

# Clients & Friends Memo

## Quick Help Guide to CFTC's New Rules for CPOs to RICs; Amended Rules for Other CPOs and CTAs

August 22, 2013

### I. Introduction and Summary

On August 22, 2013, the Commodity Futures Trading Commission (the "CFTC") published in the Federal Register its final rule-making regarding harmonization of compliance obligations for investment advisers to SEC-registered investment companies ("RICs") who are also required to register as commodity pool operators ("CPOs") under the Commodity Exchange Act<sup>1</sup>. In addition, the Harmonization Release contains relief from certain recordkeeping and disclosure requirements that is available to all CPOs and commodity trading advisors ("CTAs").

The highlights of the Harmonization Release are as follows:

#### *Relief and Obligations for CPOs to RICs*

- CPOs to RICs will be largely exempt from CFTC disclosure, reporting and recordkeeping requirements based on substituted compliance with applicable SEC RIC Rules.<sup>2</sup>
- CPOs to RICs seeking to rely on the substituted compliance regime will be required to file a claim for exemption with the CFTC.
- CPOs to RICs will remain subject to certain affirmative obligations under the CFTC and National Futures Association ("NFA") Rules, including filing annual financial statements and Form CPO-PQR and disclosing performance information for certain pools and accounts.

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<sup>1</sup> See Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 78 FR 52308, 52308-52335 (Aug. 22, 2013), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-19894a.pdf> (the "Harmonization Release"). The CFTC also published a [fact sheet](#) regarding the final rules and a set of [questions and answers](#).

<sup>2</sup> As used in this Memorandum, "SEC RIC Rules" include SEC regulations and guidance under the Investment Company Act of 1940, as amended, the Securities Act of 1933, as amended (the "Securities Act") and the Securities Exchange Act of 1934, as amended, regarding disclosure, reporting and recordkeeping requirements applicable to RICs.

*Relief Generally Granted to CPOs and CTAs*

- All CPOs will be permitted to maintain their books and records with certain specified service providers upon making filings with the CFTC and NFA regarding those recordkeeping arrangements.
- All CPOs will be exempt from obtaining from pool investors signed acknowledgements of delivery of the CFTC Disclosure Document.
- CPOs and CTAs will be required to update their Disclosure Documents every 12 months, not every 9 months, as is currently required.<sup>3</sup>

**II. Harmonization of Rules Applicable to CPOs to RIC****A. Background**

For many years, RICs were excluded from the definition of CPO under CFTC Rule 4.5 regardless of their level of commodity interest trading and the manner in which the entity was marketed. However, in February 2012<sup>4</sup>, the CFTC adopted amendments to CFTC Rule 4.5 and imposed limitations on the level of non-bona fide hedging commodity interest trading that RICs were permitted to conduct without their operators being required to register as CPOs.<sup>5</sup> The imposition of these commodity interest trading limitations was particularly burdensome as the CFTC also expanded, as authorized by Title VII of the Dodd-Frank Act, the types of commodity interests included within the CFTC Rule 4.5 trading limitation to include CFTC-regulated swaps, including interest rate and certain foreign exchange swaps and non-deliverable forwards.

As a result of these amendments, operators of RICs that engaged in commodity interest transactions beyond the trading limitations set forth in CFTC Rule 4.5, or that marketed RICs as a commodity pool or a vehicle for obtaining exposure to commodity interests, were required to register as CPOs with the CFTC. This made many RICs subject to both Securities Exchange Commission (the “SEC”) and CFTC disclosure, reporting and recordkeeping requirements with

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<sup>3</sup> As discussed below, CPOs to RICs will be permitted to update fund documents within the time periods specified by the SEC, which is currently 16 months for open-end RICs.

<sup>4</sup> See Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 FR 11252, 11252-11344 (February 24, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-3390a.pdf> (the “CFTC Rule 4.5 Amending Release”).

