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Part II: Proposal to Harmonize CFTC and SEC Requirements for Registered Investment Companies as Commodity Pools

CFTC requests comments on proposed rules intended to harmonize certain CFTC and SEC disclosure, reporting, and recordkeeping requirements in an effort to mitigate the burden on registered investment companies required to comply with the two separate compliance regimes.

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Yesterday, the U.S. Commodity Futures Trading Commission (CFTC) announced the adoption of final rules that, among other things, limit the ability of registered investment companies (but not of other types of regulated entities, such as banks, pension funds, and insurance companies) to rely on the relief currently provided by CFTC Rule 4.5. Rule 4.5 currently excludes registered investment companies, banks, pension funds, and insurance companies from the definition of "commodity pool operator" and, thus, the compliance obligations applicable to commodity pool operators (CPOs).[1] As a result, registered investment companies that conduct more than a *de minimis* amount[2] of speculative trading in commodity interests, including through controlled foreign corporations (CFCs),[3] are considered commodity pools and

1. Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Final Rules (Feb. 8, 2012) available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf (hereinafter, Final Rules). The release announcing the Final Rules may be found on the CFTC website at http://www.cftc.gov/PressRoom/PressReleases/pr6176-12.

2. Registered investment companies that engage in speculative trading in futures, commodity options, swaps, and other commodity interests may rely on Rule 4.5, as amended by the Final Rules, if (i) the aggregate initial margin and/or premiums for the registered investment company's speculative commodity positions do not exceed 5% of the liquidation value of the registered investment company's portfolio, after taking into account unrealized profits and losses, or (ii) the aggregate net notional value of its speculative commodities-related trading positions does not exceed 100% of the liquidation value of the registered investment company's portfolio, after taking into account unrealized profits and losses (excluding the in-the-money amount of an option at the time of purchase).

3. The CFTC made clear that a CFC that is engaging in commodity trading is itself a commodity pool and, accordingly, an investment adviser operating a CFC must register as a CPO unless it qualifies for an exemption "on [its] own merits." Final Rules at p. 31. Prior to the adoption of the Final Rules, investment advisers that advised both a registered investment company and the registered investment company's wholly owned CFC typically relied on an exemption from registration as a CPO provided by CFTC Rule 4.13(a)(4). Now that Rule 4.13(a)(4) has been rescinded, these registered investment advisers will be required to register as a CPO (or commodity trading advisor (CTA)) with respect to the CFC as well as the parent registered investment company. However, as CPO to the CFC and the parent registered investment company, the CPO will not be required to prepare and provide a disclosure document, monthly account statements, or annual reports to the registered investment company because CFTC Rules 4.21(a)(2), 4.22(a)(4), and 4.22(c)(8), respectively, each exclude compliance with respect to a commodity pool operated by a CPO that is the same as or that controls, is controlled by, or is under common control with the CPO of the offered pool. If the CPOs of the CFC and the parent registered investment company are unrelated entities, the CPO to the CFC may still be able to rely on the relief from certain obligations imposed by Part 4 of the general regulations under the Commodity Exchange Act provided by CFTC Rule 4.7.

the registered investment advisers that manage such registered investment companies must register as CPOs.[4]

For those registered investment companies whose investment advisers will be required to register as CPOs, the CFTC concurrently proposed rulemaking intended to harmonize certain CFTC- and U.S. Securities and Exchange Commission (SEC)–imposed compliance requirements in an effort to mitigate the burden of complying with the two similar, but separate compliance regimes (the Proposed Harmonization Rule). The Proposed Harmonization Rule addresses each of the harmonization concerns raised by the National Futures Association (NFA) in its comment letter to the CFTC[5] and focuses on the harmonization of certain requirements in three key areas: disclosure documents, periodic reports, and recordkeeping.

Disclosure Documents

Content and Presentation Requirements. Rather than prepare both a prospectus to be filed with the SEC and a separate disclosure document to be filed with the CFTC and NFA, registered investment companies no longer able to rely on Rule 4.5 may include CFTC-required disclosures in their prospectuses. In the Proposed Harmonization Rule, the CFTC provides that certain disclosures that are required to be presented in the forefront of a disclosure document, but that are not consistent with Form N-1A's Summary Section disclosure requirements, may instead be presented immediately following the Summary Section of the prospectus.

