

CFTC Adopts Final Rules for Commodity Pool Operators of Registered Investment Companies and Amends Rules for All Registered Commodity Pool Operators; SEC Issues Related Guidance for Registered Investment Companies that Invest in Commodity Interests

On August 22, 2013, the Commodity Futures Trading Commission (the “CFTC”) published final rules (the “Final Rules”) intended to harmonize the compliance obligations for investment advisers to investment companies registered under the Investment Company Act of 1940 (“RICs”) that also are required to register as commodity pool operators (“CPOs”) with the CFTC. The Final Rules largely rely on a “substituted compliance” regime that allows CPOs of RICs to comply with most CFTC disclosure, reporting and recordkeeping requirements by complying with comparable requirements of the Securities and Exchange Commission (the “SEC”). The CFTC also amended certain of its rules applicable to all registered CPOs, including registered CPOs to private funds. On August 13, 2013, the staff of the SEC’s Division of Investment Management (the “Staff”) issued guidance entitled “Disclosure and Compliance Matters for Investment Company Registrants that Invest in Commodity Interests” (the “IM Guidance”), which is intended to complement the Final Rules by facilitating compliance with both SEC and CFTC disclosure and reporting requirements and which otherwise largely restates the Staff’s views on derivatives disclosure previously communicated to the Investment Company Institute (the “ICI”) in a letter dated July 30, 2010. The IM Guidance is discussed below under “SEC Guidance for RICs that Invest in Commodity Interests.” The full text of the CFTC’s adopting release related to the Final Rules (the “Adopting Release”) can be found [here](#).

The Final Rules have been long-awaited and were adopted following the dismissal of a lawsuit by the ICI and the U.S. Chamber of Commerce challenging the CFTC’s February 2012 amendments to CFTC Rule 4.5 (the “Rule 4.5 Amendments”) that limited the availability of an exclusion from the definition of CPO previously relied upon by many RICs. As a result of the Rule 4.5 Amendments, the exclusion under Rule 4.5 is available only to RICs that meet certain *de minimis* commodity interest trading thresholds and that have not been marketed as commodity pools or otherwise as vehicles for trading in commodity interests. Commodity interests include futures, options on futures or commodities and many types of swaps and foreign exchange products. CPOs of RICs that no longer qualified for the exclusion were required to register with the CFTC by January 1, 2013. Registered CPOs are subject to numerous detailed disclosure, reporting and recordkeeping requirements, many of which are duplicative, inconsistent and potentially conflict with the SEC rules governing RICs. Accordingly, at the same time it adopted the Rule 4.5 amendments, the CFTC proposed amendments to certain CFTC regulations to harmonize its rules with those of the SEC. The proposal generated controversy as the CFTC attempted to preserve much of its regulatory regime applicable to registered CPOs, which would have significantly added to the compliance burden on registered CPOs to RICs. The Ropes & Gray Alert summarizing the Rule 4.5 amendments and the CFTC’s proposed harmonization rules can be found [here](#).

Substituted Compliance for CPOs of RICs

In contrast to the 2012 proposal, the Final Rules do not preserve many of the CFTC's requirements for registered CPOs, but instead adopt a "substituted compliance" regime that allows registered CPOs of RICs to comply with most CFTC requirements relating to disclosure, reporting and recordkeeping by (1) filing a notice with the National Futures Association ("NFA"), (2) complying with the SEC rules and guidance under the Investment Company Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934 regarding disclosure, reporting, and recordkeeping by RICs (the "SEC RIC Rules"), and (3) satisfying certain other conditions imposed by the Final Rules. In the event that such a CPO fails to comply with applicable SEC RIC Rules, however, it will be deemed to be in violation of its obligations under Part 4 of CFTC regulations and subject to enforcement action by the CFTC.

Disclosure

Rule 4.21 requires a registered CPO to deliver a disclosure document to prospective investors by the time a subscription agreement is delivered. However, under the Final Rules, registered CPOs of RICs that comply with SEC RIC Rules regarding prospectus delivery are deemed to satisfy the disclosure document delivery obligations imposed by Rule 4.21. The Adopting Release explicitly permits the use of summary prospectuses to the extent a statutory prospectus and other required information are provided on a website and other applicable SEC RIC Rules are satisfied.

