

CFTC Issues Harmonization Rule for CPOs of Registered Investment Companies

September 3, 2013

Introduction

On August 13, 2013, the Commodity Futures Trading Commission (“CFTC”) issued a final rule (the “Harmonization Rule”) on compliance obligations for certain investment companies registered with the Securities and Exchange Commission (“SEC”) under the Investment Company Act of 1940, as amended (the “1940 Act”), whose advisers are required to register as commodity pool operators (“CPOs”).¹

In 2012, the CFTC amended Rule 4.5 under the Commodity Exchange Act (“CEA”) to modify the blanket exclusion from the definition of CPO for advisers of registered investment companies (“RICs”) and imposed a new *de minimis* trading threshold.² As a result of the amendment and related changes to the CEA resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act, an adviser of a RIC was required to register as a CPO with the CFTC if the RIC traded in commodity interests above the *de minimis* threshold as of December 31, 2012.³ As CPOs, CFTC reporting, disclosure, recordkeeping and other compliance and licensing requirements apply to these advisers, and such advisers are required to become members of the National Futures Association (“NFA”), a self-regulatory organization, and comply with NFA rules. The CFTC proposed the Harmonization Rule at that time to address the disclosure, reporting and recordkeeping regimes of the CFTC and SEC for advisers to RICs registered with both entities. The CFTC and the NFA deferred compliance with CPO rule requirements pending adoption of final rules.⁴

In this Memorandum, we focus on aspects of the Harmonization Rule that apply to RICs. This Memorandum begins with a summary of the Harmonization Rule and is followed by an analysis

¹ The Final Rule Release is available at: <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2013-19894> (the “Release”).

² Pursuant to amended Rule 4.5, RICs can utilize derivatives that are “commodity interests” under CFTC Rules, including commodity futures, commodity options contracts and swaps, only for bona fide hedging, unless the initial margins and premium for non-hedging activities do not exceed 5% of a fund’s liquidation value.

³ A RIC that is marketed as a commodity pool or other commodity investment is also included in the definition of CPO under Rule 4.5. Additionally, the staff of the CFTC’s Division of Swap Dealer and Intermediary Oversight has stated that sub-advisers of funds for which a RIC’s adviser can no longer rely on Rule 4.5 must also register with the CFTC. However, the Release does not address the compliance obligations of such sub-advisers.

⁴ The U.S. Court of Appeals for the District of Columbia Circuit upheld a District Court ruling in favor of the CFTC in a case challenging the CFTC’s decision to include advisers to RICs that invest in commodity interests in the definition of CPO.

of the Harmonization Rule as it affects RICs. Appendix A provides a chart highlighting certain important requirements under the Harmonization Rule.

Summary

The Harmonization Rule provides welcome relief for RICs trading in commodity interests, whose advisers are required to register as CPOs under amended Rule 4.5, from having to comply with different regulatory regimes. The CFTC has adopted a substituted compliance regime for CPOs of RICs, which generally allows such entities to meet the CFTC compliance requirements through adherence to the SEC statutory and regulatory compliance regime.

Additionally, the Harmonization Rule amends certain provisions of Part 4 of the CFTC's regulations that are applicable to all CPOs. For instance, all CPOs will be permitted to use third-party service providers to maintain their books and records, and the signed acknowledgment requirement for receipt of disclosure materials by prospective participants has been rescinded. Further, CPOs and commodity trading advisors ("CTAs") will be allowed to update their disclosure documents under Rules 4.26 and 4.36 on an annual basis, instead of every nine months as required under previous regulations.

The Harmonization Rule

General Aspects of the Substituted Regime for CPOs of RICs

The Harmonization Rule generally provides that the CFTC will accept as a substitute for substantially all of the Part 4 regulations under the CEA compliance by CPOs of RICs with the disclosure, reporting and recordkeeping requirements of the SEC (the "SEC RIC Rules"). This substitution, in effect, relieves CPOs of RICs from having to, among other things:

- (i) file disclosure documents with the NFA;
- (ii) obtain acknowledgements from investors of receipt of a disclosure document;
- (iii) include past performance data for certain RICs; and
- (iv) include a break-even point analysis in their disclosure documents.

