

Compliance with New NFA Written Supervisory Framework Requirement for CPO and CTA Members that Outsource Regulatory Functions to Service Providers – Answers to Frequently Asked Questions

I. Introduction and Executive Summary

Effective Sept. 30, 2021, a new National Futures Association (“**NFA**”) Interpretive Notice (the “**Notice**”) will require all NFA Members, including commodity pool operator (“**CPO**”) and commodity trading advisor (“**CTA**”) Members, to adopt and implement a written supervisory framework (an “**outsourcing framework**” or “**framework**”) over their outsourcing of **regulatory functions** to third-party service providers or vendors, including affiliated entities (“**Service Providers**”).¹ The term “**regulatory function**” refers to functions that the Member itself would otherwise be required to undertake in order to comply with regulatory requirements imposed on the Member by NFA or the Commodity Futures Trading Commission (the “**CFTC**”). The outsourcing framework requirement is designed to mitigate the risks associated with outsourcing regulatory functions, and arises from NFA Compliance Rule 2-9, which places a continuing responsibility on Members to diligently supervise their employees and agents in all aspects of their commodity interest activities.

While NFA recognizes that Members need flexibility to design an outsourcing framework that is tailored to their specific needs and business, the Notice requires the framework to address, at a minimum, the following five areas:

- Initial risk assessment;
- Onboarding due diligence;
- Ongoing monitoring;
- Termination; and
- Recordkeeping.

¹ See NFA Interpretive Notice 9079, NFA Compliance Rules 2-9 and 2-36: Members’ Use of Third-Party Service Providers (effective Sept. 30, 2021), <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9079>. See also NFA Notice to Members I-21-13, Effective Date for Interpretive Notice regarding Members’ Use of Third-Party Service Providers (Mar. 24, 2021), <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=5342>; Rule Submission to the CFTC, Proposed Interpretive Notice entitled NFA Compliance Rules 2-9 and 2-36: Members’ Use of Third-Party Service Providers (Feb. 26, 2021), <https://www.nfa.futures.org/news/PDF/CFTC/022621-ProposedInterpNoticeCRS2-9and2-36-MembersUse3rdPartyServiceProviders.pdf> (“**Rule Submission**”).

The Notice also applies to other NFA Member categories, *i.e.*, futures commission merchants (“**FCMs**”), introducing broker (“**IBs**”), swap dealers (“**SDs**”), major swap participants (“**MSPs**”) and forex dealers. However, for purposes of this client alert, we have focused on application of the Notice to CPOs and CTAs.

The Notice provides guidance on the types of supervisory provisions that Members should include or consider in each of these areas. In order to further assist Members in drafting their outsourcing frameworks, NFA has published a detailed questionnaire specifically relating to the new outsourcing framework requirement and the guidance provided in the Notice, which is referenced in a new section about the use of Service Providers in the NFA self-examination questionnaire, and has included a segment on the Notice as part of its 2021 Virtual Member Regulatory Workshop (collectively, the “**Additional Guidance**”).²

The Notice will require NFA Members to review their existing outsourcing policies and procedures and, if appropriate, make adjustments in accordance with the requirements and guidance set forth in the Notice. While CPOs and CTAs, and in particular those subject to comprehensive regulation by the Securities and Exchange Commission (“**SEC**”) under the Investment Company Act of 1940 (the “**ICA**”), the Investment Advisers Act of 1940 (the “**Advisers Act**”), and other federal securities laws (“**dual registrants**”), will already have substantial outsourcing policies and procedures in place, the guidance in the Notice describes a number of specific measures and considerations that may not necessarily be expressly included in a particular Member’s existing outsourcing practices. In addition, the Notice makes clear that Members will be expected to be able to demonstrate, through appropriate records and documentation, that they have addressed, at a minimum, the five required areas identified in the Notice.

This client alert describes the requirements and guidance set forth in the Notice, as well as the Additional Guidance, and suggests next steps for Member CPOs and CTAs to consider in order to have in place an outsourcing framework consistent with the Notice in time for the Sept. 30, 2021 effective date. To address the practical and interpretive issues that have arisen in the review and implementation process, we have used a “Frequently Asked Questions” (“**FAQs**”) format. Answers to the FAQs are set forth in Section II, below, and are divided into sections by subject matter that address: (1) the purpose and scope of the new requirements; (2) the specific guidance provided for each required section of the framework; and (3) next steps for designing a tailored outsourcing framework that complies with the Notice (including tools provided by NFA for this purpose).

II. Answers to Frequently Asked Questions

A. Purpose and Scope of the Notice

1. What is the purpose of the new outsourcing framework requirement?

NFA recognizes that Members may fulfill some of their regulatory obligations by having one or more Service Providers perform a regulatory function. However, a Member remains responsible for the performance of such functions in compliance with applicable NFA and CFTC requirements and may be subject to discipline if a Service Provider causes the Member to fail to comply with those requirements. The outsourcing framework requirement is intended to mitigate the risks associated with outsourcing the Member’s regulatory functions.