Delivery Requirement. A CPO is currently required to deliver a disclosure document prepared in accordance with CFTC Rules 4.24 and 4.25 to each prospective investor in the pool by no later than the time it delivers to the prospective investor a subscription agreement for the pool. CFTC Rule 4.21 further requires that a CPO may not accept or receive funds, securities, or other property from a prospective investor unless the CPO first receives a signed and dated acknowledgement from the prospective investor stating that he or she received the disclosure document.

In response to comments that these requirements are at odds with prospectus delivery requirements applicable to registered investment companies under Section 5(b)(2) of the Securities Act of 1933 (the Securities Act), the CFTC proposes to amend Rule 4.12(c) to permit the CPO of any pool whose interests are offered and sold pursuant to an effective registration statement under the Securities Act to claim relief from, among other requirements, the disclosure document delivery and acknowledgement requirements under Rule 4.21. Currently, CFTC Rule 4.12(c), which was adopted to provide compliance relief to exchange-traded funds, is available only to CPOs of pools whose interests are both offered and sold pursuant to an effective registration statement under the Securities Act and listed for trading on a national securities exchange registered as such under the Securities Exchange Act of 1934.

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4. In response to requests from commenters, the CFTC confirmed "that the investment adviser for the registered investment company is the entity required to register as the CPO," if registration is required. Prior to the adoption of the Final Rules, there was a lack of clarity around which entity or persons might be considered to be the CPO of a registered investment company that was deemed to be a commodity pool. Many in the industry were concerned that a registered investment company's board of trustees or directors would be required to register. The CFTC recognized that requiring trustees or directors to register as CPOs "would raise operational concerns for the registered investment company as it would result in piercing the limitation on liability for actions undertaken in the capacity as director." Final Rules at p. 29.

5. Comment Letter, dated April 12, 2011, to David A. Stawick, Secretary of the Commodity Futures Trading Commission, from the National Futures Association Regarding Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations; Proposed Rule, 76 Fed. Reg. 7976 (Feb. 11, 2011).

The relief provided by Rule 4.12(c) is subject to certain conditions, including that the CPO make the disclosure document readily accessible on its website. In addition, to rely on the exemptive relief provided by Rule 4.12(c), a registered investment company and its CPO must file a notice of claim for exemption consistent with the requirements of Rule 4.12(d).

Performance. Registered investment companies subject to Part 4 of the general regulations under the Commodities Exchange Act will be required to comply with the performance reporting requirements of Rule 4.25. While certain of the CFTC performance reporting requirements overlap with those required by the SEC and the federal securities laws, others do not. Most notably, Rule 4.25(c) requires that pools that have less than a three-year operating history disclose the performance of each other pool operated by the CPO (and the CTA, if applicable) and each other account traded by the CPO (and the CTA, if applicable).

In the Proposed Harmonization Rule, the CFTC specifically recognizes that such reporting may conflict with the SEC's position concerning the use of past performance and seeks comment on whether it should try to harmonize its past performance reporting requirements with those of the SEC. To the extent such performance disclosure is required, the CFTC is proposing that the performance of other pools and accounts may be included in the registered investment company's statement of additional information (SAI) instead of its prospectus.

Break-Even Point and Fees and Expenses Disclosure. The Proposed Harmonization Rule also contemplates that registered investment companies would present in their prospectus, following the Summary Section, a tabular presentation of the calculation of the registered investment company's break-even point required by Rule 4.24. The Proposed Harmonization Rule also indicates that the registered investment company must disclose all fees and expenses required to be disclosed pursuant to CFTC Rule 4.24(i). Certain of the fees required by Rule 4.24(i) are not currently required to be presented separately in a registered investment company's fee table pursuant to Item 3 of Form N-1A. These fees include brokerage fees and commissions; incentive fees other than advisory fees as structured fulcrum fees; commissions or other benefits in connection with the solicitation of participations in the pool outside of sales loads and payments made pursuant to a Rule 12b-1 plan; clearance fees and fees paid to national exchanges and self-regulatory organizations; for principal-protected pools, any direct or indirect costs to the pool associated with providing the protection feature; any costs or fees included in the spread between bid and asked prices for retail forex transactions; and any other direct or indirect cost.[6] These fees and expenses must be presented together with the break-even analysis.

Updating Amendments. CFTC Rule 4.26 requires that a new Disclosure Document must be prepared and filed after nine months of use. In contrast, registered investment companies are generally required to update their prospectuses annually. The CFTC proposes to harmonize the updating requirements by permitting CPOs (and CTAs) to file updates to Disclosure Documents 12 months from the date of the document.

