

CFTC Issues Rules to Increase Oversight of Funds That Invest in Commodity Interests

February 29, 2012

On February 9, the Commodity Futures Trading Commission (CFTC) adopted amendments (Final Rules) to its regulations governing the registration of commodity pool operators (CPOs) and the compliance obligations of CPOs and commodity trading advisors (CTAs).¹ As a result, advisers to investment companies that are registered with the Securities and Exchange Commission (SEC) pursuant to the Investment Company Act of 1940 (registered investment companies), among others, will now be required to (1) register with the CFTC as CPOs and (2) comply with the myriad of CFTC regulations applicable to CPOs.

Also on February 9, the CFTC proposed to harmonize certain CFTC regulations with SEC regulations (the Proposed Harmonization Rules). These rules were proposed to address issues faced by entities that are subject to CFTC and SEC regulation and oversight, so-called dual registrants, in trying to comply with conflicting and potentially duplicative regulatory requirements. The Proposed Harmonization Rules would afford exemptive relief from certain compliance obligations for CPOs, to the extent that they apply to registered investment companies and their advisers that are affected by the Final Rules, and amend certain CFTC regulations that apply to CPOs and CTAs generally.

The [Final Rules](#) and [Proposed Harmonization Rules](#) were reviewed and approved by the CFTC Commissioners in private and were published in the Federal Register last Friday. The majority of the Final Rules will become effective on April 24, 2012 but, as discussed below, compliance with the Final Rules will not be required until later this year. The public comment period for the Proposed Harmonization Rules will be open until April 24, 2012. Market participants that expect to be affected by the Proposed Harmonization Rules should consider submitting comments to the CFTC in response to the Proposed Harmonization Rules.

Section 1 of this Legal Alert highlights some of the changes that the Final Rules make to existing CFTC regulations.² Section 2 describes several changes to existing CFTC regulations that the Proposed Harmonization Rules would make if they are adopted as proposed.

1. The Final Rules' Amendments to CPO Registration and CPO/CTA Compliance Regulations

With respect to CPO registration requirements, the Final Rules, whose adoption was motivated, in large part, by a desire on the part of the CFTC to increase transparency and accountability in the commodities markets, significantly narrow the exclusion from the CPO definition for certain investment advisers of registered investment companies afforded by CFTC Regulation 4.5 (the Regulation 4.5 Exclusion) and

¹ The proposed versions of these rules are discussed in Sutherland's February 8, 2012 Legal Alert, ["Regulatory Watch List for 2012: The Shifting Landscape for Hedge Funds and Other Private Funds."](#)

² For additional information, please see fact sheets and Q&As prepared by CFTC staff, and concurring and dissenting statements by CFTC Commissioners, which are available on the CFTC's [website](#).

rescind the exemption from CPO registration available to operators of certain private funds under existing CFTC Regulation 4.13(a)(4). The Final Rules also modify and add to existing CPO and CTA compliance obligations including, among others, CPO and CTA reporting and disclosure requirements.

a. Amended CPO Registration Requirements

i. The Regulation 4.5 Exclusion

The Regulation 4.5 Exclusion currently excludes advisers of registered investment companies³ that trade commodity futures or commodity options from the CFTC's CPO definition.⁴ As a result, these advisers do not have to register with the CFTC as CPOs or satisfy the CFTC's compliance obligations for CPOs. In addition, the Regulation 4.5 Exclusion does not place any limits on a registered investment company's commodity futures or commodity options trading.

The Final Rules amend the Regulation 4.5 Exclusion so that it will only extend to an adviser of a registered investment company if (1) no more than 5% of the registered investment company's portfolio will be invested in commodity futures, options or swaps for speculative purposes (*i.e.*, excluding those used for bona fide hedging purposes), and (2) the registered investment company is not marketed to the public as a vehicle for trading in commodity futures, options or swaps.⁵ These amendments substantially narrow the Regulation 4.5 Exclusion and were adopted to address concerns, on the part of the CFTC, that certain registered investment companies, offering commodity futures-only investment products, use the Regulation 4.5 Exclusion to avoid CFTC oversight.

The amendments to the Regulation 4.5 Exclusion will become effective on April 24, 2012. Advisers subject to registration under the Final Rules will have additional time to comply with the amended Regulation 4.5 Exclusion. An adviser to a registered investment company that currently relies on the existing Regulation 4.5 Exclusion, unless eligible for another exclusion/exemption from CPO registration requirements, must register as a CPO by the later of (1) December 31, 2012 or (2) 60 days following the CFTC's adoption of final rules to (a) define the term "swap," and (b) establish margin requirements for these instruments.⁶ Further, such an adviser will have additional time to update its compliance programs

³ The CFTC's adopting release states that advisers to registered investment companies are the most logical persons/entities to register as CPOs. Under this view, registered investment companies would be treated as commodity pools for purposes of CFTC regulations.