² All of these materials are available on NFA’s website. See NFA Self-Examination Questionnaire – Use of Third-Party Service Providers, <https://www.nfa.futures.org/members/member-resources/files/self-exam-files/self-exam-questionnaire.pdf>; Appendix E - Use of Third-Party Service Providers Questionnaire, <https://www.nfa.futures.org/members/member-resources/files/self-exam-files/self-exam-questionnaire-appendix-e.pdf>; and NFA 2021 Virtual Member Regulatory Workshops, Segment: “Member Outsourcing to Third Parties,” <https://www.nfa.futures.org/members/member-resources/files/2021-regulatory-workshop.html>.

2. Are there specific instances of misconduct or concern that gave rise to the new requirement?

Neither the Notice nor NFA's explanation of the Notice provided in its submission of the Notice to the CFTC for approval identifies any particular incident or industry trend that gave rise to the Notice. However, we understand that NFA has seen instances in the past where vendors did not fulfill the responsibilities that had been outsourced to them, which led to deficiencies by Members. For example, some Members have used third parties for performing required calculations, such as of net asset value or net capital, where the calculations were not done correctly and the errors were not caught by the Member, due to absence of adequate monitoring or verification procedures. In addition, NFA has seen firms use third-party vendors for recording and maintaining calls with customers where, because of outages or for other reasons, vendor records were lost. NFA also wanted to remind Members that they remain responsible for compliance of the outsourced regulatory functions.

3. What is a regulatory function?

The Notice does not define the term "regulatory function," but generally refers to functions that would otherwise (if not outsourced) be undertaken by the Member itself to comply with NFA and CFTC requirements. The Notice further describes a Member's regulatory functions as those for which a compliance failure, whether by the Member or by a Service Provider to which the function has been outsourced, may expose the Member to disciplinary action. The Notice does not outline which regulatory functions may or may not be outsourced, noting that this determination rests with the Member.³

As a general matter, the Notice refers to regulatory functions such as keeping and maintaining required records, data security, protection of customer assets, and preparation of financial and other information for regulatory and customer reporting. In addition, the Notice provides a number of specific examples of regulatory functions, including conducting annual branch office reviews, conducting initial due diligence on a potential branch office, collecting long-term outstanding debit balances, monitoring outstanding daily margin calls, issuing swaps confirmations, calculating and issuing margin calls, and reporting swaps data to a swap data repository.

Note that the Notice is directed to all NFA Member categories, not specifically to CPOs and CTAs, and that not all of the specific examples of regulatory functions provided in the Notice are directly relevant to the operations or regulatory functions of CPOs and CTAs. While these examples may provide guidance by way of analogy, in order to identify regulatory functions for CPOs and CTAs in particular, one method would be to review general areas covered by CFTC and NFA rules applicable to CPOs and CTAs, such as Part 4 of the CFTC's regulations and NFA rules and notices that specifically mention CPOs and CTAs.

4. What types of Service Providers perform a regulatory function and thus must be covered by the framework?

The first step in complying with the Notice will be to identify Service Providers that perform outsourced regulatory functions for the Member CPO or CTA. The Notice clearly

³ See Notice at n.8.

states that compliance with the Notice is required **only** with respect to Service Providers that perform functions to assist the Member in fulfilling its regulatory obligations that address NFA and/or CFTC requirements.⁴

Some types of Service Providers will be common to most if not all NFA Members, such as providers of information security and data storage services. Other examples NFA has provided, either in the Notice or the Additional Guidance, include accountants that compute performance or net capital calculations and vendors that maintain voice records of conversations with customers, conduct anti-money laundering or cyber security audits, or conduct background checks on employees.

The types of Service Providers that are retained to perform regulatory functions for CPOs and CTAs, however, in particular by dual registrants, are likely to vary significantly from those retained by Members in other categories, such as FCMs, SDs, and IBs. Based on the guidance and examples in the Notice, relevant Service Providers for CPOs and CTAs would likely include, among others, custodians, transfer agents, and fund administrators with responsibility for financial statements, shareholder reports and account statements, net asset value calculations, and regulatory reporting.⁵ Arrangements with some types of vendors, for example, pricing vendors that provide input for valuation of portfolio holdings, may require further analysis to determine whether they involve outsourcing to Service Providers as contemplated by the Notice. There may also be vendors or other parties providing services to a CPO or CTA that are not clearly contemplated as Service Providers in the Notice, but that the Member may wish to include in the framework for other reasons, such as organizational efficiency, consistency, or general risk management.