Registered CPOs of RICs are not required to file disclosure documents with the NFA as otherwise required by Rule 4.26(d), and thus disclosure documents of RICs are not subject to NFA approval. However, registered CPOs of RICs must make the RIC's disclosure document available to the NFA during its examination of the CPO. Pursuant to amended Rule 4.26(a), registered CPOs of RICs are permitted to use a disclosure document for up to 12 months, an increase from the nine-month period previously required by CFTC regulations. Moreover, registered CPOs of open-end RICs are permitted to use a disclosure document in accordance with the 16-month time frame imposed by SEC RIC Rules (i.e., the annual prospectus and registration statement update cycle ending four months after the fiscal year-end).

Rule 4.26(c) requires a registered CPO to correct material inaccuracies in a disclosure document within 21 days of the CPO becoming aware of the defect. Registered CPOs of RICs will not be required to comply with this rule, so long as they comply with applicable SEC RIC Rules on interim updates, which generally prohibit offers and sales by means of a materially misleading prospectus.

Registered CPOs of RICs are permitted to use a cautionary statement on the cover page consistent with Rule 481(b)(1) under the Securities Act of 1933 to satisfy a similar requirement under Rule 4.24(a) of the CFTC regulations, subject to certain minor modifications. CFTC Rules 4.24(b) and (g), which require specific risk legends and a discussion of principal risk factors, respectively, are deemed satisfied for registered CPOs of RICs if the disclosure document contains risk disclosure consistent with applicable SEC RIC Rules and guidance, including the recently released IM Guidance discussed below under "SEC Guidance for RICs that Invest in Commodity Interests."

CFTC Rules 4.24(d)(5) and 4.24(i) require specific break-even information and expanded fee disclosure, including brokerage fees and commissions. Registered CPOs of RICs that comply with SEC RIC Rules are not required to include this information as specified by the CFTC Rules.

Registered CPOs subject to the full Part 4 Rules are subject to extensive disclosure requirements on past performance, including not only past performance of the pool being offered, but also other performance of the CPO and of certain of the commodity trading advisors or funds to which it allocates its assets (if any). Under the Final Rules, CPOs of RICs are deemed to be in compliance with these past performance disclosure requirements if they disclose performance information consistent with SEC RIC Rules with one notable exception: RICs with less than three years of performance history must disclose the past performance of accounts and pools managed by the CPO that have investment objectives, policies, and strategies substantially similar to those of such RIC. The CFTC staff has informally confirmed that the determination of whether a RIC has three years of performance history should be made individually for each series of the RIC and that the three-year period should be measured from the date of the prospectus of that series.

Reporting

Registered CPOs of RICs that meet certain conditions are exempt from the requirement to distribute monthly account statements to pool participants under Rule 4.22(a) and (b) of the CFTC regulations. These conditions require that the CPO (1) make the RIC's current net asset value per share available to investors and (2) furnish semi-annual and annual reports to investors and file periodic reports with the SEC as required by SEC RIC Rules.

Notably, the Final Rules do not provide relief from Rule 4.22(c), which requires registered CPOs of RICs to file annual financial statements with the NFA within 90 days of each pool's fiscal year end, or from Rule 4.27, which requires registered CPOs of RICs to file detailed reports with respect to the fund and its investments on Form CPO-PQR with the NFA.

Recordkeeping

CFTC Rule 4.23 requires a registered CPO to keep specified books and records at its main business office and to make them available to investors for inspection and copying during normal business hours. Under the Final Rules, registered CPOs of RICs are not required to make such books and records available to investors for inspection and copying. Moreover, the required records need not be kept at the CPO's main business office if certain conditions (discussed below) are met.

Controlled Foreign Corporations ("CFCs")

The CFTC reaffirmed its previous statements that RICs may continue to use CFCs and that such CFCs may fall within the definition of "commodity pool." In the Final Rules, the CFTC determined that if the RIC provides full disclosure of material information regarding the activities of its CFC through its obligations to the SEC, the CFC will not be required to separately prepare a disclosure document that complies with Part 4 of the CFTC's rules. Moreover, provided that the RIC consolidates the financial statements of the CFC with

those of the RIC in the financial statements that are filed by the CPO with the NFA on behalf of the RIC, the CFC will not be required to file separate financial statements.

Amendments Applicable to All Registered CPOs

In addition to the amendments applicable to CPOs of RICs, the Final Rules amend several provisions applicable to all registered CPOs, including registered CPOs to private funds.