<sup>5</sup> The trading limitations for non-bona fide hedging commodity interest positions must meet one of the following tests: (A) aggregate initial margin and premiums required to establish non-bona hedging commodity interest positions will not exceed 5% of the liquidation value of the pool's portfolio (after taking into account unrealized profits or losses); OR (B) aggregate net notional value of non-bona hedging commodity interest positions does not exceed 100% of the liquidation value of the pool's portfolio (after taking into account unrealized profits or losses).

respect to the operation of RICs. On the positive side, the CFTC recognized the necessity of addressing the potentially duplicative and conflicting regimes to which newly-registered CPOs to RICs were potentially subject, and deferred implementation of its disclosure, recordkeeping and reporting requirements to RICs pending a separate rulemaking.<sup>6</sup>

In the Harmonization Release, the CFTC has provided significant relief to CPOs of RICs from compliance with the CFTC requirements, assuming “substituted compliance” with the SEC RIC Rules. While RICs and their CPOs will be subject to some additional requirements associated even with the substituted compliance regime, as described below, the harmonized final rules do address many of the concerns as to duplication and inconsistent regulations.

#### **B. Substituted Compliance with SEC RIC Rules for CPOs of RICs**

The Harmonization Release generally exempts CPOs of RICs from the disclosure, recordkeeping and reporting requirements otherwise applicable to CPOs under Part 4 of the CFTC Rules *provided that* the CPO complies with applicable SEC RIC Rules with respect to operation of the RIC. This “substituted compliance” regime is generally set forth in CFTC Rule 4.12(c). The chart below contains a summary of the relief provided to CPOs to RICs under this regime. The relief is not self-effecting. CPOs to RICs that intend to rely on the substituted compliance regime are required to file a notice of claim for exemption with the NFA, as described in Section II.C below.

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<sup>6</sup> See the proposed rule in Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators, 77 FR 11345, 11345-11352 (February 24, 2012) available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-3388a.pdf>

Substituted Compliance with SEC RIC Rules		
Topic	Summary of Relief	Compliance Date
Delivery of Pool Disclosure Document	CPOs to RICs exempt subject to compliance with SEC disclosure delivery requirements.	The later of (i) September 23, 2013 and (ii) (x) <b>with respect to open-end RICs</b> , (A) <i>for new funds</i> , upon filing initial registration statement with SEC on Form N-1A and (B) <i>for existing funds</i> , the first post-effective amendment that is an annual update to an effective registration statement on Form N-1A and (y) <b>with respect to closed-end RICs</b> , (A) <i>for new funds</i> , upon filing initial registration statement with SEC and (B) <i>for existing funds</i> , when fund is required to update its registration statement.
General Disclosures	CPOs to RICs generally exempt subject to compliance with SEC RIC Rules.  <i>Note:</i> The CFTC requires certain additional disclosures, as described in Section II.C below.	Same as above.
Performance Disclosures	CPOs to RICs generally exempt subject to compliance with SEC RIC Rules.  <i>Note:</i> A CPO of a RIC that has less than a three-year operating history must disclose performance of accounts and pools managed by the CPO that have substantially similar investment objectives, policies and strategies, as described in Section II.C. below.	Same as above.
Account Statements	Operators of RICs will be exempt from complying with the CFTC account statement requirements <i>provided</i> the operator makes the current NAV per share available to investors, and furnishes semi-annual and annual reports to investors, and files periodic reports with the SEC in accordance with SEC RIC Rules.	August 22, 2013
Recordkeeping	Operators of RICs will generally be subject to the recordkeeping requirements of CFTC Rule 4.23. However, operators of RICs will be (i) permitted to maintain required books and records at a third-party service provider as described in Section III.A below, <sup>7</sup> and (ii) exempt from the CFTC requirement that a pool operator's books and records be made available to investors for inspection and copying at the request of the investor. <sup>8</sup>	September 23, 2013
Filing and Updating Disclosure Documents	CPOs to RICs exempt subject to compliance with SEC requirements.	August 22, 2013

<sup>7</sup> RIC operators will similarly be deemed to comply with the requirement in CFTC Rule 4.23(a)(4) to maintain a subsidiary ledger for each investor, showing the investor's name, address, and funds and securities received from or distributed to the investor where the RIC's transfer agent, bank or broker-dealer maintains this information with respect to investors. See Harmonization Release at 52321.

