CLIENT UPDATE

CFTC ADOPTS HARMONIZATION RULES FOR REGISTERED INVESTMENT COMPANY CPOs; AMENDS RULES FOR ALL CPOs AND CTAs

NEW YORK
Byungkwon Lim
blim@debevoise.com

Gary E. Murphy
gemurphy@debevoise.com

Michael J. Decker
mdecker@debevoise.com

WASHINGTON, D.C.
Kenneth J. Berman
kjberman@debevoise.com

On August 12, 2013, the Commodity Futures Trading Commission (the "Commission" or "CFTC") issued final rules (the "Final Rules")[1] with respect to certain compliance obligations for commodity pool operators ("CPOs") of investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act") that are required to register with the CFTC due to the recent amendments to section 4.5 of the regulations under the Commodity Exchange Act (the "Regulations").[2] The Final Rules also adopt amendments to certain provisions of part 4 of the Commission's regulations that are applicable to all CPOs and commodity trading advisors ("CTAs").

In addition, on August 13, 2013, the Division of Investment Management (the "Division") of the Securities and Exchange Commission ("SEC") released guidance for registered investment companies ("RICs") that invest in commodity interests (the "Division Guidance").[3]

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1 Available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister081213.pdf and published on August 22, 2013, in the Federal Register at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-19894a.pdf

2 Unless otherwise indicated, all section references are to the Regulations.

3 Available at: http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf

The Final Rules generally permit a CPO of a RIC (a "RIC CPO") to comply with certain portions of the CFTC's regulatory regime through compliance with obligations imposed by the SEC. This "substitute compliance regime" is designed to harmonize the Commission's CPO regulatory framework with that of the SEC in a way that allows the Commission to discharge its regulatory oversight function while at the same time avoiding unnecessary regulatory burdens on dually-regulated RIC CPOs with respect to disclosure, reporting, and recordkeeping requirements. A RIC CPO that elects to rely on the substitute compliance regime must file with the National Futures Association (the "NFA") notice of its use of the substituted compliance regime outlined in section 4.12, notice of its use of third-party recordkeeping service providers if applicable, and the financial statements prepared pursuant to SEC obligations.

The CFTC determined, however, that in at least one circumstance, substituted compliance was not sufficient. A RIC CPO with less than three years operating history will be required to disclose the performance of all accounts and pools that are managed by the CPO and have investment objectives, policies, and strategies substantially similar to those of the offered pool. In addition, the Final Rules modify several provisions of part 4 for all CPOs, including RIC CPOs.

DISCLOSURE REQUIREMENTS GENERALLY

Disclosure Document Timing issues

Sections 4.26(a)(2) and 4.36(b) of the Regulations currently provide that CPOs and CTAs, respectively, may not use a Disclosure Document (as contemplated for purposes of the Regulations) or profile document dated more than nine months prior to the date of its use. In addition, Section 4.26(c) requires a CPO to correct material inaccuracies in a Disclosure Document within 21 days of the date upon which it first becomes aware of the defect. These timeframes differ from those that are applicable to RICs, particularly open-end RICs (or mutual funds).

The Final Rules provide that the CPO of an open-end RIC will be deemed to be in compliance with these sections if it complies with the timeframes under the disclosure rules applicable to RICs (the "SEC RIC Rules"). Accordingly, a CPO of an open-end RIC will be deemed to be in compliance with section 4.26(a)(2) if it complies with Section 10(a)(3) of the Securities Act of 1933 (the "Securities Act"), which provides generally that when a prospectus is used more than nine months after the effective date of a registration statement, the information contained in the prospectus shall be as of a date not more than sixteen months prior to its use. In addition, the Final Rules will deem a RIC CPO to be

compliant with the provisions of section 4.26 if it is in compliance with the disclosure requirements under the SEC RIC Rules. Finally, the Final Rules permit all CPOs and CTAs to use a Disclosure Document for up to twelve months from the date of the document.

Review of Disclosure Documents by the NFA

The Regulations require a CPO to submit all Disclosure Documents to the NFA prior to distributing the document to participants, and to submit to the NFA updates that correct material inaccuracies or incompleteness in the Disclosure Documents within 21 days of becoming aware of any such defects. Under the Final Rules, a RIC CPO is not required to comply with the specific provisions of sections 4.21 ("Required delivery of pool Disclosure Document"), 4.24 ("General disclosures required"), 4.25 ("Performance disclosures"), and 4.26 ("Use, amendment and filing of Disclosure Document"). However, the RIC CPO must file a notice with the NFA claiming such relief. Upon filing such a notice, it will not be necessary for the CPO to file such documents with the NFA, and those documents will not be subject to NFA approval. This notice will allow the NFA to monitor compliance, without imposing additional filing burdens of the RIC CPO.