Books and Records

The Final Rules amend Rules 4.23 and 4.7(b)(4) to eliminate the requirement that books and records be kept at the CPO's main business location. Under the Final Rules, a CPO may use certain third-party service providers to store required books and records, provided that the CPO has complete access to such books and records within 48 hours (72 hours if held outside the United States). The enumerated service providers are: an administrator, distributor or custodian, or a bank or registered broker or dealer acting in a similar capacity. In a letter dated August 28, 2013 (the "ICI Letter") to the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO"), the ICI stated its understanding based on telephone conversations with the DSIO staff that the CFTC intends to further amend Rule 4.23 to permit a broader list of third-party service providers, including sub-advisers, commodity trading advisers and professional storage companies. The full text of the ICI Letter can be found [here](#).

Amended Rule 4.23 also requires a CPO to file a notice with the NFA that it has delegated its recordkeeping obligations to a third party. The third-party recordkeeper must also file a statement with the NFA acknowledging and agreeing to its obligations. In addition to making an exemption filing, the CPO must disclose in the pool's disclosure document the location of its books and records that are maintained with third-party recordkeepers and must amend its Form 7-R to reflect where the required books and records are maintained.

Signed Acknowledgments

The Final Rules amend Rule 4.21(b) to eliminate the requirement for a registered CPO subject to the full Part 4 Rules to obtain a signed acknowledgment of delivery of a disclosure document from each prospective participant in a commodity pool prior to accepting or receiving funds from a participant.

Effective Time for Disclosure Documents

The Final Rules amend Rule 4.26(a)(2) to permit CPOs subject to the full Part 4 Rules to use disclosure documents for a 12-month cycle, rather than the current nine-month cycle. As noted, CPOs of open-end RICs may use the 16-month time frame under SEC RIC Rules.

Effective and Compliance Dates

The Adopting Release states that the publication of the Final Rules triggers a conditional compliance date that was established by the adopting release for the Rule 4.5 Amendments, which states that entities required to register with the CFTC on account of the Rule 4.5 Amendments must comply with CFTC disclosure,

reporting and recordkeeping requirements within 60 days following the effectiveness of the CFTC's final rules on harmonization. The ICI Letter requested confirmation from the DSIO staff of the ICI's position on particular compliance dates based on its reading of the Final Rules and the conditional compliance date established by the Rule 4.5 Amendments. As of the date of this Alert, the DSIO staff had not yet formally confirmed any of the compliance dates asserted in the ICI Letter, but had informally confirmed certain compliance dates in telephone conversations with the ICI, as further discussed below.

Rule 4.12(c)(3)(ii) and (iii) (monthly and annual reports, and inspection of records) and changes to Rule 4.21 (acknowledgment of receipt of disclosure documents) became effective on August 22, 2013. The ICI Letter states that the DSIO staff confirmed by telephone that registered CPOs of RICs must comply with obligations under these rules, as well as the requirement to file a notice with the NFA under Rule 4.12(d), by October 21, 2013.

Amended Rule 4.12(c)(3)(i), which provides CPOs of RICs with relief from disclosure document rules, will become effective on September 23, 2013. The ICI Letter requested confirmation that registered CPOs of RICs must comply with obligations under this rule by November 22, 2013. Following the compliance date, compliance with the conditions in amended Rule 4.12(c)(3)(i) will be required for CPOs of existing open-end RICs beginning with an open-end RIC's first post-effective amendment that is an annual update to an effective registration statement on form N-1A. For CPOs of existing closed-end RICs, compliance will be required when the closed-end RIC is required to update its registration statement under SEC RIC Rules. For CPOs of new open-end or closed-end RICs, compliance will be required when a RIC files an initial registration statement with the SEC.

The amendments to Rules 4.7(b)(4) and 4.23 (third-party service providers for recordkeeping), and 4.26 (12-month cycle for disclosure documents) also will become effective on September 23, 2013. The ICI Letter requested confirmation that CPOs of RICs will be deemed to have complied with the notice requirements under Rules 4.12(d)(2), 4.7(d)(5) and 4.23(c)(1), as applicable, if they file such notice by November 22, 2013.

CPOs of RICs must comply with Rule 4.27, requiring CFTC Form CPO-PQR, by October 21, 2013. The DSIO staff has informally confirmed that CPOs of RICs will be required to file their first Form CPO-PQR in respect of the reporting period ending December 31, 2013.

