REGULATORY REFORM TASK FORCE
LEGALALERT

SUTHERLAND

Regulatory Watch List for 2012: Issues Anticipated to Impact the Commodity ETF Industry

February 10, 2012

Exchange-traded funds (ETFs) investing in commodities and their advisers, that are registered or required to be registered with the Commodity Futures Trading Commission (CFTC) as commodity pool operators (CPOs) or commodity trading advisors (CTAs), are accustomed to navigating a broad range of complex laws and regulations. Due, in large part, to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and increased scrutiny by regulators of the financial and commodities markets, 2012 promises to bring a host of new regulatory requirements and issues for CPOs and CTAs. Below are five areas that members of the commodity ETF industry will want to watch in 2012.

1. MF Global's Collapse Calls the Safety of Customer Collateral into Question

MF Global, Inc.'s recent collapse has raised questions in the commodity ETF industry about the safety of futures customers' collateral. Under existing commodities laws and regulations, customer collateral held by a futures commission merchant (FCM) or derivatives clearing organization (DCO), as margin or otherwise, must be segregated from the proprietary funds of the FCM or DCO. Segregation of customer collateral is the primary protection afforded to futures customers and is considered sacrosanct by futures market participants, including commodity ETFs and generally.

CFTC regulations and other systems created to provide protections to customer collateral have not met their intended goal. To date, much of the approximately $1.2 billion shortfall of MF Global customer funds remains unaccounted for by regulators. Investigations into the whereabouts of the missing funds are ongoing, including whether the funds were misappropriated in the days leading up to MF Global's demise. In response to the unfolding developments from MF Global, the CFTC is expected to review and may revise its regulations pertaining to how customer collateral for futures transactions can be held. Last month, the CFTC adopted a legal segregation with operational commingling model (the LSOC Model) for the segregation of cleared swaps customers' collateral. In discussing the LSOC Model, CFTC staff confirmed that they are currently evaluating what enhanced protections may be afforded to futures customers' collateral and that the LSOC Model will serve as a baseline.[1] Commodity ETFs, CPOs and CTAs trading in the futures market should monitor changes to CFTC regulations intended to better protect customer collateral and be prepared to adapt their current business practices accordingly. Commodity ETFs should evaluate whether their own FCMs, and the DCOs that such FCMs are members of, are meeting regulatory requirements. In addition, commodity ETFs and their CPOs and CTAs should closely monitor such entities' risk profiles and whether they are able to meet their customer obligations.

2. Implementation of the Dodd-Frank Act

- ***New Regulatory Regime for OTC Swaps***

Title VII of the Dodd-Frank Act, which was adopted in July 2010 in response to the 2008/2009 financial crisis, imposes a new regulatory regime for over-the-counter (OTC) swaps with the goals of reducing risk,

[1] For more information about the LSOC Model, please see the CFTC's adopting release, which was published in the Federal Register earlier this week and is available here.

© 2012 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

increasing transparency and promoting market integrity within the financial system. The law's new requirements include: (1) the central clearing of swaps, (2) recordkeeping and reporting obligations with respect to swap transaction data, (3) position limits for certain futures and their economically equivalent swaps, and (4) for non-standard swaps that cannot be cleared (uncleared swaps), new documentation and margin requirements. These changes are already impacting the commodity ETF industry and are presenting new challenges, including increased scrutiny from regulators and a decrease in speed to market for new ETF products that invest in commodities and swaps.

The majority of the federal regulations required to implement Title VII of the Dodd-Frank Act, including the definition of a "swap," have been proposed. Of these, some have been finalized but few are effective. Further, although final position limits and recordkeeping and reporting rules have been issued, such rules are subject to phased-in compliance periods. Accordingly, it is unlikely that compliance with Title VII's mandates will be required before the second quarter of 2012, at the earliest.

CTAs directing client accounts and commodity pools that engage in OTC transactions should begin preparing to comply with the Dodd-Frank Act's new requirements now. For starters, such CTAs and commodity pools should begin analyzing the applicability of, and developing systems to comply with, new regulatory requirements, including position limits that could impact investment strategies and trading and recordkeeping and reporting obligations that could impose new administrative burdens. In addition, the central clearing of swaps will require such CTAs and commodity pools to establish swap clearing relationships with FCMs, which will require negotiation of, and entry into, numerous agreements.[2] To the extent that CTAs directing client accounts and commodity pools are able to continue to engage in uncleared swaps, such CTAs and commodity pools will need to amend their existing swap documentation to account for new swap documentation and margin requirements.

