

Financial Services and Products ADVISORY

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CFTC Approves NFA Compliance Rules 2-41 and 2-42: Disclosure by Certain Forex Pool Operators and Trading Advisors

The Commodity Futures Trading Commission (CFTC) approved National Futures Association (NFA) Compliance Rules 2-41 and 2-42 (the “new rules”)¹ on October 16, 2008. The new rules become effective on November 30, 2008.

What Do the New Rules Require?

Under NFA Compliance Rule 2-41, certain pool operators and trading advisors that trade foreign currency futures and options on a leveraged or margined basis outside of an exchange (for purposes of this advisory, “Forex”) must prepare a disclosure document that complies with the CFTC Part 4 regulations applicable to commodity pools and managed accounts trading on-exchange futures contracts;² must file the disclosure document with the NFA at least 21 days prior to soliciting potential pool participants who are not eligible contract participants (ECPs);³ and must deliver the disclosure document to investors no later than the time the subscription agreement is delivered. Additionally, a new risk disclosure statement must be used in the disclosure document for pools or accounts that do not trade on-exchange contracts and must be added to the disclosure document for pools or accounts that trade both on-exchange contracts and Forex.

Under NFA Compliance Rule 2-42, NFA members that operate a pool that trades Forex must provide participants with monthly or quarterly account statements, in compliance with the requirements of CFTC Regulation 4.22 in the same manner as would be applicable to the operation of a pool trading on-exchange futures contracts.

¹ <http://www.nfa.futures.org/nfaManual/manualCompliance.asp#2-41>; <http://www.nfa.futures.org/nfaManual/manualCompliance.asp#2-42>

² These disclosure documents must comply with CFTC Regulations 4.24, 4.25 and 4.26 for commodity pools and 4.34, 4.35 and 4.36 for managed accounts.

³ For a definition of ECPs, see Section 1a(12) of the Commodity Exchange Act, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=browse_usc&docid=Cite:+7USC1a.

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Who is Subject to the New Rules?

Generally, NFA Compliance Rule 2-41 applies to pool operators that are NFA members (outside of members that are certain regulated entities under NFA Bylaw 306(b)⁴) who solicit funds, securities or property for a pooled investment vehicle that trades Forex and does not qualify as an ECP under the Commodity Exchange Act (the “Act”). NFA Compliance Rule 2-41 applies to trading advisors that are NFA members (outside of members that are certain regulated entities under NFA Bylaw 306(b)) that manage, direct, guide or solicit to do such activities for a person that is not an ECP. Pool operators and trading advisors that are exempt from CFTC registration (and, therefore, are not NFA members) are not subject to the new rules.

Section 1a(12)(A)(iv) of the Act defines an ECP as a commodity pool with more than \$5,000,000 in total assets that is formed and operated by an entity regulated under the Act, and Section 1a(12)(A)(v) (I) defines an ECP as a corporation, partnership, trust or other entity that has more than \$10,000,000 in total assets. Forex pool operators seeking to claim ECP status will most likely invoke one of these provisions, but they are advised to investigate if another provision within the definition of ECP could potentially apply.

Two provisions within the definition of ECP are expressly unavailable for commodity pool operators and trading advisors wishing to claim exemption from Compliance Rule 2-41. Under the first provision, a business entity qualifies as an ECP if its legal obligations are guaranteed or otherwise supported by a letter of creditor, or certain other agreements by an entity with more than \$10,000,000 in total assets.⁵ Under the second provision, a business entity may claim it is an ECP if it has a net worth of more than \$1,000,000 and it enters into a contract to manage the risk associated with the conduct of the entity’s business.⁶ Compliance Rule 2-41, however, explicitly provides that Forex pool operators and trading advisors may not rely on these provisions for claiming exemption from these disclosure requirements.

Compliance Rule 2-42 applies to NFA member commodity pool operators that trade Forex in such pool (outside of members that are certain regulated entities under NFA Bylaw 306(b)).

⁴ Generally, (i) financial institutions, (ii) insurance companies, (iii) financial holding companies, (iv) investment bank holding companies, (v) registered broker-dealers or registered futures commission merchants who are members of another registered futures association, or (vi) associated persons or affiliated persons of those entities described in (v).

⁵ See Section 1a(12)(A)(v)(II) of the Commodity Exchange Act, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=browse_usc&docid=Cite:+7USC1a.

⁶ See Section 1a(12)(A)(v)(III) of the Commodity Exchange Act, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=browse_usc&docid=Cite:+7USC1a.

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