<sup>8</sup> The CFTC acknowledged that permitting inspection of a RIC operator's books and records may conflict with the SEC's prohibitions on selective disclosure, and may also make the RIC vulnerable to front-running and market manipulation. See Harmonization Release at 52321.

### Notable Consideration with respect to Controlled Foreign Corporations (“CFCs”)

The Harmonization Release reaffirmed the CFTC's view that where a RIC uses a CFC, the CFC may fall within the definition of a “commodity pool” depending on the CFC's activities. Nevertheless, the CFTC accepted that if a RIC provides disclosure regarding the activities of CFCs in accordance with SEC RIC Rules, the CFC will not be required to prepare a separate CFTC Disclosure Document. Further, if the RIC consolidates the financial statements of the CFC with those of the RIC in the financial statements that are filed by the RIC with the NFA, the CFTC will not require the CFC to file separate financial statements.<sup>9</sup>

### C. Affirmative Obligations of CPOs to RICs

While the Harmonization Release exempts CPOs to RICs from many of the requirements otherwise applicable to CPOs, it is important to note that CPOs to RICs remain subject to certain additional obligations under the CFTC and NFA Rules, as described below.

- i. **Disclosure.** CPOs to RICs relying on the substituted compliance regime are required to comply with certain disclosure requirements described in the Harmonization Release in addition to those required under the SEC RIC Rules:
  - a. **Recently Formed Pools.** If a RIC has less than a three-year operating history, the CPO will be required to disclose 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 offered pool. While the CFTC acknowledged that the determination of what pools and accounts are “substantially similar” to the offered pool involves a degree of subjectivity, the CFTC indicated that CPOs may look to SEC guidance on this issue.<sup>10</sup>
  - b. **Cautionary Statement.** The cautionary statement prescribed by SEC Rule 481 should be modified to include reference to the CFTC.<sup>11</sup>

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<sup>9</sup> See Harmonization Release at 52319. The SEC's Division of Investment Management issued a guidance update in August 2013 entitled “Disclosure and Compliance Matters for Investment Company Registrants that Invest in Commodity Interests” available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf>

<sup>10</sup> See Harmonization Release at 52318.

<sup>11</sup> The modified statement should read either:

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.

or

- c. **Risk Disclosure.** While not strictly an additional disclosure, the Harmonization Release notes that CPOs to RICs should include true, accurate and complete information describing the commodity-interest activities of the RICs, including the material risks associated with those activities. The CFTC notes that CPOs to RICs should comply with guidance issued by the SEC on disclosure of risks associated with commodity interest trading.<sup>12</sup>
- ii. **Financial Statements.** CPO of a RIC will be required to file the financial statements that it prepares pursuant to its obligations with respect to the SEC with NFA and may file notice requesting an extension to align the CFTC's filing deadline with that of the SEC.<sup>13</sup>
- iii. **Claim for Exemption.** CPOs to RICs intending to rely on the substituted compliance regime must file an electronic claim of exemption with the NFA including information as to the CPO, the names of the RICs for which relief is being sought, and the nature of the relief claimed.
- iv. **Form CPO-PQR and CTA-PR.** CPOs to RICs will be subject to Form CPO-PQR and CTA-PR filing requirements following implementation of the Harmonization Release (the compliance date is October 21, 2013). A CPO to a RIC may report the RIC's activities on Form PF.<sup>14</sup> The NFA also has its own similar reporting requirements on NFA Form PQR (and soon, NFA Form PR). The NFA has yet to provide guidance with respect to these reporting requirements and the Harmonization Release.
- v. **CFTC Entity and Registration Requirements.** The Harmonization Release provides CPOs to RICs with relief solely from the CFTC's disclosure, reporting and recordkeeping requirements. All other CFTC requirements, including firm and personnel registration requirements, continue to apply.
- vi. **NFA Rules.** As NFA member firms, CPOs to RICs are generally required to comply with the NFA Rules. CPOs to RICs are, however, subject to limited obligations under NFA Bylaw 1101. Pursuant to NFA guidance, while CPOs to RICs are required to confirm that their FCMs and sub-advisers are appropriately registered with the CFTC, the NFA has

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The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense. See Harmonization Release at 52315.