Under amended Rule 4.12(c), CPOs of RICs will be deemed to comply with the majority of the CFTC compliance obligations if they satisfy the SEC RIC Rules and certain other conditions, including the filing of a notice claiming such relief with the NFA. Such CPOs may deliver disclosure documents and account statements, and amend and file those disclosure documents, pursuant to SEC requirements. RICs must make their disclosure documents available for review by the NFA during an examination, but otherwise will not be required to file such documents with the NFA.

Treatment of Investment Company Series

The CFTC treats a commodity pool as a legal entity and requires filings to be prepared at the legal entity level, rather than at the series level. The SEC, however, permits reporting and

disclosure on an individual series basis, as a number of RICs are organized as series entities. Under the Harmonization Rule, the CFTC has agreed that series funds may continue to be able to make such individual filings consistent with the SEC RIC Rules and guidance.

Content of Disclosure Documents

Generally, the information required to be included in RIC disclosure documents, including risk disclosures and performance disclosures, will satisfy the Harmonization Rule through compliance with SEC disclosure requirements. A CPO of a RIC with less than a three-year operating history will be required, however, to disclose in its registration statement the performance of all accounts and pools that are managed by the CPO and that have investment objectives, policies and strategies substantially similar to those of the RIC.

The Harmonization Rule requires a RIC's disclosure document to contain a cautionary statement, which may be incorporated on the prospectus cover page by making minor modifications to the Rule 481(b)(1) legend required under SEC rules.⁵ The standard risk disclosures required under CFTC rules may be satisfied by a CPO of a RIC through compliance with the disclosure requirements under the SEC RIC Rules. In the release, the CFTC indicated that disclosure requirements in Forms N-1A and N-2 and guidance from the SEC staff, including a 2010 letter from the Division of Investment Management on disclosures concerning derivatives, should ensure that investors receive complete and accurate information about the risks associated with investments in commodity interests.

The Harmonization Rule will permit the use of a summary prospectus, as allowed under the SEC RIC Rules. Also, websites that comply with the SEC RIC Rules will be deemed to comply with the CFTC requirements.

Filing, Use and Delivery of Disclosure Documents

The Harmonization Rule will permit CPOs of RICs to rely on a disclosure document for up to twelve months after its first use, instead of nine months, which aligns the requirement with SEC financial statement filing timeframes. The CFTC declined to adopt a sixteen-month update period for disclosure documents, but stipulated that it will deem CPOs of RICs to have complied with the CFTC obligation if they update fund registration statements in accordance with the SEC's sixteen-month timeframe.

A CPO of a RIC may rely on 1940 Act and Securities Act of 1933 registration and disclosure requirements as substituted compliance with the CFTC disclosure document rule for

⁵ The required CFTC cautionary statement under Rule 4.24(a) is: "The Commodity Futures Trading Commission has not passed upon the merits of participating in this pool nor has the Commission passed on the adequacy or accuracy of this disclosure document." Under the Harmonization Rule, this statement may be incorporated into a RIC prospectus through minor modification of the Rule 481(b)(1) prospectus cover page legend. The statement could read: "The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or passed upon the adequacy of this prospectus. Any representation to the contrary is a criminal offense."

supplementing its prospectus in the event of material changes.⁶ CPOs of RICs will be exempt from the monthly account statement requirement of the CFTC so long as they make the current net asset value per share available to investors and clearly disclose that the information will be readily accessible, providing a website address or other means through which information will be made available. CPOs of RICs will still be required to meet the periodic regulatory reporting requirements of the CFTC, which require CPOs to file reports on Form CPO-PQR.