SEC Guidance for RICs that Invest in Commodity Interests

As discussed above, the SEC issued the IM Guidance, a companion release to the Final Rules, which summarizes the Staff's views regarding the following disclosure and compliance matters relevant to RICs that invest in derivatives that are considered commodity interests under the CFTC regulations:

Disclosure of Derivatives and Associated Risks

The IM Guidance reiterates the Staff's views concerning the disclosure of derivative strategies and risks that was previously stated in a letter from Barry D. Miller, Associate Director, Division of Investment Management, to Karrie McMillan, General Counsel, ICI, dated July 30, 2010, and affirms the application of this guidance to a RIC's disclosure of the risks associated with investments in commodity interests. The IM

Guidance stresses that disclosures of principal risks of a RIC should specifically describe the types of derivatives used by the RIC (including any investments in commodity interests), the extent of their use, and the purpose for which such derivatives are used, and that the risk disclosure for the RIC should provide an investor with the complete risk profile of the RIC's investments as a whole, rather than a list of risks of various derivatives strategies. The Staff notes that investment advisers to a RIC should continually assess the completeness and accuracy of derivatives-related disclosures based on actual operations of the RIC and such disclosures should be reviewed and updated at least annually in connection with the annual update to the RIC's registration statement.

Performance Presentations

The IM Guidance affirms prior guidance that allows a RIC to include in its registration statement information that is not required by Form N-1A or Form N-2, including the performance of private accounts and other funds managed by the RIC's investment adviser that have "substantially similar investment objectives, policies and strategies," subject to certain conditions. The Staff notes that if other fund performance of other funds or accounts is included, it is expected that performance of all other substantially similar funds and private accounts would be included, since the exclusion of any relevant fund or account may cause the disclosed performance information to be materially misleading.

Legend Requirement

The IM Guidance confirms that the Staff would not object if a RIC that invests in commodity interests included language in its legend required under Rule 481 of the Securities Act of 1933 indicating that the CFTC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus.

Compliance and Risk Management

The IM Guidance reviews the requirements imposed on advisers (pursuant to Rule 206(4)-7(a) under the Investment Advisers Act of 1940) and RICs (pursuant to Rule 38a-1 under Investment Company Act of 1940) to adopt compliance policies reasonably designed to prevent violations of the federal securities laws. The Staff emphasizes that such policies and procedures should be sufficient to monitor the accuracy of disclosures made about a RIC's use of derivatives, including commodity interests, and whether the RIC's investments in derivatives conform with the RIC's investment objectives. The Staff also reminds RICs about the obligation to include disclosure in the statement of additional information about the extent of the board of directors' role in the risk oversight of the RIC.

The IM Guidance also notes the recent creation of the SEC's Risk and Examinations office 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. This group, which has started to make on-site visits to investment management firms, is designed to increase the Staff's understanding of risk management activities, including those relating to commodity interests and other derivatives.

The full text of the IM Guidance can be found [here](#).

Action Items

Registered CPOs should consider the following action items in light of the adoption of the Final Rules and the release of the IM Guidance:

CPOs of RICs

- Registered CPOs of RICs should make the required filing with the NFA to claim substituted compliance by October 21, 2013¹ (effective August 22, 2013).
- Registered CPOs of RICs should update the fund prospectuses to comply with the Final Rules beginning November 22, 2013¹ (effective September 23, 2013).
- Registered CPOs of RICs should file annual financial statements with NFA within 90 days of the fund's fiscal year end.
- Registered CPOs of RICs should prepare for filing Form CPO-PQR in respect of the reporting period ending December 31, 2013 (effective October 21, 2013).

All Registered CPOs (of RICs or Private Funds)

- Registered CPOs who keep required books and records with an enumerated third-party service provider should make the required filing with the NFA, update their funds' offering documents to include disclosure of the location of the required books and records and amend their Form 7-R by November 22, 2013¹ (effective September 23, 2013).
- Registered CPOs should update their compliance manuals, compliance calendars and compliance training programs.

All Investment Advisers of RICs

- Investment advisers of RICs may want to review derivatives and risk management-related disclosures in the RIC's registration statement in light of the IM Guidance.
- Investment advisers of RICs may want to review their compliance policies and procedures to ensure that they are sufficient to monitor the accuracy of disclosures made about a RIC's use of derivatives.

If you would like to learn more about the issues raised in this Alert, please contact [Deborah A. Monson](#) or your usual Ropes & Gray adviser.

¹ Pending confirmation by the DSIO staff.