5. Are affiliated Service Providers included?

While the Notice refers to “third-party” Service Providers, the Notice also states that Members should comply with the Notice’s requirements “even if a Member outsources a regulatory obligation to an affiliate.”⁶ However, as described in Section II.C below, it may be reasonable for some of the requirements of the Notice, such as specific due diligence measures, to be applied differently when the Service Provider in question is an affiliate.

6. Does the Notice apply to existing as well as new Service Provider relationships?

The Notice makes clear that the outsourcing framework should address outsourcing relationships in place prior to the Sept. 30, 2021 effective date, as well as new relationships. While two of the required areas – initial risk assessment and onboarding due diligence – are directed to the initial phases of the arrangement, the remaining three areas -- ongoing risk monitoring, termination, and recordkeeping – apply throughout the term of the relationship. Moreover, while recommending that the guidance be considered in connection with renewing or renegotiating existing agreements, NFA acknowledges that some of the guidance in the Notice, in particular guidance relating to written agreements, may need to be adapted for agreements that are already in place.⁷

⁴ See Notice, text accompanying n.6.

⁵ See “Use of Administrators” section of NFA Interpretive Notice 9074, NFA Compliance Rule 2-9: CPO Internal Controls System, (effective Apr. 1, 2019), <https://www.nfa.futures.org/rulebook/rules.aspx?RuleID=9074&Section=9>.

⁶ See Notice at n.1.

⁷ See *infra* Section II.B.2.f.

7. How does the outsourcing framework apply to CPO and CTA Members that are part of a holding company or other large organization?

NFA recognizes that a Member may be part of a larger holding company that has a dedicated procurement or vendor management department responsible for onboarding and maintaining Service Provider relationships for the Member. The Notice states that a Member may meet its obligations under the Notice through this centralized department as long as the areas described in the Notice are addressed with respect to the Member. In addition, in these situations, Members should ensure that all employees involved in the process, including those of other entities in the organization, are aware of the Notice's requirements.⁸

8. What additional guidance or tools has NFA provided for designing an appropriate outsourcing framework?

For assistance to Members in drafting their outsourcing frameworks, NFA has published a questionnaire entitled "Use of Third-Party Service Providers Questionnaire" ("**NFA Service Provider Questionnaire**"), which sets forth a series of questions in each required area (other than recordkeeping), which are based on the guidance that the Notice provides in that area.⁹ The Questionnaire includes both general and specific questions for each required area. For example, under "Initial Risk Assessment," the questions include, among others:

- "How does the firm determine whether a regulatory function is appropriate to outsource?"
- "What risks does the firm evaluate when considering whether to outsource a function?"
- "How are employees that are involved in the risk assessment process made aware of [the Notice]?"

Similarly, under "Onboarding Due Diligence," the questions include, among others:

- "What is the firm's process for conducting due diligence on prospective third-party service providers?"
- "What is the firm's process to ensure compliance with Bylaw 1101 when selecting a third-party service provider?"
- "How does the firm identify whether a third-party service provider subcontracts any outsourced regulatory functions?"¹⁰

⁸ The fact that a Member's outsourcing of a function is implemented through a contract between the Service Provider and another entity in the Member's organization does not take the relationship outside of the Notice's requirements. The Notice states that a Member should comply with the Notice's requirements "even if a Member outsources a regulatory obligation to . . . a Third-Party Service Provider with an existing contractual relationship with the Member's parent entity." Notice at n.1.

⁹ See *supra* note 2 and accompanying text.

The NFA Service Provider Questionnaire states that the Member’s outsourcing framework should answer all of the questions as completely as possible. Although a Member may answer “not applicable” to certain questions, the Member should carefully consider the firm’s operations before doing so and maintain records to demonstrate that it has addressed the area.

NFA has also provided an online educational program on the Notice as part of its most recent virtual regulatory workshop, which includes both a video presentation and slides (the “**Workshop**”).¹¹ The Workshop includes background information on the Notice, as well as specific examples of regulatory functions to be addressed and practical guidance on questions raised by the Notice.

9. Must a Member CPO’s or CTA’s outsourcing framework expressly cover everything described in the Notice?

The Notice requires every Member CPO and CTA that outsources any regulatory function to a Service Provider to have a written supervisory framework over its outsourcing function that, at a minimum, addresses each of the five areas specified in the Notice – initial risk assessment, onboarding due diligence, ongoing monitoring, termination, and recordkeeping – which are referred to as the “general requirements” for the framework. The Notice also provides more detailed guidance relating to each of these required areas.

While Members must comply with the general requirements in determining which specific elements of the guidance in each area a particular Member’s outsourcing framework should include, the following considerations should be kept in mind.