<sup>12</sup> See Harmonization Release at 52316. See also SEC's Division of Investment Management guidance on RICs investing in commodity interests referenced in footnote 9 above.

<sup>13</sup> See Harmonization Release at 52328.

<sup>14</sup> See CFTC Rule 4.5 Amending Release at 11266.

currently exempted CPOs to RICs from the requirement to determine whether fund investors are appropriately registered (or exempt from registration) with the CFTC, acknowledging that CPOs to RICs may not have access to information as to fund investors. The NFA has, however, indicated that it is developing guidance on how CPOs to RICs may conduct due diligence on fund investors, and may impose Bylaw 1101 requirements with respect to RIC investors at a later date.<sup>15</sup>

- vii. **Effect of Breach.** The Harmonization Release provides that a breach of the SEC requirements applicable to RIC operators will be considered a breach of the CFTC Rules. Thus, RIC operators potentially face two sets of enforcement actions – by the SEC and CFTC – in the event that they breach SEC requirements applicable to RICs.

**III. Amendments to Part 4 Requirements Applicable to all CPOs and CTAs**

The Harmonization Release liberalizes certain requirements applicable to CPOs generally, as described in this Section. The chart below contains a summary of the relief from these requirements.

Amendments to Part 4 Requirements Applicable to All CPOs and CTAs		
Topic	Summary of Relief	Compliance Date
Recordkeeping	CPOs will be permitted to maintain required books and records at a third-party service provider as described in Section III.A below.	September 23, 2013
Rescission of Requirement for Signed Acknowledgment of, and Amendment to Updating Cycle for, Disclosure Document	Signed acknowledgement requirement for Disclosure Document has been rescinded and required update of Disclosure Documents is 12 months (formerly at least every nine months). See Section III.B below.	August 22, 2013

**A. Maintenance of Books and Records with Service Providers**

Currently, CPOs are generally required to maintain their books and records at their main business offices. The CFTC has amended its rules to permit all CPOs, including those operating “QEP” pools pursuant to CFTC Rule 4.7, to maintain their books and records with a pool’s administrator, distributor, custodian, bank or broker-dealer. CPOs intending

<sup>15</sup> See NFA Notice to Members I-12-34, dated December 19, 2012 available at <http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4170>

to maintain their books and records with one of these entities are required to file a statement with the CFTC containing information concerning the entity maintaining the firm's books and records, and must represent that they agree to produce the books and records in response to a regulatory request within 48 hours (72 hours for firms permitted to maintain records outside the United States). The CPO must also file with the NFA a statement from the entity maintaining its books and records, in which the entity agrees to maintain, and make available, the records in accordance with CFTC Rule 1.31. In addition, the CPO must disclose the location of the firm's books and records in the pool's Disclosure Document.

- i. **Firms Relying on CFTC Advisory 18-96.** CFTC Advisory 18-96 currently permits a US CPO to file a claim for relief with the CFTC to permit the CPO to maintain books and records relating to an offshore fund at the main offices of the offshore fund, rather than at the CPO's main offices, as otherwise currently required by CFTC Rule 4.23.<sup>16</sup> The Harmonization Release does not address Advisory 18-96, and thus raises questions as to the status of this relief, both for firms currently relying on the Advisory, and for firms that establish new non-US funds after the amendments to CFTC Rule 4.23 go into effect. While the amendments to CFTC Rule 4.23 contemplate the possibility of a CPO maintaining books and records with a service provider outside the United States,<sup>17</sup> it is unclear whether (i) US CPOs establishing new offshore funds will solely be required to claim relief under amended CFTC Rule 4.23, or will also be required to claim relief under Advisory 18-96; and (ii) whether US CPOs currently relying on Advisory 18-96 will continue to be able to rely on existing relief, or will be required to claim new relief under amended CFTC Rule 4.23.<sup>18</sup>

## B. Disclosure Documents

The Harmonization Release liberalizes the requirements applicable to Disclosure Documents in the following two important respects:

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<sup>16</sup> Similar considerations apply to funds operated under CFTC Rule 4.7.