Under the Harmonization Rule, the CFTC eliminates the requirement for all CPOs to obtain signed acknowledgements of receipt of a disclosure document from each prospective investor. CPOs of RICs will be deemed in compliance with the CFTC's delivery obligations if they comply with the disclosure documents delivery requirements under the SEC RIC Rules.

Recordkeeping Requirements

The Harmonization Rule permits all CPOs, including those of RICs and private funds, to use certain third-party service providers for storage of required books and records, so long as the records may be retrieved within 48 hours if held in the U.S., and within 72 hours if held outside of the U.S. In order to maintain this practice, a CPO must file a notice statement with the NFA describing the third-party recordkeeper and representing that the CPO will remain responsible for ensuring that those books and records are kept in accordance with the requirements of the CEA. The CPO must also file with the NFA a statement containing certain representations from each third-party who will be keeping such books and records.

The Harmonization Rule exempts CPOs of RICs from the CFTC requirement that investors be provided access to a CPO's books and records.

Controlled Foreign Corporations

The CFTC confirmed in the Release that RICs may use controlled foreign corporations ("CFCs") to invest in commodity interests, but that a CFC may fall within the definition of commodity pool depending on its investment activities, which could trigger a registration requirement for the operator of the CFC. In this case, the Release states that a CFC will not be required to separately prepare a disclosure document that complies with CFTC regulations if the RIC provides full disclosure of material information about the activities of the CFC as required by the SEC. Also, the CFC will not be required to file separate financial statements if the RIC consolidates the financial statements of the CFC with the financial statements that are filed by the RIC with the NFA.

Effective and Compliance Dates

The Harmonization Rule will take effect as follows:

- The compliance obligations for CPOs of RICs under Rule 4.12 (except 4.12(c)(3)(i) relating to CPOs of RICs with less than a three year operating history) that would be

⁶ The CFTC rules requires a CPO to correct material inaccuracies in disclosure documents within 21 days of the date upon which the CPO first becomes aware of the defect.

applicable under Rules 4.21 (delivery of disclosure documents), 4.24 (disclosure requirements), 4.25 (performance disclosure) and 4.26 (use, amendment and filing of disclosure document) and the elimination of the acknowledgement requirement became effective upon publication of the Release in the Federal Register on August 22, 2013.⁷

- Amendments to the recordkeeping rules and the 12-month use of the disclosure document for all CPOs, as well as Rule 4.12(c)(3)(i) for CPOs of RICs, will become effective on September 23, 2013.⁸
- Rule 4.27 (reporting on Form CPO-PQR), which applies to CPOs of RICs, and most other requirements will become effective on October 21, 2013. Therefore, all CPOs of RICs *must file*, as applicable, their first Form CPO-CQR with respect to the quarter ending December 31, 2013.

SEC IM Guidance Update for RICs That Invest in Commodity Interests

On the same day the CFTC issued the Harmonization Rule, the staff of the SEC's Division of Investment Management issued a Guidance Update aimed at facilitating compliance with SEC and CFTC disclosure and reporting requirements by RICs subject to both agencies' regulations.

The Update highlights the need for funds to adequately and clearly disclose the risks associated with investments in commodity interests. It states that in determining appropriate disclosure, funds should consider the amounts invested pursuant to derivative strategies, the degree of economic exposure the derivatives create, the purpose the derivatives are intended to serve in the portfolio, and the extent to which they may be used. The Update also emphasizes that a fund,

⁷ The Investment Company Institute ("ICI") submitted a letter to the CFTC on August 28, 2013 (the "ICI Letter") requesting written confirmation on matters discussed with CFTC staff regarding various aspects of the relief provided to CPOs of RICs under the Harmonization Rule. In the ICI Letter, the ICI addressed the effective dates for the Harmonization Rule, noting that the Release stated that the conditional compliance period established previously with respect to the amendments to Rule 4.5 was triggered by adoption of the Harmonization Rule. Accordingly, the ICI requested confirmation that the addition of the 60-day conditional compliance period will result in CPOs of RICs seeking to rely on the exemptions provided by Rules 4.12(c)(3)(ii) and (iii) needing to comply with the conditions of those exemptions and file notice with the NFA of such under Rule 4.12(d) on or before October 21, 2013.

