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Client Alert

Current Issues Relevant to Our Clients

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CFTC Adopts Harmonization Rules for CPOs of Registered Investment Companies; SEC Issues Related Guidance

The Commodity Futures Trading Commission (the "CFTC") recently adopted final rules regarding compliance obligations for commodity pool operators ("CPOs") of investment companies ("RICs") registered under the Investment Company Act of 1940 (the "1940 Act"). The harmonization rules generally provide that the CFTC will accept compliance with the disclosure, reporting and recordkeeping regime administered by the Securities and Exchange Commission ("SEC") as substituted compliance for substantially all of Part 4 of the CFTC's regulations. These regulations provide disclosure, recordkeeping and reporting obligations for CPOs and their commodity pools, among other things. The final harmonization rules should be substantially less burdensome to RICs and their CPOs than the CFTC's original harmonization proposals. The harmonization rules also provide for certain rule changes regarding reporting and disclosure obligations for all CPOs. The related CFTC release is available here.

The SEC's Division of Investment Management also issued related guidance summarizing its view regarding certain disclosure and compliance matters relating to funds that invest in commodity interests. A copy of that guidance is available here.

Why Are the Harmonization Rules Necessary?

The CFTC issued final rule amendments in 2012 that significantly narrowed the CFTC Rule 4.5 exclusion from the definition of CPO for RICs. Prior to the 2012 amendments, CFTC Rule 4.5 provided a broad exclusion from the definition of CPO for all RICs. The 2012 amendments added a requirement that non-hedging use of commodity futures by a qualifying RIC be limited to five percent of the liquidation value of the fund's portfolio and that the fund not be marketed as a commodity pool to the public. This change essentially reinstated an old pre-2003 requirement and put many RICs in a position where they could no longer rely on the Rule 4.5 exclusion. As a result, advisers of many RICs were required to register with the CFTC as CPOs as of December 31, 2012, thereby subjecting themselves and the applicable RICs to the Commodity Exchange Act ("CEA") and certain CFTC and National Futures Association ("NFA") rules. This raised a significant problem because the CEA/CFTC/NFA disclosure, recordkeeping and reporting obligations are duplicative, inconsistent and, in some cases, in direct conflict with SEC obligations for RICs. To address this problem the CFTC required RIC CPOs to register as of the end of 2012 but suspended most of the obligations set forth in Part 4 of the CFTC's regulations for CPOs of RICs pending final rules to harmonize the "commodities" regulatory regime with the SEC regulatory regime governing these entities.

When the CFTC adopted the 2012 amendments to Rule 4.5, the CFTC also issued a rule proposal to harmonize the disclosure, reporting and recordkeeping regimes of the CFTC and SEC for CPOs of RICs. The CFTC's proposal included subjecting RICs and their CPOs to a large number of CFTC and NFA disclosure and recordkeeping requirements (in many cases, modified) including requiring submission of disclosure documents to both the SEC and NFA for review and comment. The CFTC received a large number of comments in response to these harmonization proposals including comments that dually registered entities may be subject to duplicative, inconsistent and possibly conflicting disclosure and reporting requirements if required to comply with both the CFTC and SEC regimes. The CFTC's final harmonization rules are substantially less burdensome to RICs and their CPOs than the original CFTC proposals. A copy of our client alert summarizing the Rule 4.5 amendments and the original harmonization proposals is available here.

As a side note, the Investment Company Institute and U.S. Chamber of Commerce attempted a legal challenge to the CFTC's amendments to Rule 4.5. The U.S. District Court upheld the CFTC's amendments to Rule 4.5 and that decision was upheld by the U.S. Court of Appeals. For

additional information, see our related client alert available here.