- ***New Requirements for Entities Using Swaps***

In addition to imposing a new regulatory regime on OTC swaps, the Dodd-Frank Act substantially expanded the reach of the Commodity Exchange Act (CEA), and the persons who are subject to CFTC oversight thereunder, by amending the definitions of the terms CPO and CTA. Prior to the amendment, only persons who operated a fund that invested in, or was authorized to invest in, futures or exchange-traded commodity options, fell within the CPO definition. Similarly, the CTA definition only extended to persons who were engaged in the business of providing advice, for compensation or profit, with respect to trading futures and exchange-traded commodity options. Under the pre-amendment CPO/CTA definitions, persons operating a pool investing in OTC swaps, or providing advice with respect to investing in OTC swaps, were not subject to regulation as CPOs or CTAs, respectively. The Dodd-Frank Act revised the CPO and CTA definitions to include swaps. As a result, persons who previously fell outside of the scope of these definitions, unless eligible for an exclusion or exemption from the regulatory definitions of these terms, will now be required to register with the CFTC as CPOs and CTAs, respectively, and will be subject to numerous regulatory requirements as a result.[3]

---

[2] *See* James M. Cain *et al.*, *Dodd-Frank Necessitates New Legal Documentation for Cleared and Uncleared Swaps*, The Review of Securities and Commodities Regulation, July 13, 2011, available here.

[3] Although the Dodd-Frank Act's amendments to the CPO and CTA definitions have taken effect, the CFTC has yet to finalize corresponding amendments to its regulations. More importantly, the CFTC has yet to finalize regulations to define key terms that are required under the Dodd-Frank Act. As a result, the CFTC issued a temporary exemptive relief order that permits swap market participants to operate under the pre-Dodd-Frank Act regulatory regime until the earlier of July 16, 2012, or the effective date of CFTC final regulations defining the key Dodd-Frank Act terms. Until the CFTC finalizes these regulations, operators of pools investing in swaps, and persons providing advice with respect to trading in swaps, need not register with the CFTC as CPOs and CTAs, respectively. For more information, please see Sutherland's July 15, 2011 Legal Alert, titled "*CFTC Issues Final Order to Provide*

© 2012 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.

3. New and Revised Compliance Obligations

The CFTC and the Securities and Exchange Commission (SEC) have revised or adopted a number of regulations that will be applicable to CPOs and CTAs and, therefore, will impact the commodity ETF industry, including:

- ***New SEC and CFTC Reporting Forms***

Members of the ETF industry may be subject to new registration and/or reporting requirements as a result of amendments to the CEA made by the Dodd-Frank Act, and recently finalized CFTC and SEC regulations.

SEC forms. Starting as early as June of this year, depending on the amount of assets under management (AUM), SEC-registered investment advisers, including those that are registered, or required to be registered, as CPOs or CTAs, will be required to file new Form PF with the SEC. The scope of information required to be included in Form PF will depend on the size of the reporting entity (whether its AUM is less than $1 billion or is equal to or exceeds $1 billion) and the types of funds it advises. Frequency of reporting (*i.e.*, annual versus quarterly) will also depend on the same $1 billion threshold for the amount of AUM. The stated purpose of Form PF is to assist in data collection for the Financial Stability Oversight Council, which is tasked with monitoring systemic risk and, therefore, is focused on collecting non-public information about private funds and their trading strategies.

Compliance with the Form PF filing requirements will be phased-in in two stages: (1) most private fund advisers must begin filing Form PF following the end of their first fiscal year or fiscal quarter, as applicable, to end on or after December 15, 2012, and (2) the following advisers must begin filing Form PF following the end of their first fiscal year or fiscal quarter, as applicable, that ends on or after June 15, 2012:

- Advisers with at least $5 billion in AUM attributable to hedge funds;
- Liquidity fund advisers with at least $5 billion in combined AUM attributable to liquidity funds and registered money market funds; and
- Advisers with at least $5 billion in AUM attributable to private equity funds.

The form filed with the SEC and the included information is confidential; however, the SEC may use the information in targeting advisers for examination and may share the information with other federal agencies.

Temporary Relief from Provisions of the Dodd-Frank Act Slated to Become Effective on July 16, 2011 and Releases Agenda for Upcoming Meeting," and Sutherland's December 22, 2011 Legal Alert, titled "*CFTC Extends Effective Date for Swap Regulation and Finalizes Certain Swap Data Recordkeeping and Reporting Requirements*."

© 2012 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.