⁴ The Regulation 4.5 Exclusion also excludes other entities, including insurance companies and banks, from the CPO definition. The Final Rules do not amend the Regulation 4.5 Exclusion as they apply to such other entities.

⁵ In its adopting release, the CFTC states that the following factors are indicative of marketing a registered investment company as a vehicle for investing in commodity futures, commodity options or swaps: (1) the name of the fund, (2) whether the fund's primary investment objective is tied to a commodity index, (3) whether the fund makes use of a controlled foreign corporation for its derivatives trading, (4) whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index, (5) whether, during the course of its normal trading activities, the fund or entity on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives, (6) whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses, and (7) whether the fund is explicitly offering a managed futures strategy. The adopting release explains that the foregoing factors are to be instructive and that no single factor is dispositive.

⁶ Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which was adopted in July 2010 in response to the 2008/2009 financial crisis, imposes a new regulatory regime on over-the-counter (OTC) swaps which, until now, have been largely unregulated, and the entities that use them. The law's new requirements, which include among others, margin requirements for swaps, are contingent upon the CFTC's issuance of several final rules, including joint rules with the SEC to further define the term "swap." The CFTC and SEC proposed a definition of the term last year but it has not been finalized. A

to address CFTC recordkeeping, reporting and disclosure requirements, among others, to which it becomes subject as a new CPO. Advisers must complete this work prior to the effectiveness of these new requirements, which will be 60 days after the adoption and effective date of the Proposed Harmonization Rules discussed below.

*ii. Repeal of CFTC Regulation 4.13(a)(4)*⁷

The Final Rules also repeal CFTC Regulation 4.13(a)(4), the so-called “sophisticated investor” exemption, which exempts operators of pools that are privately offered to certain investors from registration as CPOs. To qualify for the exemption, the operator of such a fund must reasonably believe that all of the fund’s participants (1) are qualified eligible persons or (2) satisfy the accredited investor standard in SEC Regulation D.

Although CFTC Regulation 4.13(a)(4)’s repeal will take effect on April 24, 2012, any entity that currently claims relief under existing Regulation 4.13(a)(4) will not be required to register as a CPO until December 31, 2012. In the interim, such an entity can continue to rely on the exemption but should carefully analyze CFTC regulations to determine whether it is eligible for an alternate exemption or exclusion from CPO registration requirements. Otherwise, such an entity will be required to cease commodity futures, options and swaps transactions or become subject to CFTC oversight and regulation.

b. Amended and New CPO/CTA Compliance Obligations

The Final Rules impose new compliance obligations on CPOs and CTAs and revise existing ones, including:

i. Annual Reaffirmation of Exclusions and Exemptions From Registration

The Final Rules impose a new requirement on persons or entities claiming exclusion or exemption from registration as CPOs or CTAs under CFTC Regulations 4.5, 4.13 or 4.14. Pursuant to the Final Rules, any such person will be required to file a reaffirmation of its exclusion or exemption on an annual basis at calendar year end. Reaffirmations will have to be electronically filed with the National Futures Association (NFA).

The CFTC is implementing the annual reaffirmation requirement with the goal of improving transparency regarding the number of entities excluded or exempt from the CFTC’s registration and compliance programs and providing insight for the CFTC in determining whether exemptions and exclusions should be modified, repealed or maintained. The NFA will likely issue guidance on the reaffirmation process in the coming months. Entities that are unaffected by the Final Rules and can continue to operate under a CFTC exemption or exclusion from registration should review any such status and related guidance and be prepared to file reaffirmations with the NFA early next year.

[tentative timeline](#) for the issuance of final rules under the Dodd-Frank Act indicates that a final definition of the term “swap” will likely be issued in the first quarter of this year.

⁷ The CFTC initially proposed to repeal CFTC Regulation 4.13(a)(3), which affords a “de minimis” exemption from CPO registration. After considering public comments in response to the proposed repeal of Regulation 4.13(a)(3), the CFTC has determined to retain the de minimis exemption.

ii. New CFTC Forms CPO-PQR and CTA-PR

The CFTC, in adopting the Final Rules, will now require CPOs and CTAs to file new Forms CPO-PQR and CTA-PR, respectively. The purpose of the new forms is to give the CFTC a means to increase data collection that will allow it to more effectively monitor risks posed by participants in the commodity futures and derivatives markets.