The Final Harmonization Rules

In adopting the harmonization rules, the CFTC effectively adopted a "substitute compliance" regime for CPOs of RICs where the CFTC generally provides relief from substantially all of Part 4 of the CFTC's regulations so long as RICs and their CPOs comply with the disclosure, reporting and recordkeeping requirements of the 1940 Act, the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934, regulations promulgated thereunder and any guidance issued by the SEC and divisions thereof. In addition to complying with the SEC regulatory regime, RICs and CPOs relying on this relief must:

- With respect to CPOs of RICs with less than a three-year operating history, disclose the performance of all accounts and pools managed by the CPO that have investment objectives, policies and strategies substantially similar to those of the applicable RIC;
- Make a RIC's current net asset value per share available to all RIC investors;
- Make SEC required shareholder reports accessible on a website maintained by the CPO or its designee or otherwise be made available to participants and disclose the internet address of the website, if applicable;
- File notice with the NFA that it is relying on the relief provided by CFTC Rule 4.12 and its intent to comply with all applicable requirements of the SEC regulatory regime;
- File any of the RIC's financial statements required under the SEC regulatory regime with the NFA;
- If the CPO of a RIC uses or intends to use a third-party service provider for recordkeeping purposes, it must file notice of this with the NFA; and
- Include a reference in disclosure materials for RICs meeting the definition of commodity pools that the CFTC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus in the legend to the registration statement.

Rule Changes Applicable to all CPOs

The CFTC also made rule changes that will apply to all CPOs including:

- That all CPOs will be permitted to use third-party service providers to maintain their books and records subject to certain conditions;
- Rescinding the requirement that CPOs obtain and retain a signed acknowledgement that disclosure documents have been received; and
- That CPOs and commodity trading advisors ("CTAs") will be required to update their disclosure documents on a 12-month basis instead of a 9-month basis.

Form CPO-PQR and CTA-PR Filing Requirements

Publication of the harmonization rules in the Federal Register triggers the requirement for CPOs and CTAs of RICs to make quarterly or annual filings on Form CPO-PQR or CTA-PR, depending on the levels of assets under management attributable to commodity pools. These forms require that CPOs and CTAs provide a variety of information to the NFA and CFTC about themselves and the commodity pools that they operate including information about the pools' investments. CPOs and CTAs of RICs must begin to comply with the reporting requirements 60 days after the harmonization rules are published in the Federal Register.

Effective Dates

The harmonization rules generally become effective upon publication in the Federal Register except for the conditions to relief from Part 4 available to RICs which will become effective 30 days after publication in the Federal Register. Compliance with the conditions of relief adopted for RICs will begin for new RICs at the time of filing the initial registration statement and for existing RICS at the time of filing the first post-effective amendment that is an annual update to an effective registration statement or other required update. The rule changes applicable to all CPOs generally become effective 30 days after the rules are published in the Federal Register.

Related Guidance from the SEC Division of Investment Management

The staff of the SEC Division of Investment Management issued related guidance summarizing its view regarding certain disclosure and compliance matters relating to RICs that invest in commodity interests. Among other guidance, the staff noted that:

- The staff continues to be concerned with the adequacy of risk disclosure by RICs associated with

investments in commodity interests and other derivative instruments;

- The staff continues to be of the view that a RIC may include information in its prospectus concerning the performance of private accounts and other funds managed by the RIC's adviser that have substantially similar investment objectives, policies, and strategies to the RIC, provided the information is not presented in a misleading manner and does not obscure or impede understanding of information that is required to be included in the RIC's prospectus including the RIC's own performance information;
- The staff would not object if a RIC investing in commodity interests included in the legend required under 1933 Act Rule 481 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 staff expects that RICs investing in commodity interests and their advisers would update their policies and procedures that address, among other things, consistency of fund portfolio management with disclosed investment objectives and policies, strategies and risks to ensure they properly address issues relating to commodity interests and other derivatives;
- RICs are reminded that they are required to disclose in their statements of additional information the extent of their boards' role in their risk oversight, such as how their boards administer their oversight functions; and
- A Risk and Examinations Office has recently been created within the Division of Investment Management which is responsible for analyzing and monitoring the risk management activities of investment advisers, investment companies and the investment management industry as well as new products.

For More Information

To discuss any of the topics covered in this Client Alert, contact any attorney in our Investment Management Group or visit us online at chapman.com.