- Members have flexibility to adopt a framework that is tailored to a Member’s specific needs and business. As a general matter, the specific guidance for each required area should be interpreted in light of its purpose, which is to mitigate outsourcing risk. For dual registrants, this will include recognition of outsourcing requirements already in place in compliance with SEC regulatory requirements.
- As part of the recordkeeping requirement of the Notice, Members must maintain documentation sufficient to demonstrate that they have addressed all five of the required areas.
- In the event a Service Provider does fail to perform in a manner that meets the Member’s regulatory requirements, the Member is ultimately responsible for this failure and, based on the facts and circumstances, may be subject to discipline. It can be expected that the thoroughness (or lack thereof) of a Member’s outsourcing framework relative to the guidance will be part of the facts and circumstances considered in any determination of the Member’s responsibility for a compliance failure by a Service Provider.
- As indicated in the NFA Service Provider Questionnaire, Members may determine that some components of the guidance addressed in the Questionnaire are not applicable to

¹⁰ In the same vein, the questions under “Ongoing Monitoring” include, among others: “What and how often does the firm review to ensure the [Service Provider] is adequately performing the outsourced function” and “Does the firm require the third party to provide notice if a key employee with access to the Member’s information is terminated and ensure the individual’s access to this information has been removed”; the questions under “Termination” include, among others: “Does the written agreement with the [Service Provider] require they give sufficient notice prior to terminating its relationship with the Member?”

¹¹ See *supra* note 2.

their organization. However, they should carefully consider the firms' operations before doing so.

- The guidance relating to several areas may overlap, and an outsourcing framework need not address each of the five areas in isolation, provided the issues and risks associated with each area are addressed in the Member's initiation and management of its outsourced relationships.¹² It should also not be necessary to restate policies and procedures that are found in different places. Nonetheless, given the need for Members to demonstrate that they have addressed all of the required areas, as a practical matter it may be helpful to create and maintain an "umbrella" framework that includes a section for each of the five required areas that, where appropriate, refers to other policies and procedures in place that implement the required area.
- While the Notice states that Members must address the five areas, guidance on each specific area is expressed in terms of specific measures, some of which Members should take, and others of which Members should consider taking, should use reasonable efforts to take, or may take. In describing each section of the guidance in Section II.B, below, we have attempted to preserve these differences, in order to accurately convey the flexibility embedded in the guidance.

10. Will NFA ask to see a Member's regulatory framework in routine NFA exams?

Members should expect that a request for documentation demonstrating that the Member has addressed the five required areas will be a routine requirement in NFA exams, independent of any actual compliance failure on the part of a Service Provider. In the Workshop presentation, NFA staff have indicated that such requests may include not only the policies and procedures relating to outsourcing, but also supporting materials showing that the Member has followed the policies and procedures. For example, if the framework calls for the use of a due diligence questionnaire, NFA may ask to see a sample Service Provider response. NFA guidance on what it expects in exams can be useful in drafting an outsourcing framework, as discussed below in Section II.C.3 ("Designing an Outsourcing Framework – What will NFA look for in exams?").

11. Does the Notice supersede existing NFA guidance in specific areas?

NFA has previously issued interpretive notices relating to specific regulatory areas (such as use of email and websites and information security), which include guidance on supervising Service Providers in these areas. The Notice is intended to supplement, rather than supersede, the existing guidance in these areas.¹³

¹² See Notice at n.5.

¹³ See Notice at n.2. NFA cites several examples of such previous notices. See, e.g., NFA Interpretive Notice 9037, NFA Compliance Rules 2-9, 2-10, 2-29 and 2-39: Guidance on the Use and Supervision of Websites, Social Media and Other Electronic Communications (Aug. 19, 1999; rev'd, Jan. 1, 2020), <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9037>; NFA Interpretive Notice 9046, Compliance Rule 2-9: Supervision of the Use of Automated Order-Routing Systems (June 21, 2002; rev'd, Dec. 12, 2006), <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9046>; Interpretive Notice 9055, NFA Bylaw 1101, Compliance Rules 2-9 and 2-29: Guidelines Relating to the Registration of Third-Party Trading System Developers and the Responsibility of NFA Members for Promotional Material That Promotes Third-Party Trading System Developers and Their Trading Systems (effective Jan. 10, 2005), <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9055>; NFA Interpretive Notice 9070, NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs (effective Mar. 1, 2016), <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9070>.

B. Guidance for Each Required Component of the Outsourcing Framework

The Notice sets forth the guidance relating to each of the required areas in substantial detail. The FAQs below are intended to capture this detail in a manner that will assist Member CPOs and CTAs in designing their outsourcing framework, by serving as a kind of checklist for conducting a comparison with existing policies and procedures and the Member's specific circumstances (a "**gap analysis**"). Note that not all of the specific guidance provided for each area will be relevant for CPOs and CTAs and that, as noted above, some of the guidance is expressly phrased in terms of measures that Members should consider or make reasonable efforts to adopt.