Forms CPO-PQR and CTA-PR will require CPOs and CTAs, respectively, to disclose information about their assets under management (AUM), use of leverage, counterparty credit-risk exposure, and trading and investment decisions for each commodity pool that they direct or advise. These new reporting requirements complement SEC Form PF, which was jointly adopted by the SEC and CFTC last October and must be completed by advisers that are dually registered with the CFTC and SEC, as CPOs and investment advisers under the Investment Advisers Act of 1940, respectively.⁸

CPOs and CTAs will be required to submit Forms CPO-PQR and CTA-PR quarterly or annually depending on their size (*i.e.*, small, mid-size or large). Whether advisers to private funds that are registered with both the CFTC and SEC have to submit the reports quarterly or annually will depend on their AUM. CPOs that are dual CFTC and SEC registrants will only be required to complete a portion of Form CPO-PQR, whereas CPOs that are only registered with the CFTC will be required to complete all of Form CPO-PQR. All CTAs will be required to complete Form CTA-PR in its entirety.

Compliance with the new Form CPO-PQR and Form CTA-PR reporting requirements will be phased in as follows:

- CPOs having at least \$5 billion of AUM must file 60 days after the end of their first calendar quarter ending after July 2, 2012.
- Other CPOs having at least \$1.5 billion of AUM must file 60 days after the end of their first calendar quarter ending after December 14, 2012.
- All other CPOs and CTAs must file 90 days after the end of 2012.

Existing CPOs and CTAs, and advisers to registered investment companies that will be required to register as CPOs by virtue of the adoption of the Final Rules, should familiarize themselves with the CPO-PQR and CTA-PR templates (appended to the Final Rules) so that they will be prepared to comply with the new filing requirements when necessary.

iii. Amended Risk Disclosure Statement

Existing CFTC regulations require CPOs and CTAs to include certain risk disclosures in the forepart of their Disclosure Documents (for an SEC registered issuer, this includes the prospectus). The Final Rules adopt additional language that must be included if a CPO or CTA uses swaps. This new standardized risk disclosure is intended to reflect the Dodd-Frank Act's changes to the statutory definitions of CPO and CTA to include entities engaging in, or providing advice with respect to, swap transactions.⁹ CPOs and

⁸ For a discussion of SEC Form PF, see Sutherland's February 8 Legal Alert, accessible via note 1, *supra*.

⁹ See note 6, *supra*.

CTAs must include the additional required language in all new or updated Disclosure Documents filed with the NFA after April 24, 2012.

iv. Inclusion of Certified Financial Statements in Commodity Pool Annual Reports

CFTC regulations require a CPO to prepare and deliver an audited financial report to the NFA, for every pool that they operate, on an annual basis (annual reports). Although existing CFTC regulations that dictate the contents of commodity pool annual reports require that financial statements accompanying such reports be certified by an independent public accountant, CFTC Regulation 4.7 exempts certain CPOs from complying with this requirement. The Final Rules reinstate this requirement for all pools by rescinding the exemptive relief that CFTC Regulation 4.7 affords. According to the CFTC, reinstating this requirement will ensure the accuracy of financial information submitted to the CFTC by its registrants and will further the goals of increased transparency and accountability in the commodities markets.

The vast majority of the financial statements contained in commodity pool annual reports that are filed with the NFA are certified by independent public accountants. Nonetheless, any commodity pool that does not currently include certified financial statements in its annual report should prepare to do so next year.

2. Proposed Harmonization Rules

Many members of the public, in comments responding to the proposed version of the Final Rules, expressed concern that narrowing the Regulation 4.5 Exclusion, discussed above, would result in duplicative and conflicting compliance obligations for registered investment companies. To address these concerns, the CFTC issued the Proposed Harmonization Rules, which would reconcile CFTC regulations with SEC regulations, to the extent that they apply to advisers of registered investment companies that previously qualified for the Regulation 4.5 Exclusion. If adopted, the Proposed Harmonization Rules would facilitate compliance with CFTC disclosure, reporting and recordkeeping requirements for CPOs. Specifically, the Proposed Harmonization Rules address, among other things, CFTC regulations pertaining to (1) the delivery of Disclosure Documents to pool participants and the inclusion of performance data therein, (2) the cycle for updating Disclosure Documents, and (3) financial reporting to pool participants. Although advisers to registered investment companies may be required to register as CPOs by virtue of the adoption of the Final Rules, such advisers will not be required to comply with the CPO compliance obligations until 60 days after the effective date of the Proposed Harmonization Rules, if adopted.