In addition, generally, CPOs are not permitted to distribute a new or updated Disclosure Document until the NFA has reviewed and accepted the Disclosure Document. Registered investment companies, on the other hand, file a registration statement pursuant to Rule 485(b) under the Securities Act as part of their annual update process that is effective upon filing, unless otherwise designated. To accommodate the NFA review and comment process, the CFTC proposes to allow registered investment companies to post

6. Pursuant to Item 3 of Form N-1A, registered investment companies are required to report "Other Expenses" in their prospectus fee tables. Other Expenses include all expenses (except for extraordinary expenses) not otherwise disclosed in the registered investment company's fee table that are deducted from the registered investment company's assets or charged to all shareholder accounts and reported as expenses in the registered investment company's statement of operations. As a result, certain of the fees and expenses required by CFTC Rule 4.24(i) may be included in Other Expenses.

their updated prospectuses, with any changes highlighted, on their websites at the same time they file the updated prospectuses with the NFA. Registered investment companies would then post their final prospectuses upon completion of the NFA review process. It may be necessary for a registered investment company to supplement its final prospectus following its annual update filing with the SEC to reflect additional NFA comments because the NFA review and comment process will occur after the registered investment company has filed its annual update prospectus.

Cautionary Legend. The Proposed Harmonization Rule also addresses the legends required by the CFTC and SEC to be included on the cover pages of a pool's disclosure document and registered investment company's prospectus, respectively. Instead of including two statements on the cover page of a registered investment company's prospectus that meet the requirements of CFTC Rule 4.24 and Rule 481(b)(1) under the Securities Act, respectively, the CFTC proposes that a registered investment company include a single statement that combines the language required by both Rule 4.24 and Rule 481(b)(1).

Periodic Reports

CFTC Rule 4.22 requires that CPOs periodically distribute to each investor in each pool it operates an account statement consistent with Rule 4.22. Account statements must be distributed monthly for pools with net assets of more than $500,000 and at least quarterly for all other pools. In the Proposed Harmonization Rule, the CFTC recognizes that its requirement may be more burdensome than the semi-annual reporting requirement applicable to registered investment companies. Nonetheless, the CFTC does not propose to alter the content or eliminate the monthly delivery requirements, in large part because the CFTC believes that the information required to prepare the account statement should be readily available on CPOs' websites. The CFTC's proposed expansion of the exemption provided by Rule 4.12(c), however, would provide relief from the monthly delivery requirement, so long as the CPO makes such information available on its website.

The CFTC also addressed the harmonization of the certifications required by CFTC Rule 4.22(h) and Form N-CSR and stated that it will "accept the SEC's certification as meeting the requirement under Rule 4.22(h), as long as such certification is part of the Form N-CSR filed with the SEC."

Recordkeeping

CFTC Rule 4.23 requires CPOs to make and keep the requisite books and records at its main business office. The CFTC's proposed expansion of the exemption provided by Rule 4.12(c) would permit registered investment companies and their CPOs to continue to maintain their records with third parties subject to certain conditions. In particular, the books and records that the CPO will not keep at its main business office must be maintained by the registered investment company's administrator, distributor, or custodian, or a bank or registered broker or dealer acting in a similar capacity with respect to the registered investment company. In addition, in the notice it files with the NFA, the CPO must specify the books and records that each person will be keeping and make certain representations, including that it will promptly amend the statement if the contact information or location of any of the books and records required to be kept by Rule 4.23 changes and disclose in the pool's disclosure document the location of its books and records that are required under Rule 4.23.

CFTC Seeks Additional Comment on Areas in Need of Harmonization

In the Proposed Harmonization Rule, the CFTC also seeks comment on several areas, including whether there are other provisions of Part 4 that might require harmonization and whether the CFTC's proposals regarding break-even analysis and performance reporting strike the right balance between providing

material information and reducing conflicting or duplicative disclosure. In recognition of the NFA's suggestion that the CFTC "consider granting similar relief to public commodity pools to avoid giving one structure a competitive advantage over other similar structures in the marketplace,"[7] the CFTC also is seeking comment as to whether the proposed harmonization provisions should be applied to operators of pools that are not registered investment companies.

The proposals in the Proposed Harmonization Rule are promising for registered investment companies now faced with complying with the CFTC's regulatory regime, but it seems likely that other conflicts between the requirements of the two regulatory regimes will surface once registered investment companies and their CPOs begin to prepare their new hybrid prospectus-disclosure document.

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7. *Id.*