1. What guidance does the Notice provide for addressing "Initial Risk Assessment"?

a. Determination that outsourcing the regulatory function is appropriate

The first component of the outsourcing framework required by the Notice is referred to as "Initial Risk Assessment." First and foremost, this component involves a determination as to whether the regulatory function in question is appropriate to outsource, and an evaluation of the risks associated with outsourcing that function.¹⁴ The Notice states that unless a Member determines that it may adequately manage the risks associated with outsourcing a particular regulatory function, the Member generally should not move forward with outsourcing the function.

b. Risk areas to be considered

Although NFA recognizes that the risks associated with outsourcing a particular function or functions may vary, in making the determination that such risks can appropriately be managed and that outsourcing of the function is appropriate, Members should analyze and identify the following primary areas of risk:

- **Information security risk**—the type of confidential, personally identifying information or other valuable information a Service Provider may obtain or have access to and the measures it puts in place to protect such information;
- **Regulatory risk**—the potential impact to the Member, customers, and counterparties if the Service Provider fails to carry out the function properly; and
- **Logistics risk**—the location of the Service Provider and whether it has the resources to meet its contractual obligations and provide the Member with access to required records.

In addition to these primary areas of risk, Members should consider other potential areas of risk applicable to their business and the regulatory function that is being outsourced.

¹⁴ See Notice at n.8.

2. What guidance does the Notice provide for addressing “Onboarding Due Diligence?”

This is the longest and most detailed section of the Notice. Note that the discussion in general is geared to onboarding new Service Providers, but also provides guidance for adapting these measures for ongoing relationships.

a. Scope and level of due diligence

A Member should perform due diligence on any prospective Service Provider prior to entering into a contractual outsourcing arrangement in order to determine whether the Service Provider is able to successfully carry out the outsourced function in a manner designed to comply with NFA and/or CFTC requirements. The Member should ensure that the Service Provider:

- is aware of relevant NFA and CFTC requirements;
- has sufficient regulatory experience; and
- has the operational capabilities to fully and accurately carry out the outsourced function(s).

The level of due diligence generally should:

- be commensurate with the risks associated with outsourcing the particular regulatory function;
- be tailored to a Member’s business needs; and
- provide a Member with an appropriate level of confidence in the Service Provider’s ability to properly carry out the outsourced function.

b. Heightened due diligence for confidential data and critical functions

Onboarding due diligence should be heightened for Service Providers that (a) obtain or have access to a Member’s critical and/or confidential data or (b) support a Member’s critical regulatory-related systems, such as handling customer funds, keeping required records, and preparing or filing financial reports. In these instances, Members should consider assessing the following key areas relating to the Service Provider:

- IT security (*e.g.*, practices regarding data transmission and storage);
 - On this point, the Notice specifically states that a Member should avoid using Service Providers that are unable to meet NFA and CFTC standards regarding the confidentiality of customer data, which are set out, for example, in NFA Interpretive Notice 9070.¹⁵
- financial stability;
 - In assessing a Service Provider’s financial stability, a Member may want to consider, as appropriate, reviewing a potential Service Provider’s financial statements, audit or examination (internal or third-party) results, websites, public filings, insurance coverage, or references;¹⁶

¹⁵ See NFA Interpretive Notice 9070, *supra* note 13; Notice at n.9.

¹⁶ See Notice at n.10.

- background of the Service Provider’s key employees;
- regulatory history (*e.g.*, regulatory actions or lawsuits); and
- business continuity and contingency plans (particularly those related to data availability and integrity).

c. Due diligence for subcontracting by the Service Provider

Members should also inquire about whether a Service Provider subcontracts any of the regulatory functions that the Member outsources to the Service Provider. If so, the Member should:

- request the identity of the subcontractor;
- if possible, assess the risks associated with the Service Provider’s subcontracting function;
- require the Service Provider to notify the Member of any change in a subcontractor; and
- retain the ability to terminate the relationship if the Service Provider makes any material changes involving a subcontractor that would have an adverse effect on the performance of the outsourced function.

d. Written agreement

The Member and Service Provider should execute a written agreement that fully describes the scope of services being performed. The agreement should also address any:

- guarantees;
- indemnifications;
- limitations of liability; and
- payment terms.

The Member should make a reasonable effort to ensure that the agreement includes the Service Provider’s agreement:

- to comply with all applicable regulatory requirements, including the production of records; and
- to notify the Member immediately of any material failure(s) in performing the outsourced regulatory functions(s).

If applicable, a Member’s agreement with the Service Provider should address the process for data management at the termination of the relationship.