Delivery and Acknowledgment of Disclosure Documents

Currently, section 4.21 requires that a CPO deliver a Disclosure Document to each participant, and, before accepting or receiving funds from that participant, receive a signed acknowledgment of receipt of such Disclosure Document from such prospective participant.

Under the Final Rules, the Commission will deem a RIC CPO to be compliant with the provisions of section 4.21 provided that the CPO provides disclosure to participants and prospective participants consistent with the SEC RIC Rules. Thus, for example, the delivery by an open-end RIC of a summary prospectus permitted under the SEC RIC Rules will satisfy its Disclosure Document delivery requirement. Any delivery of disclosures by use of a website permitted under the SEC RIC Rules will also be deemed compliant with the provisions of section 4.21. The Final Rules also rescind the signed acknowledgement requirement under section 4.21(b) for all CPOs.

RISK STATEMENTS AND LEGENDS DISCLOSURE

The Standard Cautionary Statement

Both the Regulations and SEC RIC Rules require the Disclosure Document to contain "cautionary" statements. The Final Rules eliminate the need for "dueling" cautionary

statements and allow a RIC to provide a single cautionary statement that in effect combines the two. Under the Final Rules, a RIC CPO may use a cautionary statement prescribed by the SEC under Securities Act Rule 481 that may read as follows (with the registrant having the option to include one of the alternative disclosures set forth in brackets):

> 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] / [determined if this prospectus is truthful or complete]. Any representation to the contrary is a criminal offense.

Other Risk Disclosures

Both the Regulations and the SEC RIC Rules contain disclosure requirements with respect to the disclosure of risks to investors. For example the Regulations require that certain Risk Disclosure Statements required by section 4.24(b) must be displayed immediately following any disclosures required to appear on the cover page. Section 4.24(g) requires a discussion of the principal risk factors of participation in the offered pool, including risks relating to volatility, leverage, liquidity, and counterparty creditworthiness, as applicable to the trading programs followed, trading structures used, and investment activities of the offered pool.

Under the Final Rules, a RIC CPO is not required to provide the disclosures required by sections 4.24(b) and 4.24(g), provided that the CPO complies with the SEC RIC Rules. These rules include disclosure requirements in Section 10 of the Securities Act and other provisions of, and rules under, the Securities Act and the Investment Company Act, particularly the disclosure forms (i.e., Form N-1A) applicable to RICs. The disclosures must be consistent with guidance from SEC staff.[4] The Commission concluded that this substitute compliance regime will satisfy its concern that participants receive complete and accurate disclosure about the risks associated with investment in commodity interests.

The Division Guidance provides additional details regarding derivatives-related disclosures by funds in registration statements and shareholder reports. For example, the Division Guidance notes that any principal investment strategies disclosure related to derivatives should be tailored specifically to how a fund expects to be managed and should address those strategies that the fund expects to be the most important means of

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[4] The release cites in particular guidance provided by the Division in a letter, dated July 30, 2010, to the Investment Company Institute addressing derivatives-related disclosure. This letter is available at http://www.sec.gov/divisions/investment/guidance/ici073010.pdf

achieving its objectives and that it anticipates will have a significant effect on its performance. In determining the appropriate disclosure, a fund should consider the degree of economic exposure the derivatives create, in addition to the amount invested in the derivatives strategy. Derivatives-related disclosure should also be provided commensurate with the level of derivatives exposure of a fund. For example, a small investment in some derivatives does not necessarily correlate with little effect on a fund's performance because of the impact of leverage. Alternatively, a fund may have significant exposure to derivatives, but that exposure may not make the fund substantially riskier (e.g., exposure by an international fund to currency forwards, entered into to hedge against the currency risk of securities that trade in those currencies, would more likely reduce the fund's overall risk rather than increase it). Such disclosure also should describe the purpose that the derivatives are intended to serve in the portfolio (e.g., hedging, speculation, or as a substitute for investing in conventional securities), and the extent to which derivatives are expected to be used. Additionally, the disclosure concerning the principal risks of the fund should similarly be tailored to the types of derivatives used by the fund, the extent of their use, and the purpose for using derivatives transactions (including disclosure of material risks relating to volatility, leverage, liquidity, and counterparty creditworthiness that are associated with trading and investments in derivatives that are engaged in, or expected to be engaged in, by the fund).

