pool subscriptions, redemptions and transfers; (ii) risk management and investment and valuation of pool funds; and (iii) the use of administrators.

The Notice contemplates that what constitutes an adequate system of controls will vary by CPO and will depend on the CPO's size, operations, complexity and activities. With the appropriate "tone from the top," each CPO member must adopt and implement written policies and procedures that are reasonably designed to ensure that the operations of the CPO are in compliance with applicable NFA rules and CFTC regulations.

[1] *See* NFA: Proposed Interpretive Notice "*NFA Compliance Rule 2-9: CPO Internal Controls Systems*" (Dec. 10, 2018) (the "Notice"), available here.

The CPO's written policies and procedures should explain the internal controls framework, describe the CPO's supervisory system, provide for escalation to senior management of reports of suspected circumventions of internal controls and address whether and when a matter should be reported to the firm's regulator. Each CPO must monitor the effectiveness of its implemented controls and make adjustments where necessary.

Separation of Duties

Segregation of duties is a long-recognized practice that helps guard against a single person being in a position to cover up errors and perpetrate fraud. The Notice states that, to the extent possible, day-to-day functions related to the handling of pool funds, trade execution activities, financial records and risk management should be performed by personnel other than those who supervise such functions. In those instances where supervisors also handle day-to-day functions, one of the CPO's principals or another appropriate supervisory person should periodically review the supervisor's work in material areas.

The Notice states that, in order to ensure proper segregation of duties, the CPO should seek to require that:

- Duties are assigned to different employees in a manner that ensures that there is regular cross-checking of the work performed in material areas;
- Operational functions relating to the custody of pool assets are separated from financial reporting functions such as recordkeeping/accounting for the assets; and
- With respect to subscriptions, transfers and redemptions, no one person is responsible for initiating a transaction, approving the transaction, recording the transaction and reconciling the account to third party documentation and information.

Key Risk Areas

Pool Subscriptions, Redemptions and Transfers

Controls with respect to subscriptions, redemptions and transfers should include:

- Verification that pool investments are held in accounts in the pool's name and are not commingled with the assets of any other person;
- Reconciliation of transactions between the pool's financial records and those of banks and other third party depositories;

- Verification of the authenticity of redemption requests, that adequate funds are available, that the pool's NAV has been properly calculated and that timely payment of redemption proceeds is made; and

- Verification of compliance with NFA Compliance Rule 2-45, which generally prohibits loans from a pool to its CPO and affiliates.

Risk Management and Investment and Valuation of Pool Funds

The Notice indicates that appropriate principals of the CPO should be directly involved in assessing and monitoring the risks posed in these areas. Specifically, controls should be in place to:

- Ensure appropriate approval of investments and consistency thereof with the pool's strategy;

- Verify that the pool's investments are valued in accordance with the CPO's valuation policies;

- Provide ongoing due diligence of counterparties and others with which the pool's assets are custodied;

- Monitor the market, credit and other risks associated with investments held at third parties; and

- Monitor pool liquidity to ensure the pool is able to satisfy redemption requests, margin calls and other financial obligations.

Use of Third Party Administrators

According to the Notice, a CPO that engages an administrator to prepare pool financial records and account statements or perform other services should implement controls designed to ensure adequate supervision of the activities of the administrator on behalf of the pool. In connection with administrators, the CPO's controls should include initial and ongoing due diligence with respect to, among other things, the administrator's reputation, expertise, attention to detail, responsiveness, technological tools (including cybersecurity) and costs. The CPO also should be familiar with the administrator's processes and procedures (on an ongoing basis) to ensure that the CPO remains comfortable with the administrator, its services and its personnel. The CPO should obtain evidence that an internal audit department or independent specialist has examined the administrator's controls and security measures.

The Notice recommends that a CPO also consider whether its own independent financial records (*i.e.*, shadow books) are necessary as a control to ensure that the CPO's records and financial statements are in agreement with those of the administrator.

Recordkeeping

Each CPO must maintain records to demonstrate that it has implemented an effective system of internal controls.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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