In addition, the guidance on due diligence for subcontracting by the Service Provider, discussed above, as well as the guidance on ongoing monitoring and termination, discussed below, note a number of matters that could require inclusion in an agreement.¹⁷

¹⁷ See *supra* Section II.B.2.c; *infra* Sections II.B.3.b, II.B.4.a.

e. Involvement of principal or CFO

Depending on the criticality of and risk associated with the function being outsourced, a Member should consider whether it is appropriate for a firm principal to either execute the outsourcing agreement or be notified that the Member has entered into an agreement. The Notice provides, as a specific example, that a large CPO Member should consider whether its CFO should execute or be notified that the CPO has entered into an agreement for a Service Provider to provide monthly bookkeeping functions or administrative functions for the CPO's pools.

f. Existing relationships and agreements

NFA understands that Members will have existing agreements in place at the time the Notice becomes effective and does not expect a Member to renegotiate these agreements prior to their termination dates. However, NFA does recommend that a Member consider the above guidance when renegotiating, renewing existing agreements, and engaging new Service Providers.

g. Recognition of limits on ability to negotiate

NFA also recognizes that in some cases, a Member, due to its size or otherwise, may have little or no ability to negotiate and secure the inclusion of specific contractual terms, especially in agreements with industry Service Providers that support critical infrastructure. Each Member, however, should carefully review its Service Provider relationships to ensure to the extent possible that contractual terms are appropriate and reflect the outsourcing relationships as intended.

h. Bylaw 1101 compliance

While not addressed specifically in the onboarding due diligence guidance, the Notice states that when outsourcing to a Service Provider, the Member should ensure, to the extent applicable, compliance with NFA Bylaw 1101.¹⁸

3. What guidance does the Notice provide for addressing “Ongoing Monitoring”?

a. Ongoing monitoring of risk-based review

Members should conduct ongoing monitoring of the Service Provider's ability to properly carry out the outsourced regulatory function and to meet its contractual obligations. This ongoing monitoring should have two components:

- (i) Ongoing review.** The Member should engage in ongoing review of a particular outsourced function(s) to ensure it is being performed appropriately (*e.g.*, by reviewing for accuracy reports generated by the Service Provider).
- (ii) Periodic holistic performance and compliance reviews.** These reviews cover more generally the Service Provider's performance and regulatory compliance, as well as, if appropriate, the following specific areas:
 - IT security;
 - financial stability;
 - business continuity and contingency plans;

¹⁸ See Notice at n.1. Bylaw 1101 generally prohibits Members from doing business with persons that are not registered with the CFTC, if the person's activities require such registration.

- audit or examination results;
- websites;
- public filings;
- insurance coverage; and
- references.

b. Notification of material changes

In general, a Member should require a Service Provider to notify it of any material changes to the Service Provider’s material systems or processes used to carry out an outsourced regulatory function. While not explicitly stated in the Notice, such changes would logically be part of the Member’s ongoing risk-based review of the Service Provider. Note that inclusion of such a requirement in a Service Provider agreement, as the guidance suggests, would be an appropriate consideration as part of onboarding due diligence.

c. Frequency and scope of ongoing reviews

Members should tailor the frequency and scope of ongoing monitoring reviews to the criticality of, and risk associated with, the outsourced function. For example, a Member may determine to review a Service Provider with access to customer or counterparty data more frequently than a Service Provider that has no access to this type of data.

d. Risk of over-reliance on a Service Provider

The Notice recognizes that there may be constraints on a Member’s choice and/or retention of a particular Service Provider. Specifically, (1) a Service Provider may perform multiple functions for a Member or otherwise provide an essential or critical service (*e.g.*, collecting and maintaining customer onboarding data) or (2) there may be only one or few Service Providers available to perform certain functions. To the extent applicable, a Member should evaluate the risk associated with becoming overly reliant on a particular Service Provider and consider the availability of alternatives, including other Service Providers or in-house solutions in case a viable “exit strategy” is necessary.

e. Senior management involvement

The Notice addresses four items under the rubric of “Senior management involvement.”

- (i) Adequacy of resources.** Members should consider whether they have resources and qualified personnel performing ongoing monitoring. This consideration will depend on the Member’s size, operations, and risk tolerance, and the criticality and risk associated with the outsourced function.
- (ii) Escalation to senior management.** Members should have a process of escalation to senior management when a Service Provider fails to perform an outsourced function or its risk profile materially changes (*e.g.*, when the Service Provider is subject to a regulatory fine or experiences a business failure).
- (iii) Internal committee structure.** Some members may maintain internal committees including risk committees that must be notified about Service Provider relationships and any material changes to them. The definition of a “material change” may differ depending on a Member’s size, business, the

functions outsourced, and the type of Service Provider(s) utilized (*e.g.*, whether or not the Service Provider is regulated).¹⁹

- (iv) **Independent review.** Members may engage an independent party to review their outsourced relationships.

f. Contractual renewals and proposed changes

The Notice states that, as part of the ongoing monitoring process, Members should consider incorporating “best practices” relating to contractual renewals.²⁰ In addition, throughout the relationship with a Service Provider, Members should identify and evaluate the risks associated with any proposed changes to its agreements.