⁸ The ICI Letter requested confirmation that the addition of the 60-day conditional compliance period will result in the following requirements:

- (a) for open-end RICs, any initial registration statement or annual update to an existing registration statement that is filed on or after November 22, 2013 must comply with Rule 4.12(c)(3)(i);
- (b) for closed-end RICs, any initial registration statement or amendment that is required to update an existing registration statement that is filed on or after November 22, 2013 must comply with Rule 4.12(c)(3)(i);
- (c) CPOs of RICs must comply with Rule 4.23 (recordkeeping requirements) on or before November 22, 2013, and will be deemed to have complied with notice requirements relating to their use of third-party recordkeepers under Rules 4.12(d), 4.7(b)(5) and 4.23(c)(1), as applicable, if they file notice on or before November 22, 2013.

such as a new fund investing in commodity interests, that includes information in its registration statement on the performance of private accounts or other funds managed by the fund's adviser, should include the performance of all such other funds and private accounts that have investment objectives, policies and strategies similar to those of the fund. A fund should only exclude the performance of other funds or private accounts when such exclusion would not cause the performance to be materially misleading. In addition, the Update indicates that the staff of the SEC would not object if the Rule 481 legend on the outside cover of a prospectus included a statement that the CFTC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus.

The Update provides the staff's expectation that funds and their advisers should adopt policies and procedures sufficient to address the accuracy of disclosures made about a funds' use of derivatives and associated risks, as well as the consistency of the fund's investments in derivatives with the fund's investment policies. The adequacy of such policies and procedures should be assessed in the fund's annual review required by Rule 38a-1 under the 1940 Act. The Update also suggests that funds should consider their boards' role in the risk oversight of funds and the funds' risk management practices.

Conclusion

The Harmonization Rule will facilitate reporting, disclosure and recordkeeping compliance by CPOs of RICs that must register with the SEC and CFTC. While allowing such CPOs to meet many of the SEC RIC Rules for compliance with CFTC obligations, the Harmonization Rules nevertheless impose certain conditions upon the substituted regime.

If you have any questions concerning the matters discussed in this memorandum, please contact Kathleen Clarke, Paul Miller or Bibb Strench at Seward & Kissel at (202) 737-8833.

Appendix A

The following chart highlights and summarizes certain requirements that apply to a CPO of a RIC under the Harmonization Rule:

Regulatory Item	Substituted SEC Compliance Requirement	Requirements Under CFTC Rules
Registration or Notice to NFA	Comply with SEC RIC Rules.	A CPO of a RIC will be required to file notice of its use of the substituted compliance regime with the NFA.
Disclosure Documents	The CFTC will deem a CPO of a RIC to be in compliance if it updates fund registration statements within the sixteen-month SEC timeframe.	CPOs and CTAs may rely on a disclosure document for up to 12 months after its first use.
	A CPO of a RIC may adhere to the disclosure requirements of the SEC.	However, a CPO of a RIC with less than three years' operating history must disclose the performance of all accounts and pools that are managed by the CPO and have substantially similar investment objectives, policies and strategies as those of the RIC.
Rule 481 Legend on Front Cover of Prospectus	The SEC staff will not object to a reference to the CFTC in the legend.	CPOs of RICs must include a cautionary statement in disclosure documents, which may be incorporated with minor changes into the Rule 481(b)(1) legend required on prospectus cover pages.
Delivery of Disclosure Documents and Signature Acknowledgements	CPOs of RICs may provide disclosure documents to participants and prospective participants consistent with the SEC RIC Rules.	A signature acknowledgement is no longer required under CFTC rules.
Recordkeeping		All CPOs may use third-party service providers for storage of required books and records (must be accessible within 48 hours if held in the U.S., and within 72 hours if held outside of the U.S.). Certain notice requirements apply.