PERFORMANCE-RELATED DISCLOSURE

Break Even Disclosure

Section 4.24(d)(5) requires a CPO to include in the forepart of the Disclosure Document the break-even point per unit of initial investment.[5] Under the Final Rules, the Commission will deem a RIC CPO to be compliant with the requirements under section 4.24(d)(5) if it complies with the SEC RIC Rules. The Commission notes, for example, that the same types of fees and costs required by section 4.24(d)(5) are disclosed through Form N-1A, item 3.

Past Performance Disclosure

Section 4.24(n) requires CPOs to disclose past performance information in accordance with section 4.25. Section 4.25(a) requires various disclosures, including, but not limited to: aggregate gross capital subscriptions to the pool; the pool's current net asset value; the largest monthly draw-down during the most recent five calendar years and year-to-date;

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[5] Section 4.10(j) defines the break-even point as "the trading profit that a pool must realize in the first year of a participant's investment to equal all fees and expenses such that such participant will recoup its initial investment, as calculated pursuant to rules promulgated by a registered futures association pursuant to section 17(j) of the Act."

the worst peak-to-valley draw-down during the most recent five calendar years and year-to-date; and the annual and year-to-date rate of return for the pool for the most recent five calendar years and year-to-date, including a bar graph depicting such rates of return. Similar information is required for each account traded by the CPO or CTA on behalf of a client. Section 4.25(c) states that when the offered pool has less than a three-year operating history, the CPO must disclose the past performance of each other pool it operates.

In a departure from the substitute compliance regime, the Commission is requiring RIC CPOs to provide past performance information that is not required by the SEC under certain circumstances. Specifically, a RIC CPO with less than three years of performance history will be deemed compliant with section 4.25(c) if the CPO discloses the performance of all accounts and pools that are managed by the CPO and that have investment objectives, policies and strategies substantially similar to the offered pool. The Commission deems a RIC CPO compliant with the remaining requirements of section 4.25 subject to compliance with the SEC RIC Rules.

Commenters on this provision had suggested that the SEC staff might find such disclosures misleading or not appropriate for a RIC registration statement. The SEC staff has addressed this concern. The Division Guidance notes that the Investment Company Act does not prohibit a RIC from including in its registration statement information that is not required by the applicable registration form, provided that "the information is not incomplete, inaccurate, or misleading and does not, because of its nature, quantity, or manner of presentation, obscure or impede understanding of" the required information. The Division Guidance also notes that the staff of the Division has previously expressed the view that a fund may include in its prospectus information concerning the performance of private accounts and other funds managed by the fund's adviser that have substantially similar investment objectives, policies, and strategies to the fund ("Related Accounts"), provided that the information is not presented in a misleading manner and does not obscure or impede understanding of information that is required to be included in the fund's prospectus (including the fund's own performance information). The Division Guidance notes in particular that where a fund includes the performance of a limited number of Related Accounts in its registration statement, such fund should not exclude the performance of any other Related Accounts that have substantially similar investment objectives, policies, and strategies if the exclusion would cause the performance shown to be materially higher or more favorable than would be the case if the Related Accounts were included (including where such exclusion would obscure or impede understanding of information that is required to be included in the fund's prospectus).

Fee Disclosure

Section 4.24(i) requires CPOs to include in the Disclosure Document a complete description of each fee, commission, and other expense which the CPO knows has been incurred or expects to be incurred. Under the Final Rules, a RIC may provide the information required by Form N-1A in lieu of providing the information required by section 4.24(i).

CONTROLLED FOREIGN CORPORATIONS

In rules adopted by the CFTC in February 2012 (the "2012 Final Rule"),[6] the Commission determined that RICs may use controlled foreign corporations ("CFCs") to invest in commodities, but that the CPO of a CFC that falls within the statutory definition of commodity pool may be required to register even if the RIC that owns the CFC is excluded from registration under section 4.5.

Under the Final Rules, the Commission reaffirms that RICs may continue to use CFCs and that such CFCs, depending on their investment activities, may fall within the statutory and regulatory definitions of "commodity pool." In addition, the Final Rules provide that where 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 prepare a separate Disclosure Document that complies with part 4 of the Commission's regulations. In addition, 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 CFC will not be required to file separate financial statements.