4. What guidance does the Notice provide for addressing “Termination”?

a. Advance notice of termination in Service Provider agreements

A Member’s agreement with a Service Provider should require the Service Provider to give the Member sufficient notice prior to terminating the relationship in order to ensure that the Member can maintain operational, regulatory or other capabilities supported by the Service Provider.

b. Continuity in general; recordkeeping

Following termination of a Service Provider relationship, Members must be able to meet all NFA and CFTC requirements, including recordkeeping. In order to fulfill their recordkeeping obligations, Members will often need (i) to obtain records from the Service Provider or (ii) to enter into an agreement with the Service Provider to continue acting as a records custodian for an appropriate amount of time.

c. Protection of confidential information

- (i) **Cutting off access to information.** Upon termination of a Service Provider, a Member should make a reasonable effort to ensure that the Service Provider no longer has access to confidential information and data of the Member and its customers or counterparties.
- (ii) **Return of confidential information and data.** A Member should ensure that a terminated Service Provider does not unnecessarily retain and, in appropriate circumstances, that the Service Provider returns confidential information of the Member and of its customers or counterparties. For example, a Service Provider that performs accounting functions may have been granted “read-only” access to certain Member back-office systems and internal reports. A Member should verify that this Service Provider’s access is terminated.
- (iii) **Terminated employee access to information.** Independently of termination of a Service Provider itself, Members should consider requiring Service Providers to notify them if a key employee with access to the Member’s information is terminated and to provide the Member with

¹⁹ See Notice at n.14.

²⁰ The Notice does not explain what “best practices” means in this context, and this particular guidance is phrased as something that Members should consider. Note, however, that the NFA Service Provider Questionnaire specifically asks whether the firm incorporates best practices with respect to contract renewals

assurances that the employee's access to this information has been shut off.²¹

5. What guidance does the Notice provide for addressing "Recordkeeping"?

Members that engage a Service Provider to perform a regulatory function must maintain records to demonstrate that they have addressed the areas described in the Notice, in accordance with NFA Compliance Rule 2-10.²² This requirement may, but need not, be a separate provision of the framework. However, the need to make and retain documentation to demonstrate compliance with the Notice is an important consideration to keep in mind when designing provisions of the framework that address the other four required areas and is expressly noted in the NFA Service Provider Questionnaire.

C. Designing an Outsourcing Framework

1. How would a CPO or CTA Member start to design an outsourcing framework?

While the process will vary depending on the size, operations, and other facts and circumstances relevant to the particular Member, the basic steps are as follows:

- a. Review arrangements with all persons or entities that provide services for the Member, including affiliates, and identify those that perform regulatory functions, and thus should be considered Service Providers covered by the Notice.²³
- b. Conduct a gap analysis of existing policies and procedures relative to the Notice,
 - (i) Collect and review existing policies and procedures for each of the five required areas;
 - (ii) Review and complete the NFA Service Provider Questionnaire. As noted, the answer to some of the questions may be "not applicable," but such a response requires careful consideration of the firm's operations; and
 - (iii) Consider additional elements of the guidance not addressed in the NFA Service Provider Questionnaire (refer to FAQs in Section II).²⁴
- c. Address specific areas that should be added or adjusted based on the gap analysis.

²¹ See Notice at n.15. Note that such a notification provision would be appropriate for consideration in connection with the guidance on written agreements. See *supra* Section II.B.2.d. In addition, the NFA Service Provider Questionnaire includes a question about terminated employees in the "Ongoing Monitoring" section of the Questionnaire.

²² NFA Compliance Rule 2-10 generally requires Members (a) to maintain adequate books and records necessary and appropriate to conduct their business including, without limitation, the records required to be kept under CFTC Regulations 1.18, 1.32 through 1.37, and 1.71 for the period required under CFTC Regulation 1.31 and (b) to make available to NFA (during an examination or to respond to other inquiries) an individual who is authorized to act on the Member's behalf, is fluent in English, and is knowledgeable about the Member's business and about financial matters. The Notice also refers to NFA Compliance Rule 2-49, which is specific to SDs and MSPs.

²³ See *supra* Sections II.A.3, II.A.4.

²⁴ The Notice also recommends as additional guidance that Members may want to consider incorporating relevant standards and guidelines including, but not limited to, those set out in the National Institute of Standards and Technology ("NIST") SP-800 series of publications, <https://csrc.nist.gov/publications/sp800>; the International Organization of Securities Commissions' ("IOSCO") 2005 report Principles on Outsourcing of Financial Services for Market Intermediaries <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD187.pdf>; and the Federal Financial Institutions Examination Council ("FFIEC") IT Examination Handbook sections on outsourcing, <https://it handbook.ffcic.gov/it-booklets/outsourcing-technology-services.aspx>.