CFTC forms. Earlier this week, the CFTC adopted final rules that will require CPOs and CTAs to file new Forms CPO-PQR and CTA-PR, respectively, with the CFTC.[4] The new CFTC Forms were adopted with a goal similar to that of Form PF: increased data collection that will allow the CFTC to more effectively monitor risks posed by "participants in the commodity futures and derivatives markets." Specifically, CPOs and CTAs will now be required to disclose on Forms CPO-PQR and CTA-PR, respectively, information about their AUMs, use of leverage, counterparty credit-risk exposure and trading and investment decisions for each commodity pool that they direct or advise. The frequency of reporting on the new forms will depend on, for CPOs and CTAs, their size (*i.e.*, small, mid-size or large) and, for private funds that are registered with both the CFTC and SEC, their AUMs (*i.e.*, less than $1 billion or is equal to or exceeds $1 billion).

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

- CPOs having at least $5 billion in AUM must file 60 days after the end of their first calendar quarter ending after July 2, 2012.
- Other Large CPOs with assets of $1.5 billion 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.

- ***Amended Risk Disclosure Statement***

CFTC regulations prescribe certain risk disclosures that CPOs and CTAs must include in the forepart of their disclosure documents. The CFTC recently adopted additional language that must be included if a CPO or CTA uses swaps.[5] This new standardized risk disclosure is intended to reflect the Dodd-Frank Act's changes to the statutory definitions of CPO and CTA described above.

- ***New CFTC Regulations Pertaining to the Privacy of Consumer Information***

Last October, the CFTC adopted two sets of rules pertaining to the use and disposal of consumer information that impacts commodity ETFs and their sponsors. The rules became effective in November 2011 and (1) restrict an entity's ability to share certain consumer information with affiliates for marketing purposes, and (2) establish standards for maintaining the privacy of consumer information.

4. Obtaining Relief from Certain Document Delivery and Recordkeeping Requirements

Some of the new rules will help commodity ETFs and their sponsors by decreasing the time and effort required to obtain certain standard exemptive relief. Pursuant to CFTC rules that were issued last May and became effective on June 17, 2011, CPOs will face a more streamlined process for obtaining exemptive relief from the (1) disclosure document delivery and acknowledgment requirements, (2) monthly account statement delivery requirement, and (3) requirement that a CPO keep its books and

---

[4] The final rules were adopted on February 8 and are pending publication in the Federal Register. To access a pre-publication version of the final rules, click here. For more information, please visit the CFTC's website.

[5] *Id.*

© 2012 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.

records at its main business address.[6] In lieu of filing requests with the CFTC directly, CPOs can now obtain exemptive relief by electronically filing a claim with the National Futures Association (NFA). Exemptive relief previously afforded to a CPO will remain in effect so long as (1) the facts and circumstances upon which such prior relief was based have not materially changed, and (2) the conditions for relief in the rules are no more restrictive than those for the prior relief.

5. Practice Points

In addition to the foregoing, members of the commodity ETF industry should note that the NFA showed increased attention to the following requirements in 2011 and is likely to continue to do so in 2012:

- Pursuant to CFTC Regulations 4.26(a)(2) and 4.36(a)(2), a CPO's or CTA's disclosure document, respectively, cannot be used more than nine months after the date thereof.
- The NFA has interpreted CFTC Regulations 4.20(a)(1) and 4.21 as requiring CPOs to use a single disclosure document for all commodity pools that are series of a trust, instead of separate disclosure documents for each commodity pool/series.

The impact of the new Dodd-Frank Act regulatory regime on commodity pools, CPOs and CTAs, and other related topics, will be discussed at an upcoming Sutherland webinar.

Recent Regulatory Development:
On February 8, the CFTC proposed rules that would harmonize CFTC regulations with SEC regulations, to the extent that they apply to certain entities that are subject to oversight by both agencies. The proposed rules will be subject to a 60-day public comment period once published in the Federal Register. A pre-publication copy of the proposing release is available here. For more information, please visit the CFTC's website.

For more information about Sutherland's ETF practice, please click here.

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.

James M. Cain	202.383.0180	james.cain@sutherland.com
Daphne G. Frydman	202.383.0656	daphne.frydman@sutherland.com
Mary Thornton Payne	202.383.0698	mary.payne@sutherland.com
David A. Roby Jr.	202.383.0137	david.roby@sutherland.com
Holly H. Smith	202.383.0245	holly.smith@sutherland.com
H. Karl Zeswitz Jr.	202.383.0518	karl.zeswitz@sutherland.com
Cynthia Reid Beyea	202.383.0472	cynthia.beyea@sutherland.com
Meltem F. Kodaman	202.383.0674	meltem.kodaman@sutherland.com
Owen J. Pinkerton	202.383.0254	owen.pinkerton@sutherland.com
Raymond A. Ramirez	202.383.0868	ray.ramirez@sutherland.com

[6] All of these requirements are found in Part 4 of the CFTC's regulations.

© 2012 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.