

Deficiency Trends In National Futures Association Exams

By **Brian Daly and Jan-Paul Bruynes** (March 14, 2025)

On Feb. 12, the National Futures Association issued a notice to its members that outlined the most common deficiencies uncovered by NFA staff during examinations of commodity pool operator and commodity trading adviser members.

Among the most common deficiencies found at the top of the notice are findings related to NFA members' use of outsourced third parties to perform regulatory functions on behalf of the NFA.

While it is still unclear whether the U.S. Securities and Exchange Commission will finalize its proposed rule^[1] for investment advisers outsourcing covered functions, i.e., services necessary "to provide its investment advisory services in compliance with the Federal securities laws," fund managers subject to NFA rules are in the early stages of complying with an analogous supervision requirement.

Regulatory Obligations

Private fund managers required to register with the U.S. Commodity Futures Trading Commission do so by becoming NFA members. The NFA, as a broadly focused self-regulatory organization, maintains a comprehensive rulebook and carries out a variety of oversight initiatives.

In 2021, the NFA imposed diligence, supervision and recordkeeping obligations upon fund managers that elect to use third-party service providers to perform functions that the NFA deems to be regulatory in nature. This obligation is found in two items of NFA guidance:

- NFA Compliance Rule 2-9(a) requires, as a general principle, that each fund manager that is an NFA member must "diligently supervise its employees and agents" in all aspects of their "commodity interest activities."
- NFA Interpretive Notice 9079 requires members to comply with requirements for any third-party service provider or vendor performing or providing what it terms "regulatory functions." Under IN 9079, the member must perform an initial risk assessment, conduct due diligence at or prior to the vendor's onboarding, undertake ongoing monitoring of the vendor, and comply with certain recordkeeping requirements.

Regulatory Functions

IN 9079 does not define the scope of regulatory functions or identify what, if any, regulatory functions are not capable of being outsourced. Therefore, an NFA member should inventory all third parties it contracts with and internally memorialize a regulatory function determination for each third-party provider or vendor.

While not exclusive, a list of in-scope tasks could include:



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- Making determinations on investor suitability;
- Subscription and redemption processing;
- Periodic reporting, e.g., reports produced by fund administrators or compliance consultants;
- Regulatory recordkeeping, which can encompass a broad list of third-party providers;
- Information security system consultants — including cybersecurity testing and policy firms, as well as turnkey system providers;
- Outsourced defense program providers, including for cybersecurity; and
- Training providers for ethics and cybersecurity training.

Not surprisingly, on recent examinations, the NFA staff have extended the scope of IN 9079 to providers of artificial intelligence tools and services in numerous areas, including trading and research, risk management, trade surveillance, anti-money laundering, communications reviews, and cybersecurity efforts.

Reasonable Steps

Like the eponymous "Blob" (in both its 1958 and 1988 film incarnations), each ingestion by IN 9079 of a task or function results in the scope of regulatory function growing larger.

Because the task of identifying a so-called nonregulatory vendor is so difficult (beyond, perhaps, ruling out the nighttime office cleaning service), many NFA members conclude that they have no option other than to treat the vast majority of providers in their accounts payable ledger as being in scope of their compliance obligations.

Given that situation, set forth below are some practical considerations that NFA members should consider when complying with IN 9079.

Initial Risk Assessment

In the first instance, a firm needs to determine whether it is appropriate to outsource a regulatory function, and if the firm can adequately manage the risks associated with outsourcing the function.

Primary risks that should be considered include information security, regulatory and logistical risks. This process should be formal, and it should be documented.

Onboarding Due Diligence

NFA members need to establish process-driven due diligence evaluations of covered third-party service providers, which could include: an assessment of the service provider's regulatory status and operational capabilities, auditable compliance with NFA Bylaw 1101, and a cybersecurity assessment of the vendor's information security system program.

Members should also undertake due diligence on the regulatory status of the provider,

review any disciplinary actions or lawsuits, perform reference checks on the providers, and contract for background checks on senior executives.

The NFA clearly believes that mere reliance on industry reputation does not constitute a sufficient diligence exercise.

Ongoing Monitoring

Firms need to determine how frequently to review onboarded third-party service providers. The lever of review can be commensurate with the risks that the third-party service provider poses.

An annual formal review of outsourced service providers would constitute best practice, but practice can — and does — vary.

NFA members should also consider, where practicable, obtaining firmwide input on the quality of services provided, any problems experienced with the service provider during the year and the resolutions of any identified issues.

Recordkeeping Requirements

NFA members are required to maintain written records demonstrating compliance with IN 9079 and adherence to their own procedures.

Robust written records of a compliance program and implementation will serve as a foil against any SEC, CFTC, NFA or other applicable non-U.S. regulatory requirements regarding outsourced service providers.

Outsourced Diligence and Oversight Solutions

In a somewhat ironic twist, an increasing number of firms are hiring third-party vendors to perform the member's diligence and ongoing monitoring of covered third-party providers.

Provided that the NFA member complies with the requirements of IN 9079 in the selection, initial due diligence and monitoring of such vendors, this may be a practical solution for the market that may gain more traction among NFA members.

Examination Experiences

IN 9079 compliance is becoming a hot topic during NFA examinations and a common source of deficiencies in exam findings.

Members are reminded to focus their diligent attention to the questions raised in "Appendix E — Use of Third-Party Service Providers Questionnaire of the NFA Self-Examination" and the member firm's answers thereto, which can map out a compliance program designed to avoid common deficiency findings related to outsourcing.

Conclusion

While it is hard to predict the specific areas that an NFA exam will focus on, by having in place and implementing robust procedures governing the use of outsourced service providers that perform regulatory functions, NFA members can head off possible deficiencies in an area that is sure to remain a priority in NFA exams in the coming years.

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[1] <https://www.sec.gov/files/rules/proposed/2022/ia-6176.pdf>.