<sup>17</sup> See amended CFTC Rule 4.23(c)(1)(iv)(C), which provides that where a CPO's books and records "are permitted to be, and are maintained, at a location outside the United States," the CPO must produce the records within 72 hours of a regulatory request.

<sup>18</sup> We note, for example, that while Advisory 18-96 permits a US CPO to maintain books and records of an offshore fund at the **fund's** main business office, amended CFTC Rule 4.23 permits CPOs to maintain books and records with specified **outside service providers**, which do not include the offices of an offshore fund. Note also that while Advisory 18-96 solely permits a US CPO to maintain records relating to the offshore fund (but not those records relating to the CPO itself) at the offshore fund's offices, amended CFTC Rule 4.23 generally permits a CPO to maintain records, relating to both itself and its funds, at an outside service provider.

- i. **Acknowledgement.** CPOs are currently required to obtain a signed acknowledgement from investors that they have received a Disclosure Document prior to accepting funds from the investor. The CFTC has rescinded the signed acknowledgement requirement for all CPOs.
- ii. **Updating Cycle.** CPOs and CTAs are currently required to update their Disclosure Documents at least every nine months. The CFTC has extended this period to 12 months. CPOs to RICs will be permitted to update fund documents within the time periods specified by the SEC, which is currently 16 months for open-end RICs.<sup>19</sup>

We note that Disclosure Documents are not required for pools operated under CFTC Rule 4.7. Thus, the relief described above is only relevant to operators of public commodity pools and not pools operated under CFTC Rule 4.7.

#### IV. Relief to Publicly-Offered Pools

The Harmonization Release extends the relief currently available to ETFs under CFTC Rule 4.12(c)(2) to publicly-offered pools that are not traded on an exchange. The CFTC noted that as both types of pool are subject to SEC disclosure and reporting requirements under the Securities Act, both types of pool should be able to benefit from the same relief under the CFTC Rules.<sup>20</sup> This relief is effective as of August 22, 2013.

#### V. Harmonization with Jumpstart Our Business Startups Act (“JOBS Act”)

The Harmonization Release did not address harmonization of CFTC Rule 4.7 and CFTC Rule 4.13(a)(3) with the elimination of the prohibition on general solicitation in connection with marketing private funds contained in the JOBS Act<sup>21</sup>. The Harmonization Release noted that the CFTC has directed CFTC staff to evaluate the issue and make recommendations to the CFTC for future action. The Harmonization Release provides no indication of timing on this issue.<sup>22</sup>

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<sup>19</sup> See Harmonization Release at 52312-52313.

<sup>20</sup> See Harmonization Release at 52321-52322; CFTC Rule 4.12(c)(2).

<sup>21</sup> For a discussion of recent SEC rules implementing general solicitation for private funds, see our Client & Friends Memorandum entitled “SEC Adopts Significant Amendments to Private Placement Rules: JOBS Act Rule Eliminate Ban on General Solicitation and Dodd-Frank Mandate Disqualifies Bad Actors” available at [http://www.cadwalader.com/assets/client\\_friend/0813013SECAadoptsSignificantAmendmentstoPrivatePlacementRules.pdf](http://www.cadwalader.com/assets/client_friend/0813013SECAadoptsSignificantAmendmentstoPrivatePlacementRules.pdf)

<sup>22</sup> See Harmonization Release at 52322.

Please feel free to contact any of the following Cadwalader attorneys if you have any questions regarding this Memorandum.

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