The proposing release contains a series of questions for public comment, including performance disclosure and the CFTC's general approach in harmonizing its regulations with SEC regulations. Market participants that expect to be affected by the Proposed Harmonization Rules should consider submitting comments in response to the CFTC's questions or to the rules generally. All comments must be submitted to the CFTC by April 24, 2012.

a. Delivery and Contents of Disclosure Documents

i. Disclosure Document Delivery

CFTC regulations require CPOs to deliver a Disclosure Document to prospective pool participants, and to obtain from such participants a signed and dated acknowledgment of receipt thereof, prior to accepting any funds, securities or other property from such participants. The CFTC issued final rules last year that codify exemptive relief from these requirements to permit CPOs to comply with the Disclosure Document

delivery and acknowledgment requirements by, among other things, making their Disclosure Documents available on their websites and including certain representations and information in exemptive relief claims that must be filed with the NFA.¹⁰ The Proposed Harmonization Rules would expand the exemptive relief codified by the final CFTC Rules to include registered investment companies.

ii. Inclusion of Pool Performance Data in Disclosure Documents

CFTC regulations require that a commodity pool's Disclosure Document include, among other things, performance data for the offered pool and other pools operated by the CPO.¹¹ The Proposed Harmonization Rules recognize that this may conflict with the SEC's position on the use of past performance by registered investment companies, including its disclosure. Accordingly, the Proposed Harmonization Rules would permit registered investment companies that will be required to register as CPOs to include the CFTC-required performance data for other offered pools in the Statement of Additional Information, rather than in the body of their Disclosure Documents. This rule would be helpful to registered investment companies when preparing Disclosure Documents that conform to both CFTC and SEC requirements. Also, the Proposed Harmonization Rules request comment on whether the CFTC should adopt regulations to harmonize its position on the disclosure of past performance by commodity pools and the SEC's position on the use/disclosure of past performance by registered investment companies.

b. Cycle for Updating Disclosure Documents

CFTC Regulations 4.26 and 4.36 require CPOs and CTAs, respectively, to update their Disclosure Documents every nine months. This requirement can present timing issues for funds registered with the SEC that are also commodity pools with a CFTC-registered CPO. These funds are subject to an SEC requirement to update the audited financial statements in their prospectuses every 12 months, but would have to update their prospectuses more frequently to satisfy the CFTC requirement. The Proposed Harmonization Rules would amend CFTC Regulations 4.26 and 4.36 so that CPOs and CTAs would only be required to update their Disclosure Documents annually. This approach would conform to existing SEC requirements and reduce the burden on dual registrants by eliminating the extra update at nine months.¹²

c. Financial Reporting to Pool Participants

CFTC Regulation 4.22 requires CPOs to deliver account statements on a monthly basis if the pool's assets are greater than \$500,000 and on a quarterly basis for all other pools. These monthly account

¹⁰ See [Commodity Pool Operators: Relief from Compliance with Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange: CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools, 76 Fed. Reg. 28,641 \(May 18, 2011\) \(to be codified at 17 C.F.R. pt. 4\)](#).

¹¹ If the offered pool has traded commodity interests for three or more years, during which time at least 75% of the pool's contributions have been made by persons unaffiliated with the CPO, CTAs, or their principals, the only required performance is that of the offered pool.

¹² Section 10(a)(3) of the Securities Act of 1933 provides that when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein cannot be as of a date not more than 16 months prior to such use. Since financial statements are prepared annually, at the end of an investment company's fiscal year, and information from the financial statements is included in the prospectus, Section 10(a)(3) results in an annual prospectus updating cycle.

statements, which must be in the form of a statement of income (loss) and a statement of changes in net asset value of the pool, must be presented in accordance with generally accepted accounting principles and must be accompanied by a certification, on behalf of the CPO, that the information contained in the account statement is accurate.

The Proposed Harmonization Rules would expand the CFTC's final rules to codify exemptive relief from certain CPO compliance obligations, including the delivery of an account statement to pool participants, to advisers of registered investment companies that previously qualified for the Regulation 4.5 Exclusion.¹³ In accordance with those Final Rules, CPOs would comply with the account statement delivery requirement by, among other things, posting account statements on their websites and including certain representations and information in exemptive relief claims that must be filed with the NFA.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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¹³ See note 10, *supra*.