- d. Develop a format and documentation designed to demonstrate that the outsourcing framework addresses the required areas in a manner consistent with the Notice. Keep in mind that this does not require repeating policies included elsewhere. However, demonstration of compliance may be easier and more effective if the Member maintains a centralized document that indicates where each required component of the framework is addressed (such as a table of contents or umbrella policy that cross-references existing policies).²⁵ Note that the Member's answers to the NFA Service Provider Questionnaire may be a useful tool in designing and documenting the framework.
- e. Identify personnel with responsibilities under the framework and develop an appropriate educational or training protocol.
 - (i) For example, note that the NFA Service Provider Questionnaire asks specifically how employees that are involved in the risk assessment process will be made aware of the Notice.
 - (ii) Note the reminder in the Notice that Members should ensure that all employees involved in the process of outsourcing regulatory functions to Service Providers are aware of the Notice's requirements, including for Members that are part of a holding company structure or large organization where outsourcing is conducted in a dedicated organization wide procurement or vendor management department.²⁶

2. How will the process vary for dual registrants?

Dual registrants typically already have policies and procedures addressing oversight of service providers, either as part of their compliance with ICA or Advisers Act rules or as part of their general compliance culture. Both the ICA and the Advisers Act, and SEC rules thereunder, require the adoption of compliance policies and procedures and also impose express oversight obligations over a number of critical functions.

For SEC-registered funds, Rule 38a-1 under the ICA provides for the oversight of compliance by the registered fund's investment adviser, principal underwriter, administrator, and transfer agent. However, not all Service Providers covered by the Notice will fall into the categories addressed by Rule 38a-1, and the specific oversight requirements of Rule 38a-1 and the Notice differ. In addition, while Rule 38a-1 requires the registered fund to have oversight policies and procedures, it does not, *per se*, require a written outsourcing framework.

For registered investment advisers generally (independent of registered fund obligations), Advisers Act Rule 206(4)-7 requires the adviser to have policies and procedures designed to prevent violations of the Advisers Act. While this would include supervision of outsourced regulatory functions, Rule 206(4)-7 is more narrowly focused on Advisers Act compliance and does not specifically address Service Provider oversight.

Accordingly, although dual registrants will likely have existing policies and procedures that address the purpose of the Notice, in order to demonstrate compliance with the Notice's requirement of a written outsourcing framework that addresses specific areas, dual registrants will still need to conduct the gap analysis and take the other steps described

²⁵ See *supra* Section II.A.9.

²⁶ See Notice at nn.3, 7.

above, albeit in a manner tailored to take into consideration the comprehensive nature of SEC regulation to which they are already subject.

3. What will NFA look for in exams?

Following the effective date, it can be expected that NFA exams will include document requests and questions relating to the Member's outsourcing framework and compliance with the Notice. Accordingly, while, for the reasons discussed above, many CPOs and CTAs, such as dual registrants, may be confident that they have appropriate outsourcing policies and procedures in place, NFA examiners are likely to require demonstration of an appropriate outsourcing framework in terms of compliance with the Notice, through appropriate documentation of each of the five required components, rather than generally accepting compliance with SEC regulations as substituted compliance.

As is the case for other areas of CFTC and NFA compliance, it is instructive to consult the NFA Self-Examination Questionnaire, which can serve as a checklist or guide to critical compliance areas.²⁷ In this connection, NFA has added a new section specifically dedicated to the Notice. The new section asks: (1) whether the Member has a written supervisory framework over its outsourcing of regulatory obligations to Service Providers; (2) whether the framework addresses each of the five required components set forth in the Notice; and (3) whether the Member has maintained records to demonstrate that it has addressed the areas included in the supervisory framework. The NFA Self-Examination Questionnaire also refers Members to the NFA Service Provider Questionnaire for further assistance in drafting policies and procedures for the outsourcing framework.

III. Parting Words

The purpose of the new outsourcing framework requirement is to ensure that NFA Members are appropriately managing the risk inherent in the outsourcing of their regulatory functions. While many CPO and CTA Members, especially dual registrants, already have in place policies and procedures that effectively manage and mitigate their outsourcing risk, the specific requirements of the Notice merit attention. NFA has provided guidance as to its expectations, including its expectation that Members will maintain records sufficient to document their adoption of an outsourcing framework that addresses the five required areas, and has provided further assistance in drafting the framework in the form of the NFA Service Provider Questionnaire and the Workshop presentation. Understanding NFA's expectations by referencing these materials will be an important first step in allocating sufficient time and resources to developing an appropriate written framework by the Sept. 30, 2021 effective date.

²⁷ See "Use of Third-Party Service Providers" section of NFA Self-Examination Questionnaire; *supra* note 2.

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