FINANCIAL REPORTING

Section 4.22 requires that a CPO must periodically distribute Account Statements to each participant in each pool it operates, including monthly distributions for pools with net assets greater than $500,000 and at least quarterly distributions for all other pools.

The Final Rules relieve a RIC CPO from the monthly financial statements requirement, provided that the RIC's current net asset value per share is available to investors, and provided that the RIC furnishes semi-annual and annual reports to investors and files periodic reports with the SEC as required by the SEC (including via electronic delivery as permitted).

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6 See our Client Update, "Amendments to CFTC Part 4 Regulations Regarding Commodity Pool Operators and Commodity Trading Advisors," available at: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=e42014f7-c21f-4106-8932-383132e8b16a

BOOKS AND RECORDS

Location of Records

Sections 4.23 and 4.7(b)(4) require that all CPOs maintain full books and records at the main business office of the CPO, including a detailed and itemized daily record of each commodity interest transaction of the pool; all receipts and disbursements of money, securities, and other property; a participant ledger; copies of each confirmation of a commodity interest transaction; and other relevant records.

The Final Rules permit any CPO to use third-party service providers to maintain its books and records. However, the Commission will continue to require a RIC CPO to file with the NFA (i) a notice providing information about the third-party service provider, and (ii) a statement from the service provider agreeing to maintain the pool's books and records consistent with the Commission's regulations, including timely access to those records, as previously required under section 4.12(c)(iii).

Other Recordkeeping Obligations

Section 4.23 requires that a CPO's books and records be made available to participants for inspection and/or copying at the request of the participant. Additionally, section 4.23(a)(4) requires a ledger (or other record) to be kept for each participant in the pool that shows the participant's name, address, and all funds received from or distributed to the participant.

Under the Final Rules and in response to SEC prohibitions against selective disclosure, a registered CPO that operates a RIC will not be required to make its records available for inspection and copying. In addition, under the Final Rules, where a RIC holds account shares in an omnibus account, the maintenance of these records by a transfer agent or financial intermediary, in such form that complies with that as set forth by the Commission, shall satisfy the ledger requirement of section 4.23(a)(4).

ADDITIONAL SEC GUIDANCE

The Division Guidance includes additional detail regarding effective implementation of a fund's investment objectives and policies. Rule 206(4)-7(a) under the Investment Advisers Act of 1940 ("Advisers Act") makes it unlawful for an investment adviser registered with the SEC to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons. Rule 38a-1 under the Investment Company Act requires a RIC to adopt and implement written policies and procedures

reasonably designed to prevent violation of the federal securities laws by the RIC and to obtain the approval of those policies and procedures by the RIC's board of directors, including a majority of directors who are not interested persons of the RIC. The RIC's policies and procedures are required to include provisions for the RIC to oversee compliance by its investment advisers and other service providers. In light of Rule 206(4)-7(a) and Rule 38a-1, Division staff expect RICs and their advisers to adopt policies and procedures that address, among other things, consistency of RIC portfolio management with disclosed investment objectives and policies, strategies, and risks, as well as policies and procedures that are sufficient to address the accuracy of disclosures made about the RIC's use of derivatives.

The Division notes the recent creation of a Risk and Examinations Office ("REO") responsible for analyzing and monitoring the risk management activities of investment advisers, investment companies, and the investment management industry as well as new products. REO staff may make onsite visits to investment management firms to increase the staff's understanding of firms' risk management activities, including risk management activities related to commodity interests and other derivatives; generate an active dialogue between the staff and firms on key risk and other issues facing firms and the industry; and help inform SEC policy and the examination process.

EFFECTIVE DATES AND IMPLEMENTATION

The harmonized compliance obligations for RIC CPOs under section 4.12 generally became effective on August 22, 2013. The compliance obligations under section 4.12(c)(3)(i), regarding providing past performance information, will become effective on September 23, 2013. RIC CPOs must begin to comply with section 4.27, which implements Commission forms CPO-PQR and CTA-PR, on or before October 21, 2013. The rescinded signing acknowledgement requirement under Section 4.21 became effective on August 22, 2013. With respect to the amendments applicable to all registered CPOs regarding recordkeeping relief and Disclosure Document relief under sections 4.7(b)(4), 4.23, 4.26, and 4.36, such amendments will become effective on September 23, 2013, and CPOs may comply upon the effective date.

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Please do not hesitate to contact us with any questions.

August 30, 2013